



STATE BUDGETING AND LESSONS LEARNED FROM THE ECONOMIC DOWNTURN

ANALYSIS AND COMMENTARY FROM STATE BUDGET OFFICERS





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PURPOSE AND DESIGN

The economic recovery is extending into a fourth fiscal year, but many states are still expecting several more years of tight resources along with the difficult fiscal challenges that accompany budgetary constraints. However, the prolonged recovery and slow growth are also extending the opportunity for lasting fiscal reform. Evidence of structural changes made through legislation indicate that states are capitalizing on this opportunity for reform. While legislative reforms codify changes in state fiscal policy, improvements in budget execution and management often go undocumented because solutions are contingent upon discretion, judgment, managerial style, institutional variation, political and economic climates, regulatory flexibility, and other variables.

This report seeks to deliver much needed detail on less formal state budget management practices that deal directly with difficult fiscal circumstances. The report documents the logic and thought processes of budget officials as they navigated the budgetary dilemmas caused by the fiscal crisis. Fiscal data and trends are used throughout the report to convey the severity of state fiscal conditions and to bolster findings and recommendations. The overarching goal of this project is to expand the understanding of fiscal concepts and available tools to help inform future budgetary decisions under periods of economic decline or fiscal uncertainty. Budget officer commentary cited throughout the report offers readers a focus on principles, and fiscal data and state specific examples reinforce the principles and recommendations. While there are many similarities between states, there are unique statutory, political and policy differences that make it difficult to give specific advice. In many cases, there are no absolutely right or wrong answers. Rather these are observations by practitioners that may be helpful to others in similar situations. Italicized quotations highlighted throughout the text are from discussions among state budget officials and are left anonymous. NASBO staff has made their best attempt to incorporate accurate statements from convening sessions and discussions with state budget officials.

The primary resources for this paper are state budget officer commentary and analysis, NASBO fiscal data collected through annual reports, NASBO Critical Issue Committee input, and additional research materials. The report proceeds as follows: 1) background on state and federal fiscal policy responses to the recession; 2) using rainy day funds and budgetary reserves; 3) the Recovery Act; 4) the recession's impact on state revenues; 5) cutting budgets in the recession; 6) the Great Recession continues to shape current state fiscal trends; 7) conclusion.

EXECUTIVE SUMMARY

The severe deterioration in state fiscal trends during the Great Recession created an extremely difficult context for budgetary decision-making. The unprecedented contraction in the national economy led to rapid declines in state tax revenues combined with rising service demands, effectively squeezing state budgets from both ends. A variety of actions and efforts from all levels of government helped to stabilize state budgets in this challenging and uncertain fiscal environment. States used a number of fiscal management tools such as rainy day funds, prior year ending balances, across-the-board and targeted spending cuts, revenue measures and tax increases, and one-time federal resources to avert draconian budget reductions.

This report integrates budget officer commentary (which appears as blue italicized quotations throughout the text), selected state examples and fiscal trend analysis to provide a better understanding of state budget actions taken during the recession. The recommendations and findings in this report are designed to help limit public service disruptions in future recessions by improving budgetary planning and preparedness, enhancing the effectiveness of federal aid to states and highlighting sound budgeting and fiscal administration practices. Funding for all areas of state government continues to be shaped by the recession's impact on tax revenues and expenditures, and out of necessity state budgets are evolving. Below are some of the key findings and recommendations that federal and state policymakers should consider to move states toward long-term fiscal sustainability, which requires improved budgetary decision-making in times of fiscal stress as well as economic prosperity.

USING RAINY DAY FUNDS, BALANCES AND BUDGET RESERVES

- **Rainy day funds and other state budget reserves were not sufficient to withstand the fiscal impacts caused by the recession.** To better insulate budgets from revenue and expenditure volatility in the future, states should consider increasing the amount of funds held in reserve. Some states will first need to address their statutory caps that keep rainy day funds below levels necessary to ensure budget stability under severe fiscal stress.
- **The right amount to hold in a rainy day fund depends partly on the revenue system.** Decisions concerning the adequate amount of funds to hold in reserve should be considered in conjunction with the revenue system. States with more volatile revenue systems that rely heavily on collections from taxes sensitive to changes in the economy should plan to hold more in reserve to withstand economic downturns.
- **Before using rainy day funds, it is important to know how the funds were derived.** Using reserves from a rainy day account that has been built up over time with required contributions, involves less structural imbalance risk because the funds can be more easily replenished. Reserves that have been amassed from an unusual windfall or one-time revenue gain should be spent prudently to minimize the risk of future budget imbalance.
- **State revenue collections are becoming more volatile in the face of economic decline.** Over time, state revenue collections have become increasingly sensitive to changes in the economic cycle due to the behavior of personal incomes and the types of income being taxed. A portion of collections from the most volatile taxes in a state's revenue system, such as taxes on capital gains or dividends, may therefore be deposited into a state's rainy day fund during good economic times. At the end of a fiscal year, rainy day funds can also be increased by depositing a portion of unused general revenues if available.
- **Budget cuts generally come before using rainy day funds.** To effectively manage agencies and programs through a down cycle, states must determine how best to use rainy day funds. In most cases, rainy day funds can be used to manage agencies and programs through a down cycle by making cuts first, thereby incentivizing agency-driven efforts for efficiency, and then providing resources from reserves to replenish the most critical areas. Additionally, budget cuts to agencies that receive funds from reserves generally occur in tandem, otherwise agencies can potentially be positioned for significantly larger cuts in the future.
- **Delaying the use of all rainy day funds is important to help ensure spending levels can be sustained.** The end of the economic decline was unclear during the recession, causing many states to delay the use of rainy day funds. Delaying the use of reserves until there is greater certainty about when tax collections will improve or at least stop declining is helpful to ensure that

funding levels can be sustained. Using rainy day funds over a multi-year period can minimize the likelihood of an abrupt decline in spending that can occur when all or nearly all of a rainy day fund is used in a single year.

THE RECOVERY ACT

- **The Recovery Act greatly helped to alleviate state fiscal troubles in the recession; but the legislation was complicated by multiple policy objectives.** Without the Recovery Act, state budget cuts and tax increases would have been more substantial. The legislation's multiple policy objectives, including economic stimulus, job creation, and state and local budget stabilization, resulted in somewhat conflicting goals. Competing objectives within the assistance package made it in some cases less effective than otherwise could have been for states. Future federal aid policies intended to stabilize state and local budgets can be better coordinated with fiscal policies designed to stimulate the economy and create new jobs.
- **In times of fiscal crisis, federal aid to states should continue to be directed through pre-existing payment systems.** The majority of Recovery Act funds were delivered to states through pre-existing payment systems within core federal-state grant programs, such as Medicaid and Title I education programs. Additional federal dollars delivered this way stabilized state budgets most quickly and easily. However, the Recovery Act also targeted over 200 federal grant programs, many of which were very small and outside well established partnership programs, to stimulate the economy. In some instances, this fragmented delivery of additional federal dollars did not produce intended results, and overly burdened managers of smaller grant programs with additional reporting requirements and accountability demands.
- **Recovery Act funds alleviated immediate spending cuts, but also complicated future budgets.** States that made the best use of Recovery Act dollars avoided excessive spending cuts, and also positioned agencies and programs for forward-looking budgets with lower levels of funding. However, at times the Recovery Act resulted in elevated spending levels because additional federal dollars were available, and these spending levels could not easily be reduced once the funds expired. For example, the Recovery Act's maintenance of effort (MOE) requirements made cuts to areas such as education or healthcare difficult.
- **The timing of federal aid can be improved.** The federal government successfully provided additional state aid quickly; however, state tax revenues lag improvements in the economy and elevated expenditure pressures persist long after the economy has turned around. The timing of federal aid in recessionary periods can be improved by increasing flexibility and targeting aid to changes in state revenue and expenditure patterns rather than the economic cycle. The majority of flexible Recovery Act dollars expired at the end of fiscal 2011, yet state revenues did not reach pre-recession levels until fiscal 2013, indicating that states had to account for substantially less federal funds before tax revenues fully recovered.



THE RECESSION'S IMPACT ON STATE REVENUES

- **As a share of budgets, tax increases were relied upon less in this recession.** Tax collections fell more sharply than anticipated, prompting states to enact tax increases that produced more revenue than at any point in the last few decades. Yet, as a share of general fund collections, enacted tax increases were used less in the Great Recession than during prior periods of economic decline.
- **Many state revenue systems are increasing the risk of budget volatility.** The severe drop in revenues from the recession highlighted the changing landscape of state tax structures, which now pose more cyclical vulnerability for budgets than in the past. Balanced and diversified tax systems that rely upon sales, personal and corporate income to produce more stable collections can help reduce revenue volatility. State budgets that rely more heavily on less stable sources of revenue, such as income derived from capital gains and dividends, will continue to experience volatility. States can develop fiscal plans to reduce reliance on volatile revenue sources for operating purposes to a level that is sustainable and predictable from one fiscal year to the next.
- **The timing of temporary taxes can be improved to reduce budget difficulties.** A number of states that enacted tax increases did so on a temporary basis, and in instances, this has resulted in continued fiscal stress as the national economy followed



a trajectory of slow growth. To better ensure that revenues will recover and budget stability is reached before revenue actions expire or sunset, states can tie temporary tax increases to economic conditions or revenue collections rather than the fiscal or calendar year.

- **Reliable revenue projections were hard to produce in the recession.** Projecting revenues more frequently and for periods beyond the budget cycle can inform decision-makers of impending issues sooner, increasing the likelihood that changes can be made before fiscal problems worsen. In periods of uncertainty, comparisons of actual revenue collections to prior revenue estimates should be consistently communicated to state leaders and agencies to demonstrate the deterioration of state fiscal conditions.

- **Short-term revenue actions should be coupled with more substantial reform.** The recession revealed the limits of short-term solutions to falling revenues, and repeated efforts to capture one-time revenue gains have proven less effective in the sluggish recovery. Revenue measures that result in short-term gains can be accompanied by more substantial reforms, such as broadening the tax base, to capture a greater portion of economic activity that is occurring within states. Long-range revenue and expenditure forecasts can also help states assess the need for greater reforms.

CUTTING BUDGETS IN THE RECESSION

- **The recession was a catalyst for state policy changes.** The recession brought with it opportunities for lasting government reform, and many states have reduced future budgetary risks by enacting changes to areas like health care, employee retirement systems and corrections. States can capitalize on periods of economic decline by making substantial changes to spending priorities while there is sufficient political will and greater stakeholder understanding for budget adjustments.
- **Budget cuts were disproportionate across spending categories.** States have acquired less budgetary flexibility over time. This made budget cuts disproportionate across spending categories, which resulted in areas such as public assistance and higher education receiving substantial reductions in the recession, even though demand for those services was heightened.
- **Spending for programs, services and boards was often reduced rather than eliminated.** Eliminating inefficient or ineffective boards, programs and services is difficult, but the benefits are potentially greater. Difficulties arise because programs and services have constituencies who find value in the activities under consideration for reduction. However, merely reducing the budget for an ineffective board or program can result in expectations for restoring funding cuts in the future, which can drain resources that could be put to better use. Budgeting efforts that seek to eliminate boards and programs that are no longer useful or deemed to have limited value can reduce future spending commitments and promote reform more rapidly. Budgeting processes that prioritize data-driven results can help states better identify low priority and underperforming programs.
- **Areas of the budget not to cut, even during an economic recession.** Deciding what activities can be cut back when budgets are tight is difficult. Budget cuts to some areas such as, contract monitoring, tax compliance, internal or external audits of departments, may leave states vulnerable to abuse or actually cost a state more money than is saved through reductions. Cuts to areas known to reduce future spending obligations, such as crime prevention and juvenile justice programs, should also be avoided if possible.
- **Service provision levels were maximized under fiscal constraints through a combination of across-the-board and targeted cuts.** There are benefits and drawbacks from cutting the budget in different ways depending on the circumstances. Across-the-board spending cuts can quickly result in significant savings but often carry specific exemptions and limit policy decisions. If across-the-board cuts are implemented, exceptions should be as minimal as possible and accompanied with explanations. Targeted cuts require more time and political debate, but can allow priorities to drive spending decisions. In the recession states used a combination of the two methods to achieve the greatest savings with the least amount of service disruptions.

REPORT FINDINGS

RECOMMENDATIONS TO CONSIDER



USING RAINY DAY FUNDS, BALANCES AND BUDGETARY RESERVES

- Rainy day funds were not sufficient to maintain budget stability in the recession.
- State revenue collections are becoming more volatile in the face of economic decline.
- The recession challenged assumptions regarding the right amount of funds to hold in budget reserves.
- The end of the economic decline was very unclear during the recession.
- Raise statutory caps if necessary and the amount of funds held in reserve. Prioritize annual contributions to the rainy day account.
- Deposit a portion of revenue from volatile taxes into the rainy day fund.
- States can better determine the appropriate amount to hold in reserve by analyzing the volatility of the revenue system, as well as by understanding budgetary flexibility and how changes in the economy impact service demands.
- In periods of fiscal uncertainty, delay the use of rainy day funds until there is greater assurance that spending can be sustained. This generally implies that budget cuts come before spending rainy day funds, or that spending from the rainy day fund be phased in.



THE RECOVERY ACT

- The Recovery Act was complicated by multiple policy objectives, making it in some cases less effective than it otherwise could have been for states.
- Recovery Act funds directed through core federal-state grant programs, such as Medicaid, effectively stabilized budgets quickly. However, other Recovery Act funds delivered to states and local governments were fragmented, resulting in overly burdensome reporting requirements, compressed timelines, competing objectives and at times undesirable results.
- The expiration of Recovery Act funds resulted in significant budgetary challenges for some states.
- The majority of flexible Recovery Act dollars expired at the end of fiscal 2011, yet state revenues did not reach pre-recession levels until fiscal 2013, indicating that the timing of federal aid to states could have been better. Additionally, prolonged high unemployment in the wake of the Great Recession has resulted in continued spending pressures for areas such as public assistance and Medicaid.
- Federal aid policies intended to stabilize state and local budgets can be better coordinated with fiscal policies designed to stimulate the economy and create new jobs.
- Federal aid to states in times of fiscal crisis should continue to be delivered through pre-existing payment systems within core federal-state grant programs or through block grants to states. Future federal aid legislation should provide additional funding to increase management capacity, to support reporting requirements, and to support intergovernmental communications.
- The use of one-time resources, such as additional federal aid, should be accompanied by budget reforms that prepare agencies and programs for lower future funding levels.
- The timing of federal aid can be determined by triggers set by state revenue trends or economic indicators rather than the business cycle or calendar year.

continued

REPORT FINDINGS

RECOMMENDATIONS TO CONSIDER



THE RECESSION'S IMPACT ON STATE REVENUES

- Many state revenue systems are increasing the risk of budget volatility.
- The severe drop in revenues from the recession has taken states many years to recover and many states are still below pre-recession levels, indicating that revenue systems are not generating sufficient amounts of revenue to continue providing the same level of services.
- The expiration of temporary taxes before revenue recovery has been problematic for some states due to prolonged slow growth.
- Reliable revenue projections were hard to produce in the recession.
- States experienced diminishing returns to short-term revenue actions that in some instances were repeated too often.
- Reduce reliance on volatile revenues for operating purposes to a level that is sustainable.
- Broad and diverse state tax systems that tax sales, personal and corporate income are best suited to counteract revenue volatility. State tax systems can be also be expanded to capture a greater portion of economic activity occurring in the state.
- Temporary tax increases can be tied to economic conditions or revenue collections rather than the fiscal or calendar year.
- Projecting revenues more frequently and communicating assumptions built into revenue estimation models can keep policymakers better informed.
- Revenue measures that result in short-term gains can be used sparingly to avoid negative impacts from over-use.



CUTTING BUDGETS IN THE RECESSION

- Spending for programs, services and boards that are deemed no longer useful or effective was often reduced rather than eliminated.
- Budgeting efforts that seek to eliminate boards and programs that are no longer useful can reduce future spending commitments and promote reform more rapidly. Decisions should be made based on the performance of programs.
- Budget cuts during the recession were disproportionate across spending categories due to decreased budgetary flexibility.
- Temporary suspension or reduction of federal maintenance of effort (MOE) requirements could be implemented in times of fiscal crisis, prolonged decline, or slow growth to increase state budgetary flexibility.
- States used a combination of across-the-board and targeted budget cuts to utilize available resources in the most efficient manner.
- To hedge structural budget imbalance risk states can use both reduction methods simultaneously to achieve immediate targeted savings with minimal disruption, while also incorporating across-the-board cuts where appropriate to position agencies for lower funding levels.

STATE AND FEDERAL RESPONSES TO THE FISCAL CRISIS

STATE BUDGETS AND THE ECONOMIC CYCLE

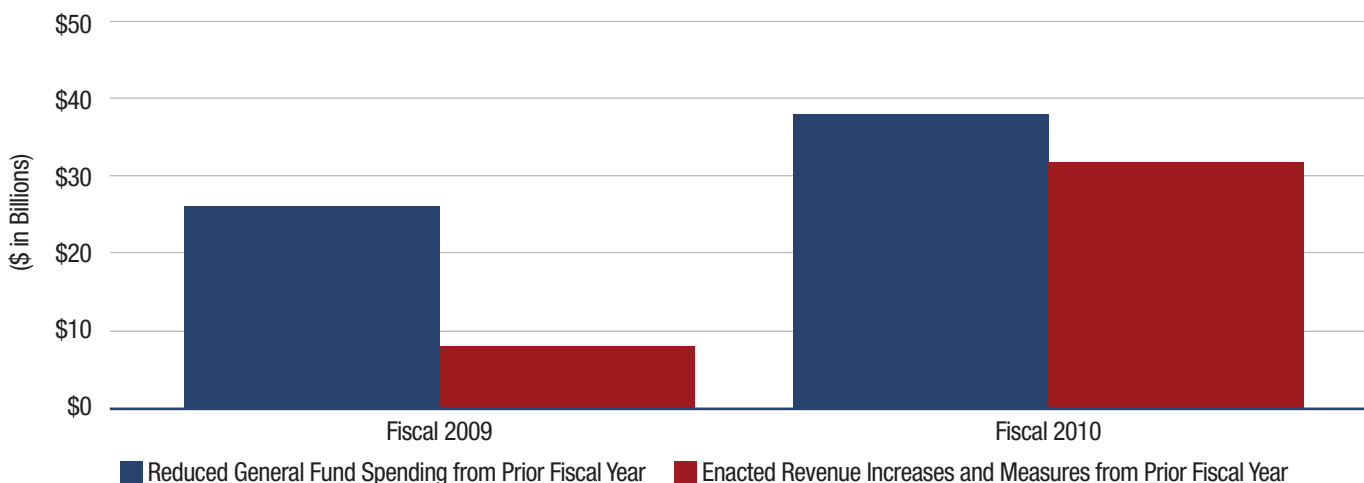
The national economy does not grow smoothly or uniformly; periods of economic expansion are followed by contraction, and the economic cycle repeats itself. Despite changes in the economy, policymakers at the state level search for long-term strategies to stabilize budgets, but too often actions still tend to be reactive. In good years, states can be flush with additional dollars to budget for program expansion or the creation of new ones. For example, in the late 1990's state tax collections grew at a remarkable pace, and as the unemployment rate stayed low and Medicaid expenditures remained under control, state governments expanded services and future spending obligations. However, in the early part of the last decade, the economy stalled, revenues collapsed, government service demands increased, and states were challenged to meet the additional spending obligations made during boom times.

The goal of budgeting through business cycles is to minimize service disruption during periods of economic decline and avoid over commitment of future spending obligations during economic expansion. Throughout the past four decades, states have experienced myriad fiscal uncertainties tied to national economic hardships such as stagflation in the 1970's, a weak national economy in the early 1980's and early 1990's, the technology bubble burst and post-9/11 fallout in the first part of this century. Each period of fiscal stress has driven states to adapt decisions of spending and taxation to meet the challenges imposed by the economic cycle. In macroeconomic terms, state fiscal policies over business cycles would generally be considered pro-cyclical, meaning that before a recession—when economic times are good, states typically increase spending and lower tax rates. As the economy stalls and economic output falls, states typically reduce expenditures and increase taxes. The creation and buildup of rainy day funds over the past four decades may have tempered this pattern to some extent.

THE FISCAL RESPONSE OF STATES TO THE GREAT RECESSION

There has been a lasting fiscal response from states due to the Great Recession, which officially began in December 2007 and ended in June 2009. During the Great Recession the collective fiscal response of state governments portrayed a pro-cyclical pattern of unprecedented budget cuts and nominal tax increases. States reduced general fund expenditures by \$64 billion over the two year period of fiscal 2009 and 2010, and enacted \$39.7 billion in revenue increases over this same time. (See Figure 1) States cut budgets in a number of ways including employee layoffs, furloughs, agency consolidation, reduced local aid, decreased state employee benefits and scaled down services to name a few. Taxes were increased by some states for major tax structures (sales, personal and corporate income) by raising rates, reducing credits and deductions, and expanding tax bases.

FIGURE 1. State Fiscal Policy in the Recession: Budget Cuts and Revenue Increases



Source: NASBO Fiscal Survey of States

States also addressed faltering collections by increasing user fees and instituting additional revenue measures. The net result of all these actions was budget cuts were greater than enacted revenue increases, and more states cut budgets in response to the recession than increased taxes.

During the recession, state policy leaders and budget officials had little control over the underlying economic factors that increased demand for state spending in areas such as Medicaid, higher education, human and social services, and unemployment compensation. Given competing demands, budget stability was achieved by deciding how much to spend and where best to spend it. Due to additional federal aid and political decisions shaped by the poor health of the economy, tax increases were less prominent than budget cuts in the budget balancing process. Despite greater reliance on budget cuts, state's capacity to manage budgets through cuts has become more complicated over time because spending requirements, attributable to entitlement programs or other legal mandates, have increased. Additionally, spending from dedicated or earmarked revenues generally does not represent an area for possible savings from budget cutbacks. As a result, budget cuts were disproportionate across spending categories during the recession, with areas like public assistance, higher education and aid to local governments receiving substantial reductions. Overall, resource allocation decisions were more difficult than in prior economic downturns because there were greater service demands, more severe revenue declines, diminished budgetary flexibility and smaller enacted revenue increases relative to past recessions.

FISCAL ACTIONS TAKEN BY THE FEDERAL GOVERNMENT

Unlike the federal government, states cannot run chronic budget deficits in economic down-cycles due to constitutional or statutory limitations. In contrast to the states, the federal government is able to spend more than is collected through taxes because the United States is a monetary sovereign with the ability to influence the money supply and avoid insolvency. Therefore, the federal government can better afford to take fiscal actions that help ameliorate declines in private sector activity in periods of economic contraction. During the Great Recession federal policy actions concerning taxation and spending were designed to stabilize state and local budgets, stimulate growth in the faltering national economy, and expand consumer purchasing power by reducing tax burdens. Increased federal aid to states and localities, additional spending and borrowing, and tax cuts, combined to partially counter private sector declines in the national economy.¹

The United States also took unusual steps through the Federal Reserve Bank to stabilize financial markets and boost employment in the broader economy during the recession and recovery period. The Federal Reserve implemented accommodative monetary policy through its additional asset purchasing programs and depressed interest rate policy. During the credit crisis, the United States Treasury Department also took large ownership stakes in corporations deemed systemically central to the health of the economy. The merits of this multi-faceted approach to stabilize the economy through unconventional intervention in equity, debt, and financial markets will continue to be debated both domestically and abroad. States, like individuals and business, have benefited from lower borrowing costs attributable to the historically low interest rates set by the Federal Reserve.

FEDERAL AID TO STATES

Prior to the Great Recession, direct federal aid to states and local governments in times of fiscal stress had occurred, but not on the scale provided by the American Recovery and Reinvestment Act (ARRA) or Recovery Act. More often federal actions in past recessions have included increased spending for programs such as unemployment insurance, worker training, public works employment or for other existing programs not administered by state or local governments.² However, the Recovery Act was different from aid efforts in most other downturns because the federal government provided substantial direct aid to states and localities. Congress was able to disburse the additional federal funds to states in a relatively short time by relying on pre-existing state aid programs, such as Medicaid, the Federal Highway grant program and Title I education programs. Without the increased federal aid directed to states through the Recovery Act, state budget cuts would have been more severe. In addition to direct aid, the Congressional Budget Office estimates that the Recovery Act raised real economic output by 1.8 to 3.5 percent in calendar year 2010³, helping to mitigate revenue declines and expenditure pressures for states. The Recovery Act brought heightened awareness of federal spending limitations, and the lessons learned may allow for improvements, should federal aid be an issue in the future.

LEARNING FROM THE ECONOMIC DOWNTURN

Periods of economic decline, such as the Great Recession, present opportunities for states to learn from past experiences to improve state budgeting practices and fiscal preparedness. For example, there is a general understanding that the Recovery Act affected state fiscal autonomy and brought unexpected fiscal administration challenges. As a result, the recession and Recovery Act have brought acknowledgement that—for many states—more robust rainy day funds are needed in the future to increase fiscal independence.

The recession has also exposed the cyclical vulnerabilities of state tax revenues, leaving executive leaders and state legislatures to reconsider crafting more stable sources of revenue. Revenue stability efforts are being addressed by broadening the tax base to include a greater portion of economic activity⁴, reducing reliance on business income and capital gains,⁵ or by developing ways to deal with the volatility of those revenue sources. The severe decline in revenues caused by the recession is also producing policy responses to long unresolved issues, such as the taxation of online consumption and the service economy.

States also enacted widespread reforms to the hiring, pay and benefit packages of the public sector workforce. Revenue shortfalls prompted state leaders to scale back health and retirement plans for state workers, institute furlough days, enact pay freezes and salary cuts, and shrink the size of the state workforce. The Great Recession demonstrated that such reforms are politically feasible in times of severe fiscal stress. However, during periods of relative fiscal stability, enacting gradual reforms that avert the need for extensive cutbacks in times of fiscal stress remains challenging.



EVOLVING STATE BUDGET PRACTICES

The funding for all areas of state government continues to be shaped by revenue and expenditure uncertainties, and out of necessity, state budgets are evolving. A better understanding of the budget officer perspective during the recession can help states learn from past experiences and inform future budgetary decisions—a future in which tough budgetary choices are likely to continue. State budget officers have developed many solutions to short-term budgetary dilemmas that can work well if economic declines are short lived, such as tax amnesties, agency streamlining efforts, new hire delays, sale-leasebacks of state properties, and bond refinancing.⁶ The extreme fiscal distress and prolonged recovery caused by the recession have exposed the limits of these and other short-term budget solutions. This paper recognizes the proper place of short-term budget management tactics and acknowledges the appropriateness of such tools under more normal fiscal conditions. However, the majority of findings and recommendations are intended to help contribute to long-term budget solutions that consider immediate fiscal pressures while also promoting fiscal reforms that last.

Under the recession's economic and fiscal policy backdrop, budget officers were held accountable for more granular financial management decisions, such as where, when, and how to cut budgets once revenues were not aligning with previously approved spending levels. State budget officials were able to provide a degree of relief by redirecting funds to the most critical areas, but budgeting under this context also required budget officials to adapt fiscal administration practices to account for greater levels of uncertainty. State decisions concerning rainy day funds and one-time resources perhaps best exemplify the dual challenges before states as they grapple to meet current service demands and prepare for future revenue and expenditure uncertainties.

When utilized appropriately, budgetary reserves, ending balances and “rainy day funds” are examples of tools that states can use to meet immediate spending demands while also limiting future budgetary risks. Budget reserves are intended to allow the most essential agency operations to continue until legislative bodies can better address fiscal decisions with more rigorous analysis and debate. During the recession, the extent to which reserve funds accomplished this goal was impacted not only by the size of reserves but also by such factors as timing and targeted use.



STATE OF OREGON SUPPLEMENTAL ENDING BALANCE FISCAL 2012

States are still learning from the heightened uncertainty caused by the recession and are continuing to implement changes to address potential problems similar to those encountered during the Great Recession. In Oregon, “The 2011–13 legislatively adopted budget included a supplemental ending balance due to uncertainty regarding the state’s overall economic situation. This ending balance was created by holding back 3.5 percent of the General and Lottery Fund budgets from agency budgets. Agencies are instructed to expend 54 percent of the budgets during the first fiscal year (essentially maintaining a regular burn rate). The supplemental ending balance will be held until the February 2012 session following the results of a General Fund revenue forecast.”⁷

USING RAINY DAY FUNDS, BALANCES AND BUDGET RESERVES

WHAT THE RECESSION TAUGHT STATES ABOUT TIMING, DECISION INDICATORS, AND RESERVE ALLOCATION.

“Our reserve policy worked, but the depth of this recession was far larger than we had previously anticipated. Before the recession, we used to have a reserve target of 7.0 to 12.0 percent, but now we are looking at 10.0 to 15.0 percent.”

BACKGROUND ON RAINY DAY FUNDS AND BUDGET RESERVES

Rainy day funds are also known as budget stabilization funds because they are budget reserves specifically designated to guard against revenue or expenditure volatility. They often carry greater spending restrictions and necessitate demonstration of need before use, which makes rainy day funds different from other budget reserves such as ending balances that can simply arise if revenues exceed planned expenditures. Additional features of rainy day funds, such as requirements for contributions, limitations on how much can be held in reserve, and restrictions on use, make them distinct from ending balances. In general, state officials try to avoid drawing down rainy day funds at the beginning of a downturn, and may also be prohibited from exhausting these funds in a single budget cycle. Prescribed statutory uses and caps, as well as political will, continue to impact rainy day fund expenditure patterns and how much states hold in reserve. The features of rainy day funds vary greatly across states. (See Table 1)

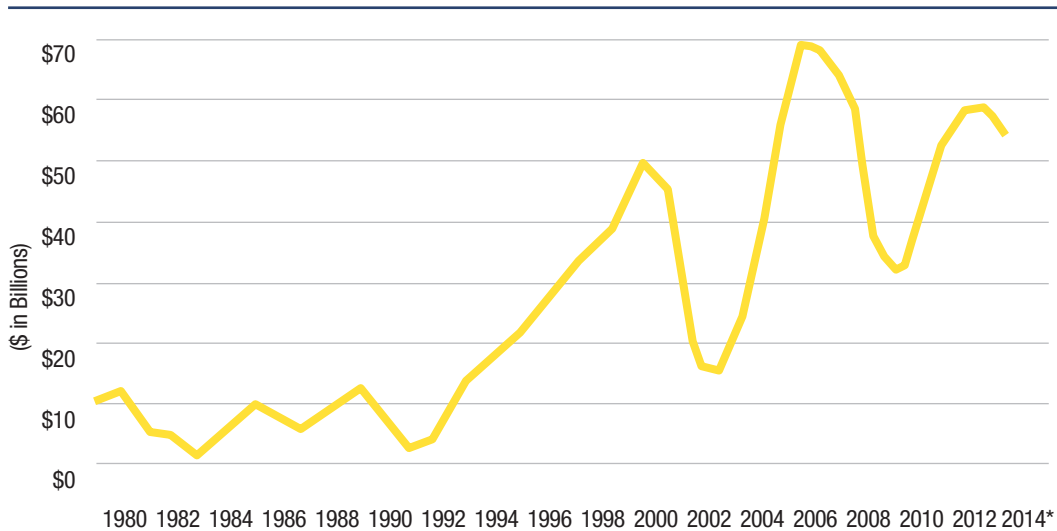
Total balances include both ending balances and the amounts in states’ budget stabilization funds or rainy day funds. Rising total balance levels over the past 20 years indicate that states have developed fiscal policies with greater emphasis on the benefits of creating and using rainy day funds. (See Figure 2) The rise in balance levels also suggests that states are building budgetary reserves slowly with recurring funds by transferring a portion of budget surpluses to rainy day funds. Before the Great Recession, a very informal rule-of-thumb was to hold approximately five percent of expenditures in total balances; however, states are now rethinking how much should be held in reserve, with some states recognizing that higher amounts are essential.

TABLE 1. VARIANCE IN STATE BUDGET STABILIZATION FUNDS

- Most states’ budget stabilization funds are statutorily created, 12 states (Alabama, Alaska, California, Delaware, Louisiana, Missouri, Oklahoma, Oregon, South Carolina, Texas, Virginia and Washington) have constitutionally authorized funds. Five states (Alabama, Alaska, California, Oregon and South Carolina) have one statutorily and one constitutionally authorized budget stabilization fund.
- In seven states, authorization for a withdrawal only comes after a supermajority (by three-fifths, two-thirds or three-fourths) of the legislature approves the withdrawal.
- The majority of states (40), along with the District of Columbia and Puerto Rico, limit the sizes of their budget stabilization funds by capping the size of the funds in relation to state general fund revenues or appropriations.
- Alternatively, governors in North Dakota and Puerto Rico have authority to make transfers from their budget stabilization funds.
- In Connecticut, Indiana, Michigan, Nebraska and New York withdrawals are triggered when anticipated revenues or other economic indicators fall below specified levels.
- At least ten states (Alabama, Alaska, California, Iowa, New York, Oregon, South Carolina, Utah, Vermont and West Virginia) and the District of Columbia maintain at least two separately operating budget stabilization funds. States have often created multiple funds to house certain sources of unanticipated revenues, e.g., a one-time carve-out of oil and gas royalty funds (Alabama), or money received from mineral extraction litigation and dispute settlements (Alaska).
- Fifteen states, the District of Columbia and the U.S. Virgin Islands require withdrawals to be repaid to their budget stabilization funds. The terms and conditions under which withdrawals must be repaid typically contain a due date for repayment or a statutorily prescribed repayment schedule.

Source: National Conference of State Legislatures⁹

FIGURE 2. Total Year-End Balances Fiscal 1979 to Fiscal 2014



Source: NASBO Fiscal Survey of States

* Fiscal 2014 data are based on governors' recommended budgets.

Prior to the recession, states built up fairly significant balance levels. In fiscal 2006, total balances reached a peak at \$69 billion or 11.5 percent of general fund expenditures, but by fiscal 2009, balance levels had fallen to \$30.6 billion or 5.7 percent of general fund expenditures. It should however be noted that if Texas and Alaska are removed from total balance levels, the remaining 48 states had average (See Figures 2 and 3) balance levels representing only 2.4 percent of expenditures in both fiscal 2009 and 2010, well below the informal target of five percent.

THE BENEFITS OF RAINY DAY FUNDS

The primary reason for maintaining adequate rainy day funds is that the additional reserves can help circumvent service disruption during economic downturns by countering declines in tax revenues. However, rainy day funds have other benefits besides the potential to supplant falling revenues. Budget reserves held in rainy day funds are viewed positively by credit rating agencies, ultimately serving to help lower state borrowing costs. Rainy day funds can also be used to buy time, reducing the need to make immediate cuts to core operations before more thorough spending plans can be devised, which generally requires lengthier legislative debates. Additionally, rainy day funds can be used to maintain agency operations while states that choose tax increases wait for the revenue gains. Rainy day funds are often needed during times of natural disaster as well, and can be used to match federal funds.

During the financial crisis and ensuing credit freeze in short-term borrowing markets, rainy day funds and other budget reserves served as a source of liquidity, helping states meet short-term cash flow needs. Many states have the ability to turn to short-term lending markets for normal cash flow purposes and often do so by issuing tax anticipation notes or other promises for repayment, which were not marketable in the credit crisis. The abnormal behavior in short-term credit flows in the recession reinforced the importance of rainy day funds for states. Many of the benefits from rainy day funds and ending balances are also experienced at the agency level through increased budgetary flexibility and preparedness.

HOW TO USE RAINY DAY FUNDS

The size of a state's budget reserves is not the only factor to consider before utilization. The mentioned benefits of holding reserves must also be weighed in relation to a number of budgetary considerations about future fiscal uncertainties. Unfortunately, this means there is no universal rule on the right way to use rainy day funds that alerts state officials as to when and where reserves should be spent. However, budget officers have developed insightful ways to think about how to find answers to questions surrounding rainy day funds.



STATE OF NEBRASKA BALANCES CAN INCREASE AGENCY FLEXIBILITY FISCAL 2010

Nebraska authorized the carryover of unused budget authority remaining at the end of the fiscal year 2009 in order to promote spending restraint during the current year and to mitigate precipitous budgetary actions that otherwise would be necessary due to reductions in new appropriations for state agencies in the following fiscal year. This policy change provided \$200.1 million of additional budget authority for use in FY2010. "This was an extraordinary consideration to allow state agencies additional flexibility as they addressed constrained growth in new appropriations."⁹



**STATE OF MASSACHUSETTS
ONE-TIME SETTLEMENTS
FISCAL 2012**

“An additional \$375 million in one-time tax settlements was also received in FY12, but these settlements were deposited directly to the Stabilization Fund (and not used to balance the FY12 budget), in accordance with legislation requiring that individual settlements in excess of \$10 million be transferred to the rainy day fund.”¹¹

must contribute 1 percent of state general fund revenues to the rainy day account each year, regardless of the revenue environment, until the fund reaches a level of 10 percent of general revenues.¹⁰ If the source of the rainy day fund is recurring, that is a sign that reserves can be more easily replenished, which should help guide the appropriate use. The use of the reserves should therefore be partly determined by how the funds were created or by knowing how they may be replenished.

Another way to determine a good use of rainy day funds is to define what the fund represents. The term budgetary reserves can mean different things to different stakeholders and can have various implications for state budgets.

“The rainy day fund represents liquidity. It’s a way to buy time especially given the lag with political decision-making. Start by recognizing that it sits there as one-time money and ask the question: How much risk are you willing to take against a structural imbalance on the budget?”



**STATE OF NEW YORK
CASH FLOW MANAGEMENT
FISCAL 2010**

In addition to drawing upon rainy day funds, the need for additional liquidity during the recession prompted a number of states to take unprecedented actions to reduce budgetary constraints. New York addressed cash flow problems partly induced by the recession by enacting changes to long-standing financial management practices. “With respect to cash flow management, the 2009-2010 enacted budget provided authorization for the general fund to borrow resources temporarily from other funds for a period not to exceed four months, and provided that resources are returned to those funds prior to the end of the fiscal year. Prior to the enactment of this authorization, the State was not permitted to close a month with a negative general fund balance.”¹²

downturn was a permanent reset. Spending was reduced and rainy day funds maintained as long as possible.”

The ability to tap rainy day funds typically requires prior revenue declines set by statute, or some other form of legislative approval. Many budget officers reported that the use of reserves was delayed after statutory requirements were met, technically forestalling the allowable use of rainy day funds. In a few outlying cases, such as Vermont and South Dakota, rainy day funds were not used at all throughout the downturn. Vermont has since enacted reforms to facilitate the use of reserves by adding a new fund—the rainy day reserve—which may be used to address budget shortfalls whatever the cause.¹³

“Where did the money come from that’s in the rainy day fund? It’s important to know that—can your rainy day fund be replenished, or is it the result of a one-time surge?”

Budget reserves can be accumulated over time with structural surpluses, by formulas set in statute, or even swell from one-time windfalls, such as a legal settlement, asset sale or unusually good revenue year. Rainy day funds that are solely funded by the prior year’s surplus means that reserves are last in line after all other expenses have been met. To ensure rainy day accounts are funded, some states dedicate a portion of general fund revenues. Washington, for example,

During the recession when revenues rapidly dropped off and credit markets froze, states still had access to reserves for necessary expenses. This additional liquidity allowed decision-makers more time to consider, delay and debate budget cuts. A primary purpose of reserves is—to provide extra time and resources for agencies to continue operating until the next budget cycle when spending concerns can be more thoroughly addressed. Rainy day funds therefore function to ameliorate the immediate pain of budget cuts that would otherwise need to occur when revenues don’t meet expectations.

Several states also reported that rainy day funds were not heavily relied upon because economic indicators suggested that the downturn would be a permanent reset for the state’s budget. The reserves may well have been used on program areas that would soon receive greater cutbacks in the next budget cycle regardless of budget dollars being spent to avoid immediate reductions.

“We delayed the use of rainy day funds because it was evident that the economic



**STATE OF VERMONT
MAINTAINING RESERVES
FISCAL 2011**

“Throughout the entire economic downturn, the Governor has steadfastly resisted calls to draw down the State’s budget stabilization reserves. These reserves are intended for use when the state experiences unanticipated and unavoidable deficits near the end of the fiscal year, with no opportunity to put in place reductions necessary to close the gap prior to fiscal year end. The Governor’s proposed FY 2011 budget maintains these reserves at their statutory levels.”¹⁴

WHEN TO USE RAINY DAY FUNDS

One of the primary reasons for delaying the use of reserve funds in the recession was uncertainty. In particular, states were unsure when the economic cycle would reach a bottom. With high levels of uncertainty, it is difficult to know the most effective time to use rainy day funds. If reserves are used too early, budget cuts may need to be even greater in the future when expectations of revenue gains don’t materialize. If cuts are too large and made too soon, those cuts may be unnecessary if revenue collections pick-up. Ultimately, the plan to use rainy day funds involves a timing decision. A number of states delayed the use of rainy day funds even after statutory requirements were met in order to have greater certainty that the economy and revenues were sure to improve.

“Don’t pull the trigger until you can see where you’ll come back out. It’s better to use rainy day funds to annualize reductions.”

“We delayed using rainy day funds until we could see the low point of the recession. Even once we did that, we coupled the use of reserves with additional program cuts in roughly an equal amount.”

Delaying the use of reserve funds until there is greater certainty that tax revenues will improve to sustain agency funding implies that budget cuts come before reserve utilization. Cutting budgets before dipping into reserves is considered a good practice for spending reserves by many state budget officers, even though not all states utilized reserves in this sequence during the recession. Other states reported that the pressure to maintain pre-recession service levels drove their decision to use budgetary reserves. Vital program areas and particular spending categories may not perform as well if cuts are made first and then reserves are disbursed later. However, there are good reasons to delay the use of reserves and make budget cuts first. For example, by reducing agency budgets agency leaders are encouraged to seek efficiency gains in attempts to maintain services under shrinking resources.

“Without knowing the full impact of the economic downturn, we tried to delay the ‘burn’ on the rainy day fund by passing legislation to allow a reduction of other restricted reserves.”

Allowing agency operations to continue with reserve funds does not incentivize efficiency and can position programs for significantly larger cuts in the future. Budget officers liken the best use of reserves to a “stair-step,” in which agencies and programs are managed through an economic down cycle by making cuts first and then providing resources from reserves to replenish the most critical areas. This incremental funding style could also be implemented during an improving revenue environment, particularly when revenues are increasing but the outlook is uncertain.

“Cut first and then backfill with reserves to glide agencies into operating with less resources.”

Cutting budgets prior to tapping reserves sends a signal of prudent financial management to legislators and the public. Additionally, the use of reserves is more palatable for appropriators if programs are being scaled down, indicating that agencies are adapting to a more limited resource environment while acknowledging more time is needed to smooth the transition. Furthermore, if reserves are spent before a spending reduction, budget officers and agencies may be placed in a difficult position in the future when the need for more substantial cuts may arise, requiring even greater budget realignment with potentially less time available for preparation.



**PUERTO RICO
USE OF RESERVES FOR STRUCTURAL
TRANSITIONS
FISCAL 2010**

“The general fund budget includes an allocation of \$1 billion to facilitate the orderly implementation of certain expense reduction measures adopted by the Government of Puerto Rico pursuant to Act 7 of March 8, 2009. This allocation will cover the cost of transitioning public employees to non-governmental sectors by providing re-training vouchers, self employment opportunities, relocation and salary subsidies alternatives. On the other hand, the general fund budget also includes an allocation from the State Stabilization Fund of \$1.5 billion to cover payroll and operating expenses that are expected to be reduced through fiscal year 2010, but whose savings will not be realized in such fiscal year.”¹⁵

AFTER THE RECESSION STATES CONTINUE TO BUILD RESERVES

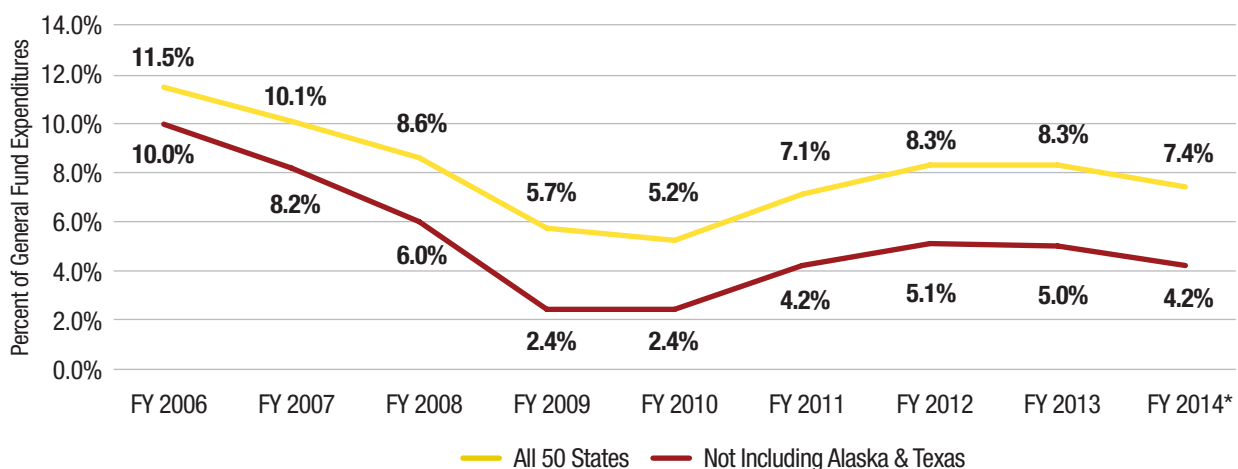
Due to the severity of revenue declines during the recession, there is general agreement among many budget officers that rainy day funds could better serve states if the amount of reserves is increased. Voters in Georgia, Oklahoma, and Virginia have all recently raised the cap on the amount the state is allowed to hold in reserve from 10.0 to 15.0 percent of revenues.¹⁶ However, developing a uniform standard for the size of state budget reserves remains challenging because there are differing views about how much money should be held reserve. Large reserve funds can be difficult to protect when there are demonstrated needs for funds by other areas of government and taxpayers. A uniform standard is also difficult because some state revenue systems are more volatile or sensitive to changes in the economy than others. States can ensure greater budget stability through economic cycles by requiring rainy day fund contributions when revenues are increasing more rapidly than expected, and by drawing down reserves when the additional funds are needed. Increasing contributions from more volatile revenue sources, such as capital gains, can also reduce budget volatility.



Budget officers from some states have also expressed concern that repayment provisions for rainy day funds are too stringent. Strict repayment provisions means that the state must refund the money taken from the rainy day account rather quickly, often before revenues have been given time to improve. This results in a disincentive to make contributions during good economic times or to access rainy day funds when needed the most. By loosening reserve replenishment standards, states can facilitate greater contributions during periods of economic growth and keep spending levels elevated longer to meet heightened service needs.

States have made significant progress rebuilding budgetary reserves since the end of the recession; total balances are estimated to reach 8.3 percent of general fund expenditures in fiscal 2013. However, Alaska and Texas, two states with the largest reserves, still accounted for 44.3 percent of states' total balances in fiscal 2013. Budget reserves for the remaining 48 states was much lower—5.0 percent of general fund expenditures. The level of reserves relative to expenditures is roughly half what states had accumulated leading up to the fiscal 2006 peak, when balances for the remaining 48 states reached 10.0 percent of expenditures. (See Figure 3)

FIGURE 3: Total Balances as a Percent of General Fund Expenditures



Source: NASBO Fiscal Survey of States

*Fiscal 2014 data are based on governors' recommended budgets.

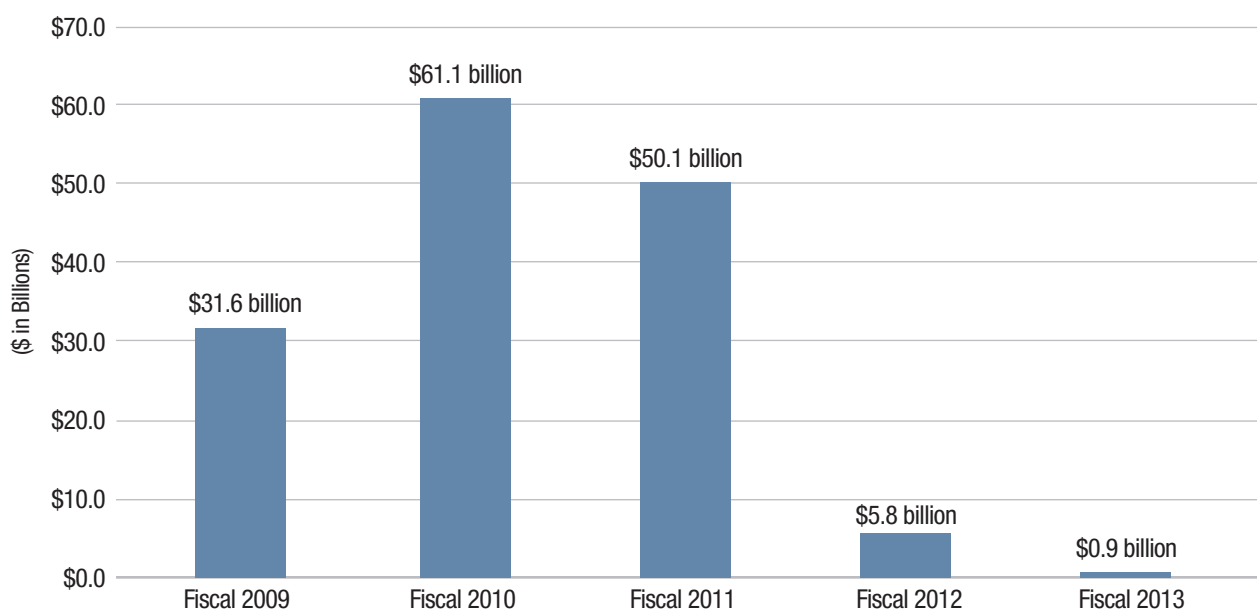
“We spent 2008 in a perpetual cold sweat. In early ’09, we were making similar decisions. FY ’13 seemed like a generation away, and we assumed the economy would be okay by then. We’re still digging out.”

BUDGET FLEXIBILITY AND THE RECOVERY ACT

The American Recovery and Reinvestment Act (ARRA), or Recovery Act, was signed into law on February 17, 2009, and contained a combination of tax cuts, grants for infrastructure projects, and additional fiscal stabilization support for state services and programs. The legislation was designed to accomplish three different policy objectives: economic stimulus, job creation, and state and local budget stabilization. Most of the federal support used to stabilize state budgets came in the form of enhanced FMAP (Federal Medical Assistance Percentage) rates and the newly created State Fiscal Stabilization Fund (SFSF), which targeted K-12 and higher education. However, the scope of the Recovery Act was much greater than Medicaid and education, providing additional funds for an estimated 200 categorical federal grant programs.¹⁷ The legislation resulted in a complex and fragmented disbursement of federal dollars to state and local governments, resulting in various degrees of programmatic success often contingent on the strength of pre-existing funding mechanisms and fiscal management capacity.¹⁸

From fiscal 2009 through fiscal 2012, states spent \$148.3 billion in flexible emergency funds, helping to maintain service levels and reduce budgetary gaps. (See Figure 4) Recovery Act funds for Medicaid, K-12, and higher education were considered flexible because the additional dollars helped free up money for other areas of state spending. Relying on state Medicaid and Title I education programs meant that Congress was able to disburse substantial federal funds to states in a relatively short time. These funds curtailed the amount of tax and fee increases and helped states avoid draconian cuts to essential state and local services. However, the fiscal relief for state budgets was not without consequences. The increased federal involvement brought new challenges to budgetary decision-making and fiscal administration including enhanced reporting requirements, compressed timelines and conflicting policy goals between levels of government.

FIGURE 4. Recovery Act Spending for Medicaid and the State Fiscal Stabilization Fund



Source: NASBO Fiscal Survey of States, various editions

THE RECOVERY ACT'S COMPLEXITY AND MULTIPLE POLICY OBJECTIVES CHALLENGED IMPLEMENTATION EFFORTS

“Substantial challenges were built in to the Recovery Act at its birth. Rather than provide assistance through a single major grant, Congress chose to carve up funding among a daunting range of over 200 categorical grant programs as well as tax expenditures, loans and contracts. Unlike the New Deal where millions of unemployed were hired in direct federal projects, the Recovery Act largely used networks of states, counties, cities, nonprofits and private contractors—a recipe often fraught with potential for goal conflict, program slippage and confusion.

Managers and professionals across all levels of government and sectors were consigned to make tradeoffs between oft-conflicting objectives built into the legislative framework of the Recovery Act—to both spend funds quickly to jump start jobs and recovery while observing strict, centrally-determined policy and accountability provisions under nearly unprecedented levels of attention and oversight from political leaders, stimulus opponents, interest groups and the media.”

Source: George Mason University¹⁹

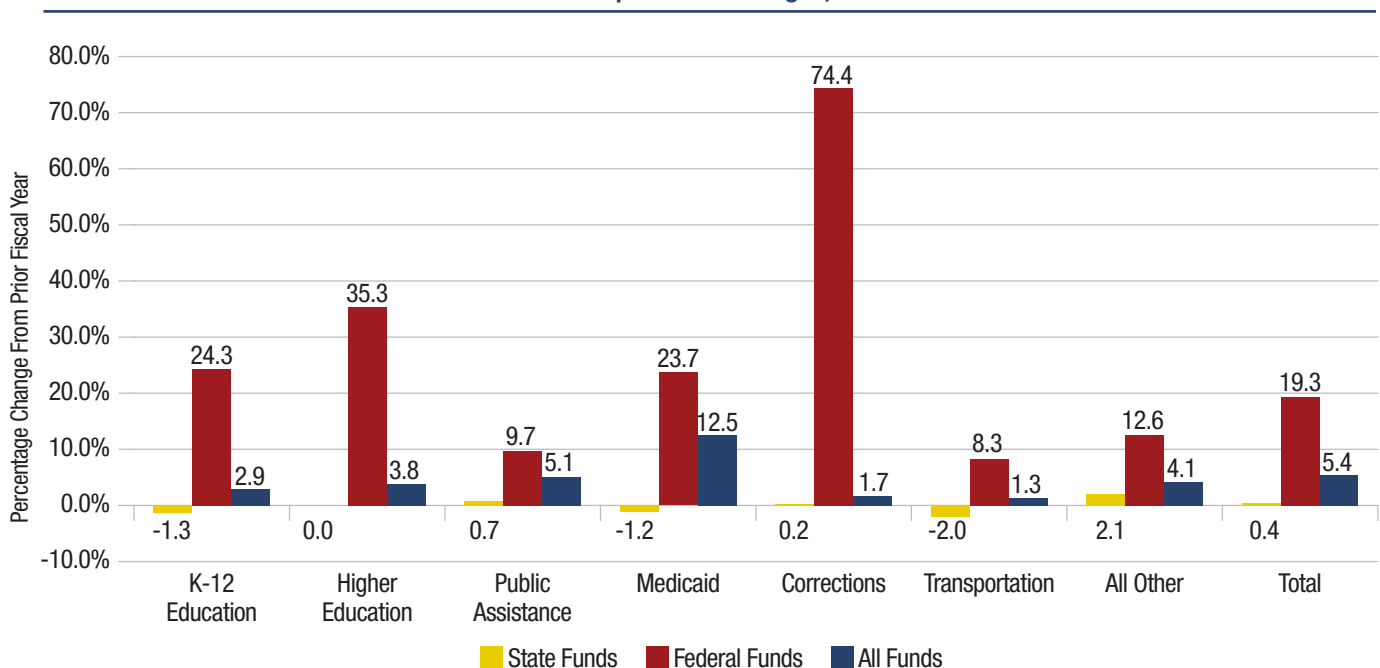
TOTAL STATE EXPENDITURES RISE SLIGHTLY UNDER THE RECOVERY ACT

As intended, the Recovery Act prevented total state expenditures from declining during the recession. By doing so, the additional federal dollars also changed the composition of revenue sources for state expenditures. At the same time that spending from state funds (general funds and other state funds) declined, state spending of federal funds experienced sizable increases. This growth in federal funds was substantial enough to raise total state expenditures in both fiscal 2009 and 2010, even though spending from state funds declined in both years. This resulted in a pattern of overall growth in state expenditures; however, the annual spending growth in fiscal 2009 and 2010 was lower than the historical average of approximately 6.0 percent.²⁰ Total state expenditures climbed to \$1.56 trillion in fiscal 2009, a 5.4 percent nominal increase from fiscal 2008, and reached \$1.62 trillion in fiscal 2010, a 3.8 percent increase. Even with Recovery Act's passage, the additional funds were not enough for states to avoid budget cuts and meet the added demand for state services caused by the faltering economy.

STATE BUDGET CUTS UNDER THE RECOVERY ACT

As demand for state services picked up and state tax revenues declined, additional federal funds provided through the Recovery Act were most heavily targeted towards K-12 education and Medicaid, by far the two largest components of state expenditures. The targeting of funds to K-12 education and Medicaid also shaped the allocation of state budget cuts, which on a dollar basis, were greatest in these

FIGURE 5. State Expenditure Changes, Fiscal Year 2009



Source: NASBO 2010 State Expenditure Report²¹

*Note: Federal funding for corrections is marginal, revealed by the fact that a large percentage increase in federal dollars was not enough to impact overall spending

areas. In fiscal 2009, state decisions to cut state funding for Medicaid and K-12 education by 1.2 percent and 1.3 percent, respectively, were in large part driven by the knowledge that Recovery Act funds could help replenish the state cuts.

While cuts from state funds occurred most heavily in areas supported by Recovery Act dollars, the 19.3 percent increase in federal dollars in fiscal 2009 allowed those spending categories to experience growth. (See Figure 5) However, Medicaid and K-12 education spending levels supported by increased federal funds would eventually need to be maintained by state dollars after Recovery Act funds expired. For some states, this delayed tough budgetary choices, resulting in continued budget cuts after it became clear that revenue increases would not be sufficient to fully offset the decline in Recovery Act funds.

In fiscal 2010, spending from state funds declined in all seven major categories, and like fiscal 2009, federal spending increased in every major category. The massive influx of federal dollars in fiscal 2009 and 2010 was directly attributable to Recovery Act funds²³, which allowed total state spending to increase both fiscal years. Federal dollars flowing to states increased by \$174.1 billion or 44.8 percent over the two year period in fiscal 2009 and 2010. Spending from state funds significantly decreased in fiscal 2010 in the areas of K-12 education, Medicaid, public assistance, and corrections. (See Figure 6)

While budget cuts were extensive in fiscal 2010, the Recovery Act did somewhat inhibit states' ability to reduce program services due to maintenance of effort (MOE) spending requirements.

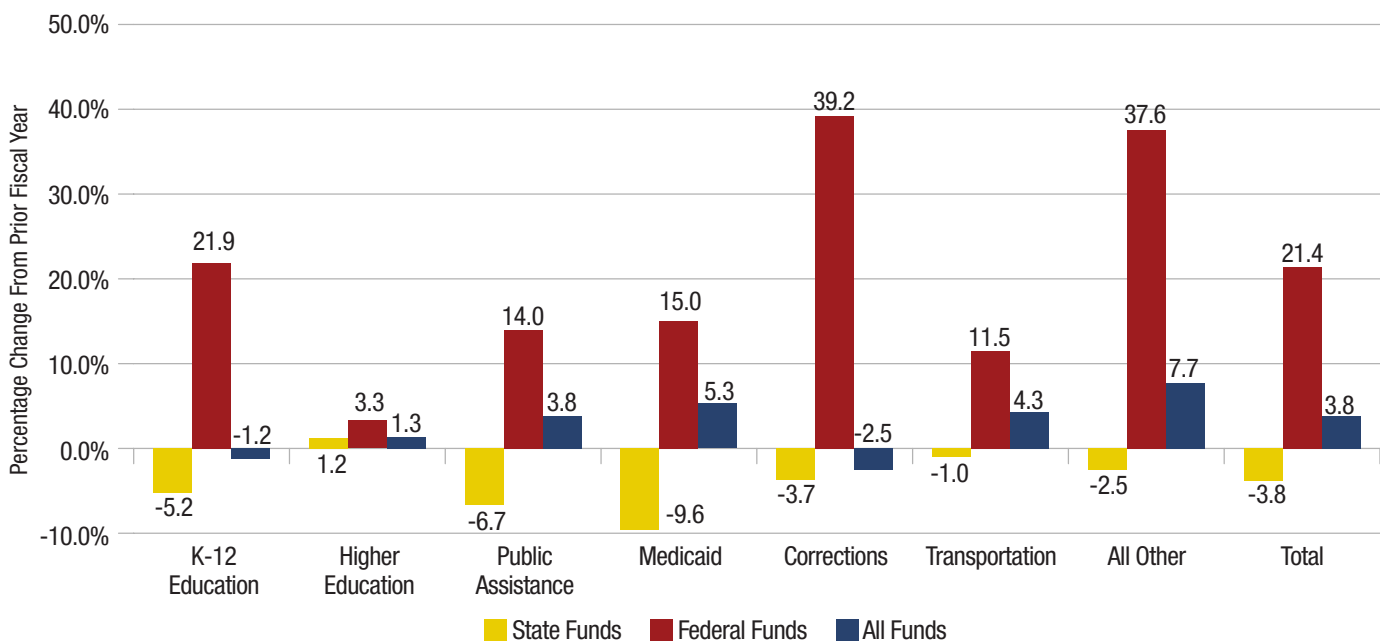


**STATE OF WISCONSIN
BUDGET CUTS UNDER THE RECOVERY ACT
FISCAL 2009**

Wisconsin made \$635 million in mid-year budget cuts in fiscal 2009. Additional ARRA dollars helped offset the cuts, but also in part dictated where the cuts took place. "Cuts were based on federal fiscal relief, unspecified reductions, and agency specific cuts, and an ATB (across the board) 1.0 percent cut. They were backfilled with federal fiscal relief dollars."²²



FIGURE 6. State Expenditure Changes, Fiscal Year 2010



Source: NASBO 2011 State Expenditure Report²⁴

The MOE spending requirements that accompanied elevated federal funding levels made cuts to areas such as healthcare and K-12 education difficult though not impossible. According to the United States Government Accountability Office (GAO), for states to qualify for the enhanced FMAP under the Recovery Act, they “generally may not apply eligibility standards, methodologies, or procedures that are more restrictive than those that were in effect under their state Medicaid programs on July 1, 2008.”²⁵ Some budget officers commented that restrictions like these increased future spending commitments for healthcare and placed states in the situation of needing to make disproportionately larger cuts in other areas. (See Table 2 for Examples of MOE Requirements Under the Recovery Act)

TABLE 2. ARRA AND MAINTENANCE OF EFFORT REQUIREMENTS²⁶

Selected Federal Programs Subject to a Maintenance of Effort or Similar Provision under the Recovery Act, by Agency

Dollars in Billions

Agency	Program	Amount
Federal Highway Administration Department of Transportation (DOT)	Highway Infrastructure Investment	\$26.8
Federal Transit Administration, DOT	Transit Capital Assistance	8.4
	Fixed Guideway Infrastructure Investment	
	Capital Investment Grants	
Federal Railroad Administration, DOT	Capital Assistance for High Speed Rail Corridors and Intercity Passenger Rail Service	8
Department of Education	State Fiscal Stabilization Fund	48.6
Department of Housing and Urban Development	Public Housing Capital Fund	4
National Telecommunications and Information Administration Department of Commerce	Broadband Technology Opportunities Program	4.7
Total		\$100.5

Source: Table Produced by the United States Government Accountability Office (GAO)

CHALLENGES OF NON-RECURRING RESOURCES INCLUDING RECOVERY ACT FUNDS

“The Recovery Act was a nice shot in the arm, but helped prolong the agony of tough decisions that needed to be made.”

Several budget officers stated that the additional federal funding allowed states to buy time, delaying the need to make immediate cuts. In many instances this was viewed as a benefit and the intent of the Recovery Act. Yet, budget officers also expressed concern that the extension of unbalanced spending and revenue collections attributable to the Recovery Act only made reductions more difficult later on when the cuts became necessary. The political will and public understanding to make budget cuts is greater when there is a common understanding that economic times are tough, and making those same cuts under improving conditions can be more difficult to explain.



STATE OF OREGON FEDERAL AID UNCERTAINTY FISCAL 2012

“In fact, preliminary information suggests that because of the use of one-time resources to close the budget gap in 2012, projected program growth would exceed revenues available to the 2013-15 budget. Further compounding the state’s budget risks, the federal government has already committed to significant spending cuts and more seem likely. The risk to the state budget resulting from federal cuts is arguably as high and as uncertain as it has ever been. It is not a given that Oregon can depend on continued or uninterrupted federal transfer payments to state programs.”²⁷

Over-reliance on one-time money during economic down cycles can potentially make budget realignment more dramatic if future growth is not sufficient. Furthermore, federal accountability officials have also expressed concern that federal aid reduces the incentive for states to increase their own countercyclical fiscal capacity or prepare for budgetary instability during economic downturns.²⁸

“The one-time funds were used primarily for ongoing expenditures. When the ARRA fund ceased, and the economy had not sufficiently recovered, this necessitated tax increases and/or expenditure reductions.”



**STATE OF VERMONT
BUDGETARY IMPACT FROM EXPIRING
RECOVERY ACT FUNDS
FISCAL 2011**

“The stimulus money was only a partial and temporary response. We must now deal with the loss of more than 40% of the ARRA funds in FY 2011 and the loss of the remainder in FY 2012. The base budget gaps temporarily filled by ARRA require General Funds to backfill, in addition to meeting inflationary increases and beginning to resolve unfunded liabilities. Unmitigated, we face a cumulative GF budget gap for FY 2011–FY 2012 of more than \$250 million.”²⁹



**STATE OF NEW YORK
FORESTALLING BUDGET CUTS
FISCAL 2010**

“New York deferred an end-of-year school aid payment of \$2.06 billion from March of 2010 to the statutory deadline of June 1, 2010 to carry-forward the fiscal 2010 budget shortfall into fiscal 2011. However, needed K-12 education cuts were only further delayed until the expiration of federal aid from the Recovery Act in fiscal 2012; whereby, New York enacted \$1.9 billion in budget cuts for K-12 education in an effort to address the additional \$5 billion in Medicaid and education costs that were shifted back to the general fund after ARRA funds were phased-out.”³⁰

Most states reported that Recovery Act funds were used appropriately for budget management and realignment. Additional Recovery Act money was treated as one-time money to enact gradual spending reductions to achieve structural balance in the future. However, some budget officers indicated that Recovery Act funds were used to avoid reductions that would have otherwise occurred—and without reducing future spending commitments.

“Use of one-time monies is always on the table for budget offices, but they often will set you up to be in a hole two years down the road.”

A forward-looking use of one-time money, such as Recovery Act funds, is to spend the funds to avoid excessive cuts, while also positioning programs and agencies to adjust to lower levels of funding in the future. States that utilized Recovery Act funds or other non-recurring resources in this manner likely made a transition to the post-stimulus budget environment more seamlessly than others. For example, Idaho in fiscal 2010, transferred \$71 million from various dedicated funds to the general fund to help balance the operating budget. At the same time, the legislature also approved a general fund budget cut of \$187.6 million that was spread across state agencies dependent on the general fund.³¹ This demonstrates a reasonable willingness to use non-recurring resources to avoid excessive cuts, while also positioning agencies for lower future funding levels.

“Timing is everything. We used SFSF (State Fiscal Stabilization Funds) over a couple of years, but it was impressed upon us that this was one-time money.”





STATE OF TEXAS
PREPARING FOR THE END OF RECOVERY
ACT FUNDS
SEPTEMBER 2010

“Recovery Act funds continue to support a range of programs in Texas. As of August 1, 2010, Texas state entities had spent a majority—approximately \$12.2 billion or about 62 percent—of the awarded \$19.8 billion Recovery Act funds, according to the State Comptroller’s Office. The Governor’s staff noted Texas has achieved a balanced budget and Recovery Act funds were not used to estimate the revenue available to support the budget. Staff from key legislative offices noted that the Recovery Act increased federal funds available to support state programs. In preparing for the end of Recovery Act funding, state officials continue to emphasize the Governor’s and the state legislature’s guidance to avoid using Recovery Act funds for ongoing expenses.”³²



STATE OF WEST VIRGINIA
RECOVERY ACT FUNDING FOR EDUCATION
FISCAL 2010

In fiscal 2010, West Virginia reported mid-year budget cuts of \$120 million after budget enactment. State general fund spending for K-12 and higher education was reduced by \$60 million and \$12.3 million respectively. However, due to ARRA, federal stimulus funds backfilled these cuts. As a result, K-12 education was fully funded and higher education was funded at the fiscal 2009 level even though fiscal 2010 mid-year budget cuts reduced appropriations from the general fund by 3.4 percent.³³

As the economy continues to improve, state revenues have increased. Yet commensurate funding increases for many services like higher education and public assistance have not occurred in recent years because new tax revenues derived from economic improvement have primarily served to offset declining federal dollars. The overwhelming majority of flexible funds provided to states through the Recovery Act expired in June 2011, leaving policy makers with difficult budgetary choices in fiscal 2012. Anecdotal evidence and press releases indicated that fiscal 2013 and 2014 budget deliberations were significantly less contentious than years past for many states. This suggests that through the help of the Recovery Act and the economy, many states have finally had enough time to reposition spending plans for a new fiscal reality.

A substantial portion of Recovery Act dollars for states was intended to stabilize state and local budgets. In addition, states can experience non-recurring revenue gains for a number of reasons, such as a legal settlement, asset sale or a sharp increase in commodity prices. Non-recurring resources that are not intended to enhance budget stability, generally the case when states receive an unanticipated revenue gain, can be used in productive ways without posing significant risks to ongoing spending demands. One-time revenue can be directed towards capital projects, investments for innovation grants or reform initiatives. Spending for such purposes can contribute to economic growth without placing states in a position of budget imbalance once the additional revenues are no longer available. The fiscal stabilization spending attributable to the Recovery Act represented an unusual use of additional funds. In general, states can enhance fiscal management by using non-recurring revenues for one-time expenditures like infrastructure or a one-time tax cut.

THE RECESSION'S IMPACT ON STATE REVENUES

TAX INCREASES, REVENUE VOLATILITY AND MANAGING BUDGETS FOR THE SHORT AND LONG-TERM

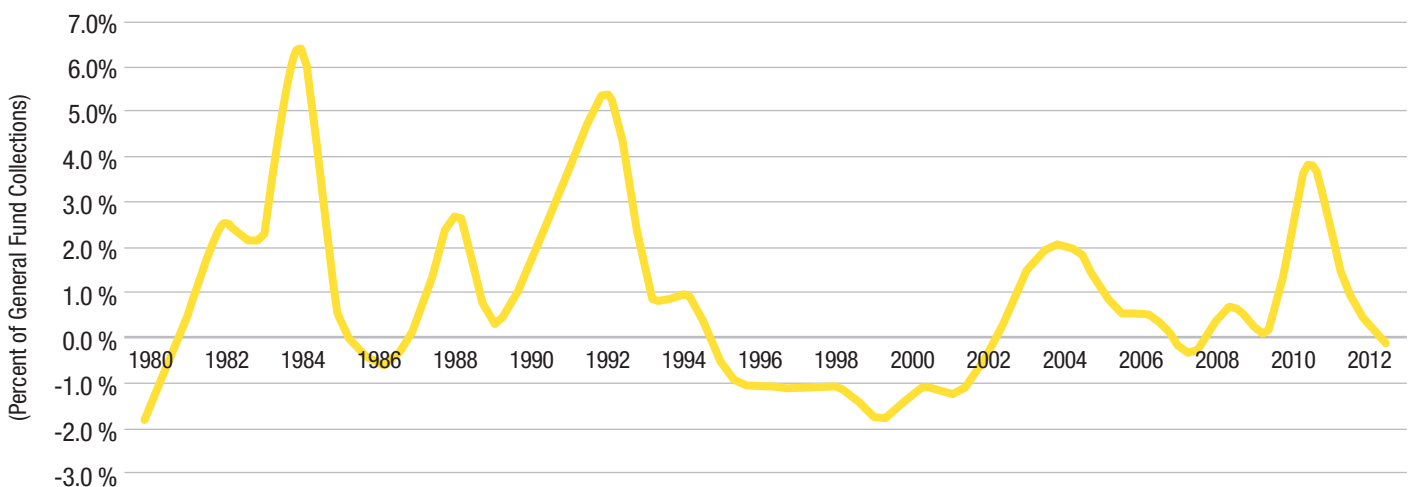
“Our governor didn’t view fees as tax increases—he viewed them as a fee for service. So those who used the services should have to pay for them. In our state, fees will continue to be a potential source of revenue.”

ENACTED TAX AND FEE INCREASES

State tax collections tend to be a lagging indicator of the national economic cycle, and before helping to balance budgets, tax increases and revenue measures require significant time for deliberations. For these reasons, it is no surprise that state tax increases usually continue to take place several years after the economic cycle has turned a corner. By June of 2009, the recession technically ended but state fiscal troubles continued, prompting state legislatures to enact tax and fee increases and authorize revenue measures totaling \$31.6 billion in fiscal 2010. Of the \$31.6 billion in additional revenue, \$23.9 billion was derived from net tax and fee increases and \$7.7 billion from revenue measures. Revenue measures differ from taxes and fees in that they enhance general fund revenue, but do not affect taxpayer liability and may rely on enforcement of existing laws, additional audits and compliance efforts, and increasing fines or late filings. Tax and fee increases in fiscal 2010 produced more revenue in dollar terms than at any other point in the last few decades, and greatly reduced the level of spending cuts that needed to be made to reach fiscal balance. However, as a percentage of the prior year’s general fund collections, enacted tax increases were lower in the Great Recession than in prior periods of economic decline.³⁴ (See Figure 7)

In response to the Great Recession, states eliminated exemptions, broadened tax bases, raised fees, limited deductions and increased tax rates. In general, tax increases were targeted towards personal income and consumption. However, the number of states that increased personal income tax rates was greater than the number of states that increased sales tax rates.³⁵ Personal income tax increases as a percentage of the prior year’s collections were also greater in this recession than in the wake of the post 9/11 recession.³⁶ A number of states that enacted tax increases did so on a temporary basis, and in instances, this has resulted in continued fiscal stress as these tax increases face expiration and the national economy continues on a trajectory of slow growth. The short-term budgetary benefits of temporary revenue actions have been hindered by prolonged high unemployment, constrained GDP growth and extensive household debt that weighed down consumption in the early stages of the recovery.

FIGURE 7. Enacted State Tax Changes as a Percent of the Prior Year's General Fund Collections



Source: Calculation from NASBO Fiscal Survey of States 1979–2012

TABLE 3. STATES THAT ENACTED PERSONAL INCOME TAX INCREASES IN FISCAL 2009 OR 2010³⁷

- California—Increase in marginal rates for all taxpayers (*temporary*)
- Connecticut—Increase in top marginal rate (*permanent*)
- Delaware—Increase in top marginal rate (*temporary*)
- Hawaii—Increase in top marginal rates (*temporary*)
- Maryland—Increase in marginal rates (*temporary and permanent*)
- New Jersey—Increase in top marginal rates (*temporary*)
- New York—Increase in top marginal rate (*temporary*)
- North Carolina—surcharge (*temporary*)
- Oregon—Added two new top brackets (*temporary and permanent*)
- Wisconsin—Added one new top bracket (*permanent*)

TABLE 4. STATES THAT ENACTED SALES TAX INCREASES IN FISCAL 2009 OR 2010³⁸

- California—1 percent increase in sales tax rate (*temporary*)
- Indiana³⁹—1 percent increase in sales tax rate (*permanent*)
- Massachusetts—1.25 percent increase in sales tax rate (*permanent*)
- Nevada—0.35 percent increase in sales tax rate (*temporary*)
- North Carolina—1 percent increase in sales tax rate (*temporary*)
- Utah⁴⁰—0.05 percent increase in sales tax rate (*permanent*)

ISSUES INVOLVING TEMPORARY TAX INCREASES

States periodically enact temporary or permanent tax increases in response to a recession. Temporary taxes have a political advantage in that there is generally greater acceptance for the tax increase with the knowledge that it will expire. However, temporary taxes that need to be extended or become permanent can require significant political capital to go against the original agreement. Temporary taxes not scheduled to expire until the distant future have what is known as longer sunset periods, which can promote skepticism that the taxes will be temporary. Likewise, temporary taxes that are not accompanied by structural budget adjustments reduce the likelihood that the taxes will be temporary. In such a situation, the temporary taxes are more likely to become permanent tax increases.

For example, Illinois raised personal income taxes on a temporary basis from 3.0 to 5.0 percent and corporate income from 7.3 to 9.5 percent resulting in an additional \$3.0 billion in fiscal 2011.⁴¹ The individual and corporate tax rates are set to revert downwards four years after enactment, but budgetary problems that led to the need for additional revenues in 2011, such as the underfunding of pensions, still remain. The state has made significant budgetary reforms in the past two fiscal years, but the expiration of the temporary tax increases will still be extremely difficult without further substantial budget cuts. The last time the state enacted a temporary income tax in the 1980's it became permanent in the 1990's.⁴²

Despite revenue growth over the last three fiscal years, 21 states enacted budgets with lower nominal general fund revenues in fiscal 2013 than in fiscal 2008, the last year before the recession.⁴³ Prolonged and tepid economic growth in the wake of the Great Recession has made the appropriate timing of temporary tax expirations difficult to predict. To better ensure that revenues will recover and budget stability is reached before revenue actions sunset, states can tie temporary tax increases to economic conditions or revenue collections rather than the fiscal or calendar year.



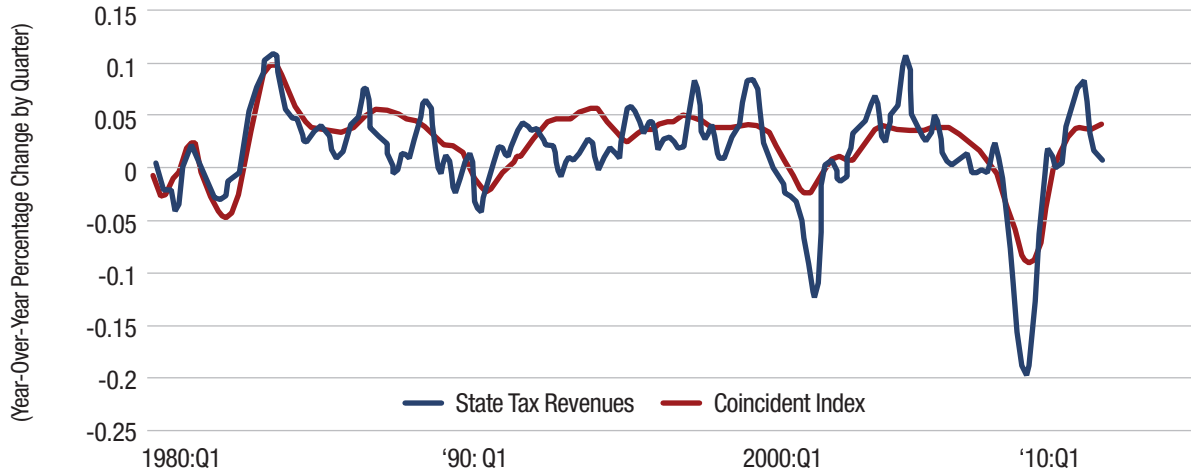
STATE OF DELAWARE BUDGETING UNDER A TAX SUNSET PROPOSED FISCAL 2014 BUDGET

“The Governor has proposed reducing personal income tax rates and other revisions to the series of revenue increases enacted in 2009 that are scheduled to sunset... If the current tax sunsets are allowed to take effect, the state could face a projected revenue shortfall of \$266M in Fiscal Year 2015.”⁴⁴

STATE TAX REVENUES INCREASINGLY SENSITIVE TO CHANGES IN THE ECONOMY

Declines in the national economy during the Great Recession were more dramatic than many economists had predicted, causing state tax collections to fall more sharply than anticipated. Falling economic activity from the end of 2007 to the middle of 2009 was the primary culprit for revenue shortfalls with real gross domestic product (GDP) contracting by 5.1 percent or \$680 billion.⁴⁵ However, the changing landscape of state tax structures also led to greater revenue declines. More so than in the past, state tax systems have become less stable in the face of changing economic conditions, which has re-

FIGURE 8. State Tax Revenues and Economic Conditions



Source: The Federal Reserve Bank of Chicago. Chicago Fed Letter June 2012.
 “State tax revenues over the business cycle: Patterns and policy responses.”

sulted in more cyclical vulnerability for states.⁴⁶ (See Figure 8) According to the Federal Reserve Bank of Chicago, “The magnitude of this response since 2000 has been much larger than in the 1980’s and 1990’s. The behavior of the state individual income tax is a key underlying factor behind this increased responsiveness to national business cycle fluctuations.”⁴⁷

“We have a different dynamic than a sales-tax state, we mitigated declines in general fund revenue with roughly ¼ coming from reserves, ¼ from revenue increases, and ½ from cuts. When volatility increases we aren’t really sure what the full impact will be, which is why most incremental increases will now go to a rainy day fund.”

The types of income being taxed by states (capital gains, dividends, salary and wages, corporate, etc.) and corresponding rates for specific taxes are the determinants of income tax collection stability. States, such as California and New York, have more economically sensitive forms of income, particularly investment income, which can lead to greater revenue volatility. And while budget officers are not fully responsible for state tax policy, governors’ recommended budgets may propose more countercyclical tax recommendations for legislative consideration. Structural weaknesses to state tax systems that were brought to the surface in the recession has provided an opportunity to examine ways to diversify revenue sources and/or tie specific revenue streams to reserves.

REVENUE ESTIMATION DIFFICULTIES CAN COMPOUND BUDGETING CHALLENGES

The residual balance from the prior budget cycle is an important part of budget construction. However, spending plans are primarily reliant on expected revenues, not money already in possession. When future expectations or forecasts prove inaccurate, budgets require more active management to achieve balance. Budgeting challenges during the early stages of the recession were compounded by the fact that spending plans were built on expectations of rising not declining revenues.⁴⁹

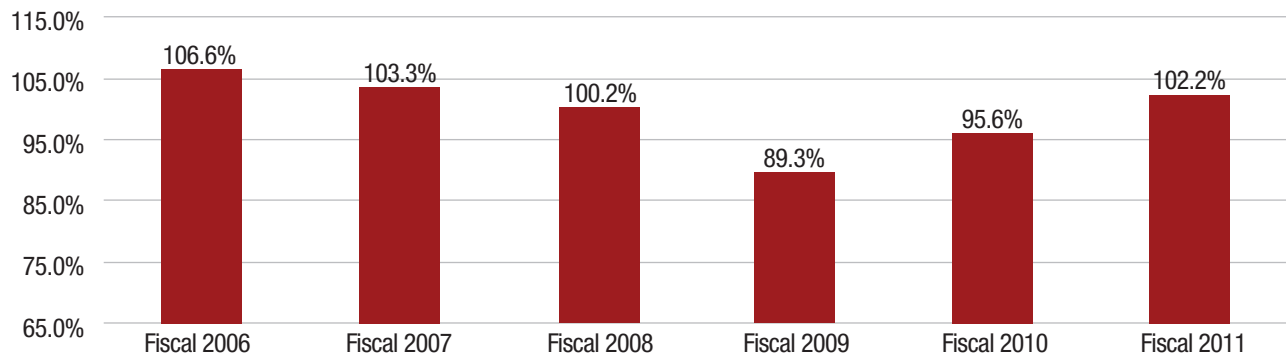
“It doesn’t take much of an overestimation of tax revenues to really disrupt the budget office.”



**STATE OF MASSACHUSETTS
 TYING RAINY DAY FUNDS TO VOLATILE
 REVENUE SOURCES
 FISCAL 2012**

“Capital Gains Receipts—In recognizing the volatile nature of capital gains and its coinciding tax revenue, Governor Patrick proposed a new policy to reduce the state’s reliance on this revenue to a level that is sustainable and predictable from one fiscal year to the next. Specifically, any capital gains receipts in excess of \$1 B are not available for annual budgeting purposes, but instead must be used to help replenish state reserves. As a result of this policy, the Administration’s FY 2013 budget proposal assumes that the \$100 M of capital gains tax revenue expected to be received in excess of \$1 B will be deposited into the rainy day fund.”⁴⁸

FIGURE 9. Revenue Collections as a Percent of Projections: Sales, Personal Income, and Corporate Income Combined



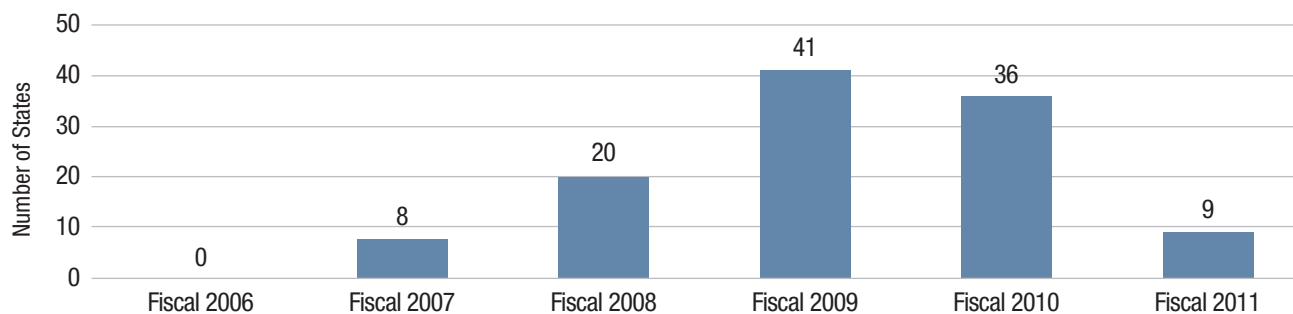
Source: Calculation from NASBO Fiscal Survey of States and State Expenditure Report

The severe and rapid erosion of the economy due to the financial crisis and housing downturn caused even the most conservative revenue estimations to be overly optimistic. Budgets were built upon revenue streams that collapsed. NASBO data indicate that for the three major taxes that states report, (sales, personal income, and corporate income tax), less than 90 percent of original revenue projections used to adopt budgets were actually collected in fiscal year 2009. (See Figure 9)

Significant revenue overestimation was due to both the degree of overestimation by individual states, and the large majority of states that fell short of forecasts. The recession's impact on the national economy was spread across almost the entire country with few states and economic forecasters anticipating the impending degree of revenue declines. As a result, the number of states that experienced revenue collections below projections increased dramatically in fiscal years 2009 and 2010, exemplifying the breadth and scale of the recession. (See Figure 10)

“We all missed the mark, but for different reasons and by different magnitudes.”

FIGURE 10. Number of States with General Fund Revenues Below Projections Used to Enact the Budget



Source: NASBO Fiscal Survey of States

REVENUE UNCERTAINTY REQUIRES MORE FREQUENT AND ROBUST BUDGET COMMUNICATION

Budget officers have noted that routine communication between the budget office, legislative staff and agencies is critical to budget management, particularly when revenues are declining. During the recession, budget officers and tax administrators were largely responsible for additional briefings to executive and legislative officials on the status of revenue collections and service demands. Presenting actual revenue collections alongside prior revenue estimates helped budget officers demonstrate the deterioration of state fiscal conditions and the need for immediate action.

When revenue collections are lower and/or expenditures are higher than forecasted, causing what is known as a budget gap, the budget office is responsible for communicating the imbalance and recommending the magnitude of an appropriate response. Since the onset of the recession, several states reported that the frequency of revenue and operating expenditure forecasts has increased, yet political momentum for particular tax and spending outcomes still poses challenges to the enhanced fiscal reporting process.

States are adapting to problems of tax and spending momentum, which can constrain the current budget and lead to an unsustainable future, by placing greater emphasis on long-term fiscal policies. Massachusetts⁵⁰ and Washington⁵¹ have both made recent changes to budgetary planning by requiring a long-term budget outlook. Projecting revenues and expenditures beyond the budget cycle can preemptively inform decision-makers of pending issues that will need to be addressed, increasing the likelihood that necessary changes will be made before fiscal problems worsen.

“Now we have to do a four-year budget outlook even though we do two-year budgets, for both the executive and legislative budget. It’s a decision-making tool. We also review the forecast model periodically, to increase transparency in the forecasting process.”



THE IMPORTANCE OF GENERAL FUND REVENUE FOR STATE GOVERNMENTS

Reliable and relatively predictable streams of own source revenue—such as state income and sales taxes—allow states to have better control over planned expenditures. General fund revenue is important because the money is flexible and carries fewer restrictions than other forms of revenue such as motor fuel taxes, typically dedicated for transportation uses, or federal grant money dedicated for specific uses. While a state general fund is only one accounting tool used for fiscal management, it does represent a number of own source revenue streams and discretionary expenditures for states. The alignment of general fund spending and general fund revenue over time not only helps to achieve budget balance, but is also an important indicator of fiscal sustainability.

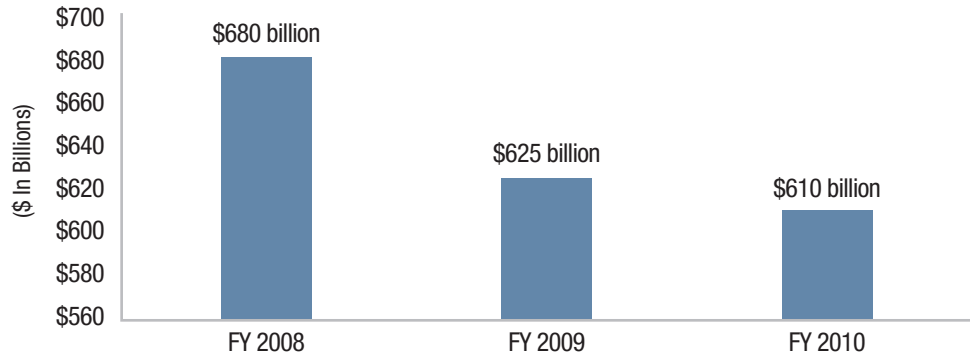
Significant volatility in states’ general fund revenue can pose problems for state budgets because so many programs and services, such as K-12 education, depend primarily on revenue in the general fund. In the past, general fund revenues have remained relatively stable from one year to the next and have generally portrayed a pattern of gradual increase. However, general fund revenues drastically declined in fiscal year 2009 by 8.0 percent, which was followed by a further decline of 2.5 percent in fiscal 2010. This decline of over 10 percent of general fund revenues over the two year period from fiscal 2008 to 2010 resulted in \$70 billion less for states at a time of peak service demands. (See Figure 11) While the Recovery Act helped to counter falling general fund revenues, the additional funds were not enough to meet increased state expenditure pressures.

MANAGING BUDGETS IN THE SHORT AND LONG-TERM

Budget managers have a number of methods designed to access existing funds, generate additional revenue quickly or reduce immediate expenses to fill budget gaps. (See Table 5) During recessions, political and economic parameters can often direct the focus of budgeting to a series of short-term financial management decisions. For example, fund transfers move money from one state account to another to increase liquidity, enhance budgetary flexibility and direct resources to the most critical areas to meet citizen needs and legal mandates. In general, however, states do not consistently achieve budget balance through such means, which generally only help fund a relatively small fraction of the overall budget.

Critics of state financial management refer to short-term budget management tactics as “budget gimmicks,” but such tools deliver effective solutions if utilized in moderation and can help states identify where lasting fiscal reforms are most needed. Over-reliance on short-term budget actions can lead to fiscal irresponsibility and undermine revenue and expenditure policies. For example, the increasing prevalence of tax amnesties over the past decade has been shown to encourage taxpayers to wait for

FIGURE 11. Aggregate State General Fund Revenue



Source: NASBO Fiscal Survey of States

the next amnesty rather than perpetually engage in voluntary compliance with the revenue system.⁵² However, when implemented sparingly short-term budget management tools, such as tax amnesties, can improve fiscal administration and reinforce structural reform efforts like tax compliance.



**STATE OF MICHIGAN
OPPORTUNITIES TO ENACT TAX REFORM
2011**

According to the Tax Foundation, “On January 1, 2012, the MBT was replaced with a flat 6 percent corporate income tax that was entirely free of tax preferences like credits for specific industries. This had the effect of catapulting the state’s corporate tax rank from 49th best (2nd worst) to 7th best, and their overall rank improved from 18th best to 12th best.”⁵⁴

Another reason why short-term budget solutions play a relatively small role in solving state budget gaps is that they tend to display diminishing returns. And repeated efforts to capture one-time gains from revenue and expenditure actions have proven even less effective in the sluggish recovery, which has not resulted in a rapid rebound in state revenues. The decline in federal revenues in the post-Recovery Act budget environment combined with slow growth has driven states to reexamine long-term changes to revenue systems because in many instances short-term solutions have proved inadequate. Revenue declines attributable to the recession have brought about increased debate on state tax issues unrelated to the recession, and for fiscal administrators an opportunity to usher in lasting reforms. Stable budgetary and program management can sometimes best be served in the long run by capitalizing on periods of budget volatility brought about by economic decline.

TABLE 5. SHORT-TERM BUDGET MANAGEMENT TOOLS⁵³

- Payment deferrals/delays
- Accounting changes
- Accelerated tax collections
- Tax amnesty programs
- Special fund balance draw-downs
- Fund transfers
- Contract renegotiations
- Fund transfers from unclaimed property
- Conservative revenue estimates
- Increase user fees, tolls and permits
- Agency cash reserves
- Unspent funds for capital projects
- Asset sale-lease backs
- Fund sweeps and fund swaps
- Interest from capital/special fund investments
- Debt restructuring/bond refinancing
- Furlough days for state employees
- Enhance tax penalties and audits
- Restructure funding formulas
- Capital project, maintenance and equipment purchase delays



STATE OF OREGON
REVIEWING TAX EXPENDITURES
2009

“The Legislature recently took the positive action of scheduling a portion of tax expenditures for elimination every two years with passage of House Bill 2067 in 2009. Tax expenditures are allocations of revenue that benefit individuals and businesses by allocating tax benefits to them. This revenue is in effect “spending,” but the revenue is never deposited into the General Fund. The legislative intent in taking this action was to provide a process for reviewing the tax expenditures to determine if they achieve the desired purposes or if changes would improve the results and benefits of allocating specific tax expenditures.”⁵⁵

Revenue declines in the Great Recession have prompted governors and state legislatures to reconsider structural reforms, such as expanding the tax base to capture advancements in the new digital and service based economy. Twenty-two states have made efforts to tax digital goods and services as broadly as the physical mediums for books, music, television/movies, games and software.⁵⁶

Additionally, more states are entering into agreements with large online retailers, such as Amazon, to collect and remit online sales taxes. Such efforts reflect state tax systems that have not advanced as quickly as consumer purchasing behavior. Many state and local interest groups argue that states have not proceeded quickly enough regarding issues like the taxing of online purchases, whereby current federal laws surrounding remote sales have left states unable to capture billions of dollars in annual sales taxes that are owed by consumers but not collected.⁵⁷

The fiscal shocks caused by the recession combined with a slow recovery have reminded state leaders that all sources of revenue remain vital and that there is a greater need for equity in sharing the challenges confronting state governments. State fiscal sustainability will remain difficult as long as state tax systems fail to capture revenue from the large portion of economic activity that is occurring in the service economy. Currently, service industries account for 68 percent of U.S. GDP and four out of five U.S. jobs.⁵⁸ Analysis of long-term economic and revenue trends is one way the budget office can help avoid service disruptions and widespread budget cuts. The recession has pushed states to look beyond the budget cycle, and consider threats to long-term fiscal sustainability.

For example, states have initiated greater efforts to re-evaluate tax expenditures and other forms of state spending through tax policy. Revenues foregone through tax breaks often support specific policies or encourage individual behavior, but this type of spending is often not transparent. State fiscal managers can increase spending transparency through tax expenditure reports; however, even with additional reporting, tax expenditures do not undergo an equivalent level of scrutiny as direct spending.

ADAPTING STATE REVENUE SYSTEMS FOR FISCAL SUSTAINABILITY

State legislators and executive leaders do not always respond to recommended solutions, but it is the job of the budget office to present options for structural change during periods of fiscal crisis. The budget office can effectively promote fiscal sustainability by communicating long-term projections and explaining how current tax and spending decisions will likely impact future budgetary choices. Revenue declines in the Great Recession have prompted governors and state legislatures to reconsider structural reforms, such as expanding the tax base to capture advancements in the new digital and service based economy. Twenty-two states have made efforts to tax digital goods and services as broadly as the physical mediums for books, music, television/movies, games and software.⁵⁶



STATE OF MICHIGAN
LONG-TERM FORECASTS
FISCAL 2012

“Effective for the fiscal 2012 budget, revenue forecasts are required to include 5 fiscal periods: the fiscal year in which the revenue estimating conference is being held and the next two ensuing fiscal years, plus revenue trend line projections for the next 2 ensuing fiscal years. In addition, the May revenue estimating conference must include expenditure forecasts for Medicaid expenditures and for human services caseloads and expenditures for the fiscal year in which the conference is being held and the next 2 ensuing fiscal years (Public Act 47 of 2011).”⁵⁹

CUTTING BUDGETS IN THE RECESSION

ADVANTAGES AND DISADVANTAGES TO BUDGET REDUCTION METHODS

“The big disappointment was that it was about shaving rather than eliminating programs, and now everything that was done before is still being done, just with less money. However, there is significant pressure to refund programs because they are still there, the actual programs were not cut.”

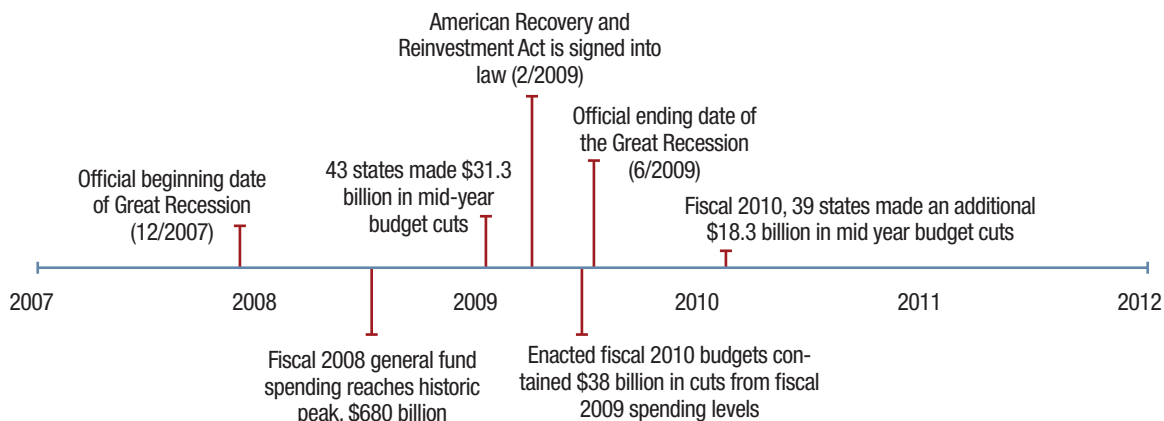
THE BUDGET CYCLE AND RECESSION TIMELINE

At the onset of the recession in December 2007, states were already in the middle of fiscal 2008, a historic peak in general fund spending and revenue. Budget proposals for fiscal 2009 were therefore formed in an environment of rising revenues and enacted before diminished tax collections revealed the onset and severity of the downturn. Throughout fiscal 2009, revenues declined so rapidly that state decision makers were not able to wait until the next scheduled legislative session to make important budget decisions. The primary mechanism to achieve budget balance in this scenario is mid-year spending cuts authorized either through executive authority or special legislative sessions. (See Figure 12)

Mid-year budget cuts are an important indicator of fiscal stress because they are evidence that states will not be able to meet previously set revenue collection forecasts. In fiscal 2009, 41 states made mid-year budget cuts totaling \$ 31.3 billion, far greater than mid-year cuts at any other point in the past 20 years. (See Figure 13) Tax increases and other revenue measures require more time for legislative deliberation and the collection process, which made them less prominent in the budget balancing process in fiscal 2009.

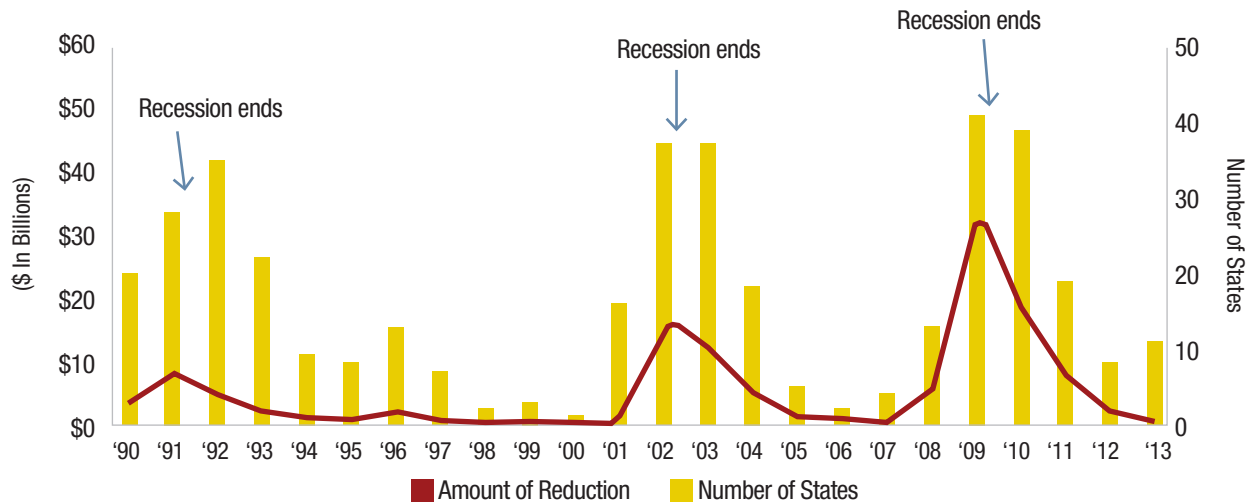
As the revenue situation worsened, fiscal 2010 budgets contained decreased spending authorization, reflecting more prudent expenditure plans as states developed a much clearer picture of the revenue situation. But the downwardly revised spending plans again proved to be inadequate, prompting 39 states to enact mid-year cuts totaling \$18.3 billion. General fund spending levels in fiscal 2010 were much lower than in fiscal 2009, and mid-year budget cuts were also significantly smaller. Mid-year budget cuts were also less in fiscal 2010 because the economy had begun to stabilize as the recession ended in June of 2009 and more Recovery Act dollars were available to states. State legislatures also had the opportunity to enact tax and fee increases and other revenue measures, which greatly reduced the level of cuts that needed to be made to reach fiscal balance. In fiscal 2010, state legislatures enacted tax and fee increases and authorized revenue measures totaling \$31.6 billion, raising more revenue than at any point in the last few decades.

FIGURE 12. Timeline of State Budget Cuts During the Recession



Source: Produced from NASBO Fiscal Survey of States

FIGURE 13. Budget Cuts Made After the Budget Passed Fiscal 1990 to Fiscal 2013



Source: NASBO Fiscal Survey of States

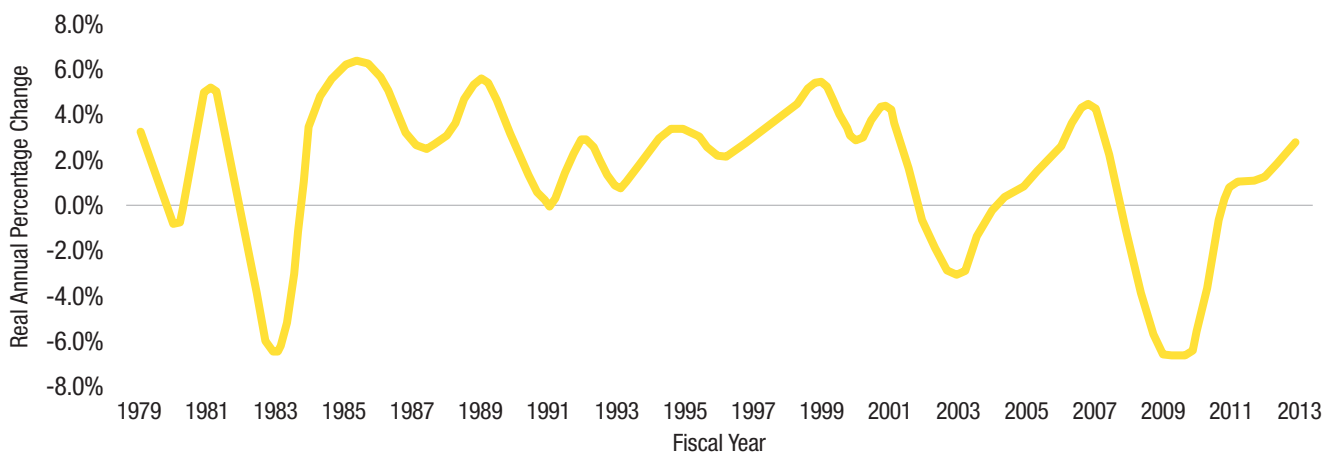
STATE BUDGETS HAVE A HISTORY OF GROWING

For nearly three decades, from fiscal year 1979 through fiscal year 2008, state general fund expenditures for the most part exhibited a normal, healthy pattern of growth, averaging real increases of 1.6 percent per year. (See Figure 14) Nominal annual budget increases averaged 5.6 percent over this same time period, indicating that in most instances, states could develop spending options by examining the prior year funding levels with the expectation that there would be deliberations around the margins. State budget officers have developed fiscal administration practices and budgetary solutions in response to resource constraints arising in an expansionary fiscal environment, whereby budget adjustments for programs and services are often incremental after accounting for inflationary pressures.

Nominal general fund expenditure growth had only slipped into negative territory once in the recent past, slightly by -0.7 percent in 1983, but rapidly increased by 8.0 percent as the national economy began to rebound in fiscal year 1984. (See Figure 15) Even during the post-9/11 recession and in the absence of federal support on the scale of the Recovery Act, state budgets exhibited nominal growth in 2002 and 2003.⁶⁰ However, in fiscal 2009 and 2010, general fund spending levels experienced outright declines for two consecutive years by -3.8 percent and -5.7 respectively.

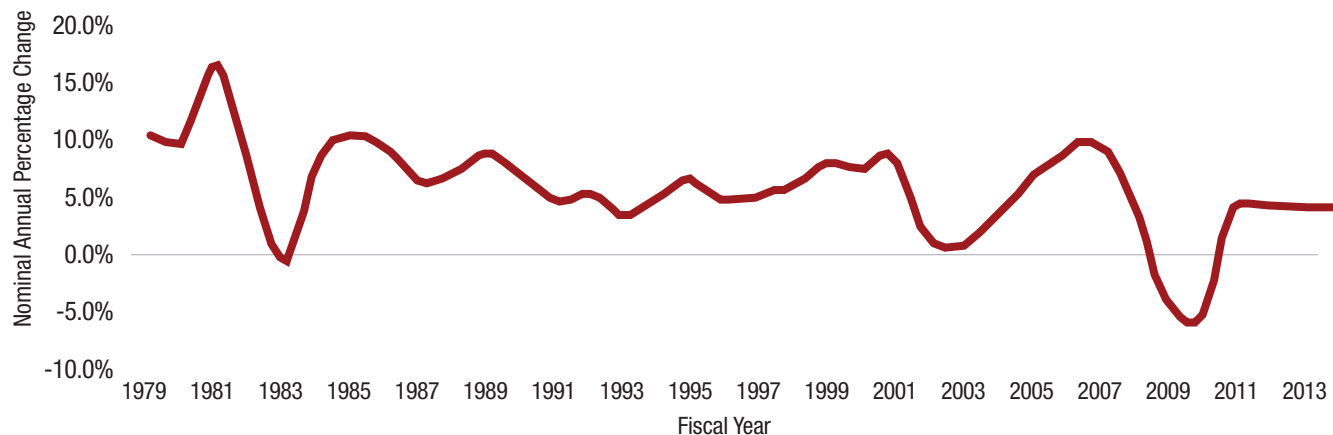
These drops in general fund spending marked the first occurrence of consecutive spending declines since 1979 when NASBO began tracking general fund data. In the past, budgets did experience volatility in the growth rate, but a slower rate of spending increases is much more easily aligned with the political processes of budgeting and agency funding needs than outright spending declines. Budget cuts that lead to negative levels of spending rather than merely decreased rates of growth demand significantly more financial and managerial considerations. The Great Recession caused a volatile fiscal environment for states leaving budget officers to recommend and implement massive budget cuts across program areas often considered politically sacrosanct, such as elementary and secondary school aid.

FIGURE 14. Real Annual Percentage Change in General Fund Spending (Average Real Annual Increase 1.6%)



Source: NASBO Fiscal Survey of States and the United State Bureau of Economic Analysis (state and local government) price deflators.

FIGURE 15. Nominal Annual Percentage Change in General Fund Spending



Source: NASBO Fiscal Survey of the States

*Fiscal 2014 is based upon governors' recommended budgets.



**STATE OF WASHINGTON
BALANCING THE BUDGET ON LESS
THAN 100 PERCENT
2009–2011 BIENNIUM**

“About 60 percent of the state’s General Fund spending is largely off limits—such as basic education, debt service and federally funded programs that have strict maintenance-of-effort requirements — for cuts. That means most spending cuts typically had to come from the remaining 40 percent of the budget.”⁶¹

“OFM had already finished its work on a supplemental budget and used it as a base for the across-the-board cuts. But instead of serving as a budget solution, the imposition of across-the-board cuts proved unworkable for a number of reasons:

- By having to cut everything by the same percentage amount, agencies had no ability to prioritize programs or services.
- Federal government spending requirements could not be changed.
- In some cases, the state needed to renegotiate contracts.
- Some across-the-board cuts—especially in areas such as state prisons and entitlement programs—were impossible without statute changes.”⁶²

NOT ALL AREAS OF THE BUDGET CAN BE CUT

A range of program areas generally not subject to budget cuts were reduced to the extent possible in the recession; however, large portions of state budgets still remained un-touchable. The effect of untouchable expenditures on the remaining areas of the budget means that some program areas receive a disproportionate share of the cuts. This is referred to as balancing the budget on less than 100 percent because the entire budget is not part of the balancing process. Across-the-board cuts can run into problems when contracts are in place, or when programs and services are required by federal mandates or state legal provisions. Entitlement programs, for example, are often set by formulae enacted in law. This results in areas of the budget receiving a disproportionate share of cuts because certain other spending priorities cannot easily be reduced.

ANALYZING ACROSS-THE-BOARD AND TARGETED CUTS

In most instances, states made multiple rounds of budget cuts during the recession. States also used both across-the-board cuts and targeted cuts at different times in the expenditure reduction process. For political, legal, financial, and programmatic reasons, there is no hard and fast rule for the best way to cut spending because reduction methods have advantages and disadvantages depending on the circumstance. Targeted cuts allow for more flexibility and smarter reductions, while across-the-board cuts are often more acceptable to agency personnel, the public, and other stakeholders.

Mid-year budget cuts can minimize the political consequences from cutting services, but cuts during budget enactment

allow for more transparency and debate. Some budget officers expressed a strong preference for involving the legislature in expenditure reductions and others indicated that budget cuts are more manageable under executive authority. The extent to when, where, and how much state budget officers can unilaterally make budget cuts under executive authority varies by state. State budget officers were asked to describe their use of targeted and across-the-board cuts during the recession, and the responses delivered a number of considerations that can help future budgetary decision-making in times of fiscal stress.

STRATEGIES USED TO REDUCE OR ELIMINATE BUDGET GAPS, FISCAL 2009⁶³

- 29 states reported the use of across the board percentage cuts
- 33 states reported the use of targeted cuts
- 23 states reported using both across the board percentage cuts and targeted cuts

Source: NASBO Fiscal Survey of States, Fiscal 2009



STATE OF KENTUCKY MULTIPLE ROUNDS OF BUDGET CUTS 2010–2012 BIENNIUM

“The Executive Budget calls for a continued reduction in spending in the areas of the government that have received up to 20% to 25% in spending cuts since fiscal year 2008. There have been six rounds of budget cuts and spending reductions since the middle of fiscal year 2008. Over \$900 million in spending reductions have been required to keep the General Fund in balance. This effort has twice involved the extraordinary action by the General Assembly outside the regular biennial budget process to enact legislation to balance the budget, actions that have likely never before taken place.”⁶⁴

Budget officers highlighted a number of advantages behind targeted reductions, which were often used in conjunction with across-the-board spending cuts. Targeted budget cuts allow for policy choices, can be less disruptive, and can eliminate non-essential services before tangential agency activities jeopardize core missions. Targeted cuts also promote agency recommendations for ways to reduce spending, which can lead to improved relations between agencies and the budget office as this process is more likely to require collaborative efforts to reach fiscal balance.

“We had a lot of help from agencies. We couldn’t use all their ideas, but we got a lot of usable suggestions. Our governor has authority to cut the budget mid-year and is not shy about using that authority. We’ve cut programs, furloughed employees, etc. Big money has been saved in the area of health finance by shifting Medicaid costs within the health system, changing what hospitals pay vs. what Medicaid pays.”

The sequence of targeted cuts vs. across-the-board cuts also varied across the states. Some states reported that targeted cuts were used first, followed by across-the-board reductions, while other budget officers provided an explanation for cutting across-the-board first and then further targeting cuts. There were justifications for using either method first or both at the same time depending on the goal of the budget reductions. Deciding what policies or

objectives are to be achieved through budget reductions can help budget officers and state legislatures determine an appropriate sequence of budget cuts.

“We started with targeted cuts on programs that were easy to reduce. As the recession worsened, we moved to an across-the-board reduction of each agency’s biennial budget, and ultimately reduced the biennial budget. Because these cuts came solely in the second year, however, it roughly doubled the cut in the annual budget.”

Reducing budgets through targeted cuts first allows for greater control and can minimize funding disruptions for agencies through calculated selection. However, delaying more substantial across-the-board cuts can put agencies under greater pressure if the revenue situation worsens. To hedge this risk many states reported that both reduction methods were used simultaneously to achieve immediate targeted savings with minimal disruption, while also incorporating across-the-board cuts where appropriate to position agencies for lower funding levels.

“We implemented across-the-board cuts (with specific exemptions like education and public safety) in addition to targeted cuts where greater savings could be achieved without impacting service levels, which was key.”

Across-the-board cuts are the quickest way to reduce aggregate expenditures even though federal and state mandates and other legal considerations generally prohibit true across-the-board reductions. States must also consider the financial implications of cutting programs that are funded with multiple funding streams, such as federal matching dollars. However, across-the-board



**STATE OF CALIFORNIA
STATE PROGRAMS ARE OFTEN EXEMPT
FROM BUDGET CUTS
FISCAL 2009**

“Major Exempt Programs from the Governors’ Recommended Budget, which needed to close a projected \$14.5 billion budget gap.”⁶⁵

- Constitutional Restrictions
- Debt Service/Lease Payments
- Homeowners Exemption
- Health and Dental Benefits for Retirees
- Proposition 42
- Contributions to Public Employees, Judges and Teachers Retirement Systems
- Impractical to Implement
- Medi-Cal Rates for Certain Long-Term Care Facilities
- State Hospitals
- Non-Proposition 98 Mandates
- Major Revenue Generating Departments (Franchise Tax Board and Board of Equalization)
- CalGrant High School and Community College Entitlement Grants
- Juvenile Justice Programs
- Health Care for Inmates
- Proposition 58 Budget Stabilization Account Transfer (fully suspended)
- Capital Outlay
- Undistributed Employee Compensation

cuts are beneficial in other ways besides ease of use. Across-the-board cuts minimize political infighting and communicate a message of shared sacrifice, appealing to the general public and public sector employees. Reducing agency budgets across-the-board can also immediately cap expenditures while allowing time for additional dialogue between appropriators.

“Our state started with across-the-board reductions and then backed out the ones that decision makers did not want to cut, which is easier than asking them to go through each appropriation and deciding how much to cut each one.”

Despite these positive features of across-the-board budget cuts, they often evoke criticisms because across-the-board cuts do not facilitate priority setting or encourage agencies to deliver recommendations on ways to save money. Across-the-board cuts can also be especially challenging to justify when too many exemptions are necessary for legal or political reasons. Furthermore, across-the-board budget cuts reduce critical services even as demand is increasing.

“We did not use across-the-board because it isn’t really across-the-board and is not policy driven enough.”

PROGRAM BUDGET CUTS VS. ELIMINATION

Once a program, board, commission or council is created through legislation or executive authority, it becomes very difficult to entirely cut the program or entity. Budget managers have many tools to reduce expenditures by shaving around

the edges; however, program elimination often remains elusive. This is because government programs and initiatives develop constituencies, such as service recipients, businesses, government employees and elected officials, all of which can find value in the activities subject to elimination. However, data-driven spending decisions can help states determine strong from weak claims on the use of public resources and help separate claims from constituencies. Avoiding program elimination poses real problems for creating effective institutional change and for realigning government to meet evolving citizen and service demands.

“The cookie has gotten smaller, we have nibbled around the edges, but it is still a cookie, and nobody has had the courage to take a bite out of it and make a change in government.”

If inefficient programs persist through periods of economic and revenue decline, once revenues begin to pick up, there are also expectations that these programs and initiatives will see a funding increase, which can drain resources that potentially could be put to better use. Steadfast spending during periods of fiscal stress can remove an opportunity to eliminate ineffective programs or boards. One budget officer recommended a solution to eliminate the spending momentum of boards and commissions that are no longer relevant.

“If possible, take away funding repeatedly over several years. If you slowly draw down the money they get, it makes it much easier to go back and eliminate them in the future.”

AREAS OF THE BUDGET NOT TO CUT

While an opportunity to reduce unnecessary expenditures accompanied the recession, some states reduced spending in areas that probably should not have been cut. Agencies or departments that collect, audit, or monitor revenue become more crucial when revenue is declining and expenditures are rising. Procurement officials and contracting officers still need to monitor vendors that carry out the functions of state government.

“The first thing that goes is contract monitoring when cuts are implemented but consultants all say that you have to monitor contracts.”

Deciding what operations and activities can be cut back when budgets are tight is difficult and varies by state. However, it remains clear that cutting budgets in some areas, such as contract monitoring, may leave the state vulnerable or position the state for increased spending. For example, cutting crime prevention and juvenile justice programs can potentially greatly increase corrections and public safety spending in the future. At the beginning of the recession, one state dramatically cut the number of auditors at the tax department and compliance with revenue laws decreased — costing the state significantly more than the savings achieved from reducing the auditor workforce. Seeking out cuts that are fiscally sustainable and offer a viable direction for reform over extended time periods is better budget management than focusing efforts on the short-term. Budget cuts that cannot be left in place due to mandated spending requirements or political spending expectations do little to promote long-term fiscal balance.

“We made cuts to places we knew would be sustained and are now giving some back.”

BUDGET CUTS ENTAIL MANAGING EXPECTATIONS

The ability of states to control costs and maintain fiscal balance does not only entail strategic budget cutting, but there is also commensurate efforts to managing expectations. As states continue to recover from the recession, there are known spending increases in particular areas of the budget, such as K-12 education, but there are also programs and services that likely will not be replenished to pre-recession levels. States’ recovery from the Great Recession is slow because economic growth is not as robust as in previous recoveries. Improving budgetary and fiscal communication between the budget office and vested stakeholders can help states react swiftly in times of fiscal crisis and maintain cautious spending plans in the ensuing recoveries. Some states, such as Montana, have automatic spending reductions required by statute, which can facilitate budget cuts with less debate.

The budget office has limited control over economic activity, revenue generation, and the factors that increase state spending demands. An understanding of how state revenues and expenditures respond to economic cycles can help reduce the lag-time between appropriate fiscal policy responses and current economic conditions. Frequently communicating actual revenue collections to prior revenue estimates can also be consistently communicated to state leaders and agencies to demonstrate the deterioration of state fiscal conditions. Budgetary flexibility also depends on state agencies’ communicating with the budget office and state policymakers. Well-informed agencies can recommend adequate solutions and slow spending more strategically by staying ahead of legislative sessions and by positioning operations for fewer resources. Communication with agencies can lead to bottom-up budget reduction recommendations, resulting in decisions that maintain program efficiency without compromising core service delivery. Utilizing agency recommendations can also improve collaborative efforts between agencies and the budget office, and strengthen budget justifications put before the legislature. As economic conditions change, managing budgetary expectations through enhanced communication can reduce budgetary instability, improve performance, and promote structural balance in times of extended uncertainty.



STATE OF MONTANA MAKING BUDGET CUTS AUTOMATIC FISCAL 2010

“Section 17-7-140, MCA, directs the governor to reduce general fund spending when the projected ending general fund balance for the biennium drops below a specified level - in this case 1 percent of estimated general fund expenditures for the biennium. This state statute acts as a “safety trigger” to maintain appropriate levels of fund balance, but at no time has the state operated with an estimated budget gap. In March 2010, it was forecast that fund balance may drop below the “trigger” and therefore, budget reductions were implemented.”⁶⁶

THE GREAT RECESSION SHAPES CURRENT STATE FISCAL TRENDS

Attributes of a Recession: “The trough marks the end of the declining phase and the start of the rising phase of the business cycle. Economic activity is typically below normal in the early stages of an expansion, and it sometimes remains so well into the expansion.”

— Announcement of June 2009 business cycle trough/end of last recession, Business Cycle Dating Committee, National Bureau of Economic Research. September 20, 2010.

Current state tax revenues and spending patterns mirror this description issued in the early stages of the Great Recession’s prolonged recovery. State budgets and revenue collections have ended the declining phase, and are undergoing a similarly slow improvement in lock-step with the tepid growth in the national economy. Economic growth has remained relatively weak throughout the four years since the recovery began, and according to the Congressional Budget Office, unemployment is expected to remain above 7.5 percent through 2014.⁶⁷ In the first year of the recovery, gross domestic product (GDP) rose at an annual rate 3.3 percent⁶⁸, a much lower growth rate than other post-war recoveries, and has since slowed to an annual rate of increase of 2.4 percent in the first quarter of calendar year 2013.⁶⁹

“The increase in real GDP in the first quarter primarily reflected positive contributions from personal consumption expenditures (PCE), private inventory investment, residential fixed investment, nonresidential fixed investment, and exports that were partly offset by negative contributions from federal government spending and state and local government spending. Imports, which are a subtraction in the calculation of GDP, increased.”

— United States Department of Commerce, Bureau of Economic Analysis. May 2013. News Release.

State fiscal trends indicate levels of growth similar to that in the national economy with recommended fiscal 2014 budgets rising by 4.0 percent from fiscal 2013. Although general fund budgets reflect continued fiscal stability for most states, spending growth is less than the historical average. The effects of the recession were widespread and lasting, which is why state budgets are still facing pressure. As long as the economy continues on a path of tepid growth and unemployment remains high, the outlook for state budgets will entail tough resource allocation decisions. Governors’ fiscal 2014 recommended budgets in 19 states still have nominal general fund expenditure levels below pre-recession highs, reflecting an economic recovery that remains uneven across the country.⁷⁰ Additionally, state spending in fiscal 2013 for the 50 states combined is still below the fiscal 2008 pre-recession peak after accounting for inflation. Aggregate spending levels would need to be at \$757 billion, or 8.3 percent higher than the \$699.2 billion currently estimated for fiscal 2013 to remain equivalent with real 2008 spending levels.⁷¹ The fiscal havoc caused by the Great Recession and continued deleveraging of households and businesses are still hampering state budgets, which remain below normal patterns of historical growth and reflect a degree of caution concerning the strength of the national economic recovery.

States are also now challenged with replenishing reserves, reinstating funds for effective programs that experienced cutbacks, initiating new capital projects and providing resources for new initiatives put on hold during the recession. Additionally, states face fiscal pressures from local governments still adapting to the historic decline in property taxes caused by the deterioration of the housing market. With these added demands and the expiration of Recovery Act funds, states will continue to experience budgetary difficulties. Capacity to meet these new challenges will also be constrained by the state government workforce, which remains thinly stretched after shedding 135,000 positions, or 2.6 percent, since peak levels in August of 2008.⁷²

Despite these challenges, increased revenues are relieving some fiscal pressure, and trends are moving in a positive direction, with 42 governors recommending higher general fund spending in fiscal 2014 compared to fiscal 2013. Recommended fiscal 2014 budgets also portray continued fiscal stability for states, a welcome advancement compared to the years immediately following the recession. As the economy gains traction, revenue improvement and successful cost controls will help strengthen state budgets, but full recovery remains elusive in many states.

CONCLUSION

States experienced substantial fiscal stress from the Great Recession, resulting in broad-based fiscal actions from all levels of government. Collectively, states responded to the Great Recession with greater reliance on rainy day funds, unprecedented additional federal aid, tax increases, budget cuts and a number of other budget stabilizing actions. This report provides an explanation of these fiscal responses from the point of view of budget officers. The research findings, budget officer commentary and recommendations indicate that state and federal responses to fiscal stress can be improved, especially by making policy changes that consider how current spending levels impact future spending commitments. The recession has also served as a much needed reminder to states that spending growth in good economic times should be coupled with fiscal reforms that guard against spending disruptions when revenues decline.

Acknowledgement that prior spending commitments cannot easily be undone elevates the importance of rainy day funds, which remain one of the most effective countercyclical tools. These specially designated state reserves were not sufficient to maintain budget stability during the recession. To avoid similar budget problems in future economic downturns, states should consider increasing the amount of funds held in rainy day accounts. Furthermore, building larger rainy day funds through an annual contribution limits spending for operating purposes, which also reduces future spending commitments. States can maximize the return on their rainy day funds by making strategic decisions about the timing and use of these reserves and by accounting for the budgetary risks involved with temporarily maintaining elevated spending levels. The recommendations from budget officers included in this report can help states analyze these risks and make decisions about how best to use reserves in periods of economic decline.

In recognition of state fiscal troubles and severe deterioration in the national economy in the recession, Congress passed the Recovery Act, which contained a combination of tax cuts, grants for infrastructure projects, and additional federal aid to stabilize state and local budgets. Most of the federal support used to stabilize state budgets was targeted towards Medicaid and K-12 education. The Recovery Act did help states achieve a degree of budget stability in the recession, but due to multiple policy objectives, the legislation was less effective than it otherwise could have been for states. States were confronted with competing demands—to spend additional federal dollars quickly while having to be under enhanced oversight and accountable for onerous reporting requirements—which complicated fiscal administration under the Recovery Act. Fiscal policies designed to stabilize state and local budgets can be better coordinated with those designed to achieve an economic stimulus and create new jobs. Budget officers also reported that elevated spending levels made possible by the Recovery Act also became problematic once the additional funds expired due to maintenance of effort (MOE) commitments that remained. Future federal aid packages designed to deliver immediate short-term relief could facilitate state budget realignments by allowing greater flexibility until revenues recover. States that best used ARRA funds avoided excessive immediate spending cuts, and also positioned programs and services for forward-looking budgets with lower levels of funding.

One-time funds, such as Recovery Act dollars, are an example of non-recurring resources that states used to maintain service levels, lessen reductions and avoid greater tax increases in the recession. One-time measures and nonrecurring resources that are used to solve budget gaps are not necessarily budget gimmickry as some contend. Rather one-time budgetary solutions are short-term financial management decisions that entail calculated risk, fiscal expertise and strategy to promote the optimal use of resources under political, legal and economic constraints. However, concern arises if states become over reliant on non-recurring resources and one-time measures that potentially forestall and intensify tough decisions of structural budget balance. The lessons from budget officers in this report indicate that state budgeting practices strive to meet immediate challenges while positioning expenditure patterns for future sustainability. Budget planning and foresight beyond the budget year can help guide and determine the extent to which structural reforms are reasonable in a given budget cycle.

To increase revenues in the recession, states eliminated exemptions, broadened tax bases, raised fees, limited deductions and increased tax rates. However, tax increases as a share of general fund collections were less in the Great Recession than in prior periods of economic decline. The majority of tax increases were targeted towards personal income and consumption, with more states increasing personal income taxes than sales taxes. A number of states that enacted tax increases did so on a temporary basis, and in some instances, this has resulted in continued fiscal stress as these tax increases face expiration and revenue growth remains slow.

The severity of revenue declines during the recession exemplified how state tax collections are over time becoming increasingly sensitive to changes in the national economy. This heightened volatility in state revenue collections is partly due to the behavior of

personal incomes and the types of income being taxed. A portion of collections from volatile taxes, such as capital gains or dividends, should therefore be deposited into a state's rainy day fund during good economic times. Revenue declines experienced in the recession also indicate that state tax systems have not kept pace with changes in the economy. State tax systems are failing to capture revenue from the large swath of economic activity occurring in the form of services. In order for states revenues to continue on an upward trajectory, states should consider targeting areas of the economy that are growing yet remain untaxed, such as services, online sales and digital goods.

Budgetary problems in the recession were also compounded by revenue forecasts that in most instances proved inaccurate due to a rapidly deteriorating economy. To improve fiscal preparedness, states can adjust forecasting models more frequently, better understand the assumptions built into revenue estimations, and compare actual revenue collections to estimations more often. Policies that enhance revenue estimation can improve the budget process because budgets are built on expected revenue not money already in the state's possession. States can also achieve better revenue certainty by tying temporary tax increases to economic conditions or revenue collections rather than the fiscal or calendar year.

When revenues failed to meet expectations during the economic downturn, the primary mechanism by which states achieved budget balance was through spending cuts. States made broad-based budget cuts at the time of budget enactment and mid-year. Due to legal mandates, entitlements, and political pressures, states have acquired less budgetary flexibility over time. This resulted in disproportionately large budget cuts in some spending areas such as public assistance and higher education receiving more than their fair share during the recession. Budget cuts were also in large part driven by the knowledge that Recovery Act funds could help replenish the state cuts.

States made multiple rounds of budget cuts, often using both targeted and across-the-board cuts. Reducing state government expenditures generally requires some combination of both methods because exemptions and political roadblocks can make true across-the-board cuts difficult. Conversely, targeted cuts allow for more policy driven spending cuts but require more time and political debate. Despite widespread cuts, budgets for most programs, services and boards were generally reduced rather than eliminated. As revenues recover, resources that could have been used to reform government have at times been used to refund inefficient programs or provide services that produce undesirable results. For some state budget officers this has proved frustrating, particularly for those expressing real need for government reform.

WHY ARE THE LESSONS LEARNED FROM THE DOWNTURN IMPORTANT NOW

The combination of slow economic growth, demographic changes, eroding tax bases, and rising long-term public sector liabilities such as employee retirement and benefit packages indicates an inflection point in state and local governments. Immediate budgetary challenges are being considered in relation to the financial cost of promised benefits and other long-term financial obligations more so than at any other period in recent memory. Greater emphasis on reforming states' long-term spending obligations is reducing structural imbalance risk for future state budgets even though states are still faced with current spending pressures. The Great Recession has made clear that while every state is unique, their budgetary challenges and linkages to the national demographic and economic trends are increasingly similar.

States are adapting long-term financial plans to account for an economy and population that are both maturing. Budgeting amid revenue and expenditure volatility as done in the recession presents difficulties that are distinct from the need to adapt to structural changes in the economy. For example, solving budget problems attributable to an aging service recipient population and public sector workforce is vastly different than building a healthy rainy day fund. However, a common theme pervades budget officer commentary, which is to make budgetary choices that reduce structural imbalance risk in upcoming budget cycles without enacting draconian cuts. The principle of gradual long-term fiscal sustainability can guide budgeting and fiscal administration practices during times of extreme fiscal uncertainty and in implementing policies for lasting fiscal reform.

The Recovery Act served to extend the available timeline for tough budgetary decision-making by sustaining state and local government budgets into the economic recovery. Now that many states are expecting a fourth consecutive year of general fund revenue and spending growth, there is time to debate long-term financial obligations, such as infrastructure planning, public pensions and the rising costs of health care and higher education. In the absence of a rapid economic recovery, there is also an opportunity for structural reform of state revenue systems to capture a greater portion of economic activity occurring in the service sector and online.

The lessons learned from the economic downturn cannot only help states in periods of budget instability, but these principles can also encourage long-term realignment for today's limited resource environment. Currently, a steady demand for public services persists, along with economic projections for possibly prolonged slower than average growth. This means that budget realignment must occur. States cannot afford to adopt a wait-and-see course of action on budgeting decisions and program reforms. In order to ensure that states continue down a path of fiscal sustainability, budgeting for current expenditures must not only consider current revenues but also account for future obligations.

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