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"WHEN IT RAINS IT POURS" - ONE YEAR LATER
A Second Look at Delaware, Indiana, Massachusetts, Michigan and Minnesota

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Introduction

Most states are enjoying the best fiscal health they have in years. Annual budget surpluses have been substantial in many states, and some states have accumulated growing fund balances. In these good times, it is worth asking whether states are making prudent choices in using their additional resources. One important question is whether states are preparing adequately for a time in the future when the outlook may be less rosy.

In March 1999, the Center on Budget and Policy Priorities published *When It Rains It Pours: A Look at the Adequacy of State Rainy Day Funds*. The report — which assessed the adequacy of each state's budget reserves to weather a recession similar to the one in the early 1990s — found that only eight states had enough "savings" in budget reserves and rainy day funds to maintain services through a future recession without raising taxes. These eight states were Delaware, Indiana, Iowa, Maine, Massachusetts, Michigan, Minnesota and North Dakota.[1]

Subsequent to the publication of *When It Rains It Pours*, five of the eight states have enacted tax cuts that significantly impair their ability to weather a future recession. Each of the five states enacted significant tax cuts in the 1999 legislative session.[2] Two of the five states have enacted additional tax cuts in 2000, and one of the five is in the process of considering an additional large tax reduction.

In each of each of the five states, available funds now are projected to fall short of the amount required to maintain spending in a future recession. As shown in Table 1, the projected

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[1] The study included 48 states; Alaska and Hawaii were excluded because they would have unduly skewed the state averages.

[2] For the purposes of this report, a significant tax cut is defined as a cut of more than one percent of revenues.

Table 1
Projected Recession: FY 2002-2004
Reserves as a Percentage of General Fund Expenditures Required to Weather The Next Recession and Difference Between Required Reserves and Available Reserves

Needed Reserves	**Shortfall with Enacted Tax Cuts**		**Shortfall with Enacted *and Proposed* Tax Cuts**	
	State	**Shortfall**	**State**	**Shortfall**
More than 25%	Delaware Michigan	4.1% 10.4%	Massachusetts	24.4%
20% to 25%	Indiana Minnesota	8.0% 9.0%		
10% to 20%	Massachusetts	2.7%		

shortfalls in the five states range from 2.7 percent of general fund expenditures in Massachusetts to 10.4 percent of general fund expenditures in Michigan. Moreover, if Massachusetts enacts the additional income tax rate reduction and other tax cut legislation currently under consideration, the projected shortfall would exceed 24 percent.

The methodology used in this report to determine each state's ability to weather a future recession is the same as that used in the Center's March 1999 report. State revenue growth is assumed to slow for three years, from the end of FY 2001 to the end of FY 2004. The three-year duration is similar to the pattern of lagging revenue growth in the recession of the early 1990s. Since the geographic pattern of a future recession may differ from patterns in past recessions, each state is projected to experience the average revenue decline in the recession of the early 1990s, adjusted for specific state circumstances such as tax cuts that are scheduled to phase in over the period of the projected recession. To simulate the maintenance of programs and services during the projected recession, general fund expenditures in each state are assumed to grow throughout the recession at their state-specific historical annual rate.

The budget reserve necessary at the beginning of the recession is calculated for each state as the cumulative three-year gap between projected expenditures and projected revenues. These required resources are compared to the amount a state has on hand in budget surpluses and "rainy day funds" at the beginning of the hypothetical recession. The difference is the projected shortfall. Note that the analysis does *not* adjust expenditures upwards to meet the increased need for government programs and services because of increasing unemployment and poverty during a recession. As a result, the analysis may understate projected shortfalls. (For additional information on the methodology used, see the box on page 8.)

Assessing Required Reserves

This report and our earlier report, *When It Rains It Pours*, project the gaps between revenues and expenditures states could face in the next recession, assuming the next downturn is on average the same severity and length as in the early 1990s. The reports also look at the amount of reserve funds each state would need to have on hand at the onset of the recession to weather the downturn without raising taxes, substantially reducing spending, or engaging in fiscal gimmickry such as shifting costs to other levels of government. It is true that historically few states have lasted through a downturn of any significant duration without utilizing tax increases, spending cuts, or fiscal gimmicks — and in many states it would be impossible, difficult, or even unwise to accumulate sufficient reserves to avoid all such actions. Nevertheless, this is an area where some reassessment of policies and laws may now be appropriate and necessary. To inform that process, this report builds on our earlier analysis of what it would take to finance government through the next recession without the "yo-yo budgeting" — tax increases and budget cuts during recession followed by tax cuts during recovery — that so often in the past has skewed budget priorities, interfered with efficient delivery of services, and deprived residents of needed services.

The analysis finds that the five states examined in this report would need reserves ranging from 11 percent to 28 percent of expenditures to maintain services though an economic downturn of the magnitude of the last recession, which sharply reduced revenue growth for three consecutive years. By the end of fiscal year 2000, the five states that are the focus of this report — Delaware, Indiana, Massachusetts, Michigan and Minnesota — anticipate reserves ranging from 8.6 percent to 23.5 percent of expenditures. However, in each of the states the amount of funds needed to sustain current spending during a three year recession exceeds the size of their current reserves.

The updated analysis finds that each of the five states — Delaware, Indiana, Massachusetts, Michigan, and Minnesota — has taken actions over the last two legislative sessions that has reduced its ability to weather a recession.

- **Delaware** enacted a large income tax cut in 1999 as well as several smaller tax cuts. At the same time, spending was increased significantly. As a result of the budget and tax changes, the resources Delaware would need to maintain services during the projected recession are estimated to exceed the state's current reserves by $95 million. Delaware went from having reserves that were 3.1 percent of spending more than would be needed during a recession to a projected shortfall equal to 4.1 percent of general fund expenditures.

- In 1999, **Indiana** reduced personal income taxes, enacted property tax relief, and increased spending at the same time. The tax reductions have reduced revenues below annual expenditure levels and, as a result, the state has been using its accumulated reserves to fund annual appropriations. In the March 1999 report, Indiana's reserves were projected to exceed recessionary needs by 4.8 percent of spending. As of the end of FY 2000, Indiana's reserves are projected to be 8.0 percent of spending short of the amount that would be needed to maintain services during the projected three year recession.

- In the March 1999 report, **Massachusetts** was found to have reserves approximately equal to the amount necessary to weather the projected recession without raising taxes or substantially cutting spending. As a result of the tax cuts enacted in 1999, Massachusetts would face a relatively small shortfall of 2.7 percent of spending in the projected three year recession. If Massachusetts enacts the income tax rate reduction and other tax cuts currently being debated, however, the state's projected shortfall would increase dramatically to almost 25 percent of general fund expenditures.

- Enactment of large, phased-in tax cuts in two successive years converted **Michigan**'s projected cushion of 8 percent of spending to a projected shortfall of 10 percent of expenditures in the hypothetical next recession. Michigan is phasing in a reduction of its personal income tax rate from 4.4 to 3.9 percent by FY 2004, and has enacted a gradual, complete phase-out of its major business tax. The annual cost of these tax cuts is projected to grow to $1.9 billion by FY 2004.

- **Minnesota**'s ability to weather a recession has worsened as a result of the enactment of tax cuts totaling more than $2 billion in 1999 coupled with spending growth of 9 percent between 1998 and 1999. The Minnesota legislature recently approved a one-time sales tax rebate costing about $650 million in FY 2000. The legislature also approved permanent tax cuts, including an income tax rate reduction and motor vehicle registration tax reduction, that will cost about $400 million beginning in FY 2001. The projected shortfall between Minnesota's reserves and what would be required to maintain services during a future recession is relatively large — 9.0 percent. Minnesota's projected shortfall would be much larger if the legislature had enacted a large phased-in tax cut instead of a tax rebate and permanent tax cuts that take effect fully in the first year. (See box on page 5).

While this analysis focuses on five states, it has implications for all states considering tax cuts during the current economic recovery. The states examined here are the ones that had the best ability to cope with an economic downturn before enacting tax reductions. The other states start out in a less favorable position and so need to exercise even more caution as they consider future budget actions.

As states consider their budgets for fiscal year 2001 and beyond, there are important choices to be made about the amount of funds that will be held in reserve and about the

Rebate vs Permanent Tax Cut?
States Should Consider the Form of Tax Cuts Carefully

If a state does enact a tax reduction, the decision on how to structure the tax cut — as a one-time rebate, a permanent tax reduction that takes effect in the year of adoption or a permanent tax cut that phases in over a number of years — has a significant impact on how a tax reduction affects a state's future ability to weather a recession.

A tax cut that is provided as a one-time rebate, such as Minnesota's $1.3 billion sales tax rebate enacted in 1999, has a relatively straightforward impact on a state's ability to weather a recession. One of the main determinants of a state's ability to maintain services when revenue growth slows during a recession is the size of the state's reserves — both fund balances and rainy day funds — at the start of the recession. When budget surpluses are used to finance a one-time tax rebate the state's reserves drop by an amount equal to the total cost of the rebate. This puts the state in a worse position to handle the fiscal impact of a recession by reducing the amount of resources a state has on hand at the start of the recession. A rebate, however, will not reduce annual revenue collections in the years following enactment and, thus, will have no further impact on the state's future ability to weather a recession.

Permanent tax cuts can affect both the size of a state's reserves at the start of a recession and the amount of annual revenue available in future years. The timing of permanent tax cuts is also important. A permanent tax cut can either take effect fully in the year it is enacted or can be phased in over a number of years. A tax cut that is fully effective in the year adopted is less likely to affect a state's ability to weather a recession than a phased-in tax cut. Because states adopt balanced budgets each year, a state's revenues after adjusting for the tax cut must be sufficient to cover the cost of on-going spending in the budget. When a state adopts a budget that is structurally balanced — that is ongoing revenues excluding surplus funds carried over from prior years are sufficient to finance ongoing expenditures — a tax cut that reduces revenues only in the budget year will be financed with offsetting revenue increases or spending reductions and, thus, will not affect the state's future fiscal balance.

Often, however, a state finances a tax cut by using a portion of its surplus funds from prior years as revenue. Indiana and Delaware have done this recently. In that case, the portion of the tax cut that is financed with surplus funds will serve to reduce the reserves a state has on hand to weather a recession. In addition, the state may face an ongoing gap between available revenues and ongoing expenditures and will continue to draw down reserves in future years even in good times.

A permanent tax cut that is phased in over a number of years such as the tax cuts recently adopted by Michigan and Massachusetts will have the largest impact on a state's future ability to weather a recession, because the full cost of the tax cut is masked. The first year of a phased-in tax cut will have the same impact as a tax cut that is effective in the year it is adopted; a state generally will take that impact into account when adopting its budget. However, problems are likely to arise in future years as the tax cut is phased in. The subsequent years of the tax cut increase the budget gap that a state will face during a recession. Each year of the recession, the reduction in revenues resulting from the economic slowdown will be compounded by the reduction in revenues from the next phase of the tax cut. Thus, a state will have less funds available to fund on-going services than if it were dealing only with the effects of the recession. Moreover, because these impacts are often not considered at the time a phased-in tax cut is enacted, a state is likely to adopt a larger tax cut than is fiscally prudent.

disposition of “surplus” funds that are not saved for future contingencies. As always, these choices have implications for the adequacy of current state services and for the distribution of the burden of paying for those services. But at this point in the long-running economic recovery, the choices also have particular significance for a state’s fiscal health during the next economic slowdown. The fact that tax cuts have had such a significant negative impact on those states that previously had the most adequate reserves serves to reinforce the conclusions of our previous report and to suggest others.

- Many states are considering enacting new tax cuts or accelerating the phase-in of previously enacted tax cuts. These states should consider how the tax reductions would affect the ability of the state to provide current programs over the next several years, under both healthy and adverse economic conditions.

- States that are considering tax cuts can better ensure that the full impact of these actions are accounted for by not phasing-in the tax reduction over a number of years. When for practical or political reasons tax reductions must be phased-in, they could be accompanied by provisions that suspend the phase-in if revenue growth slows or reserves drop below a specified level.

- Some 45 states have budget stabilization funds, commonly known as "rainy day funds." Not all states with stabilization funds have made adequate deposits to them; states could consider using the opportunity of healthy revenues to further shore up their funds. States lacking stabilization funds could consider creating such funds.

- General fund expenditures as a percent of income have declined since 1993 in about 20 states. Such declines suggest that state services may not be keeping pace with the needs of the population. States with declining expenditure levels could consider devoting some of their surpluses to improving public investments and services.

- Finally, states that used a variety of fiscal gimmicks in the last recession, such as requiring vendors to wait longer periods for payment or delaying tax refunds, could assess whether all those gimmicks have been reversed during the economic recovery. States that have not reversed fiscal gimmicks from the last recession could use a portion of surpluses to restore more standard fiscal practices. States that changed state-local funding relationships during the last recession could also reassess whether those relationships are still appropriate. These types of actions could leave state and local governments in a more fiscally responsible position and increase their flexibility during a future recession.

About the Data

This report is based on an analysis of state general fund revenues and expenditures from 1989 through 2000. The primary sources for this data were *Fiscal Survey of the State*s, a semi-annual publication of the National Association of State Budget Officers that provides information on state general fund budgets, and the budget and finance agencies of the various states. This report also uses information on the effects of legislated changes in state taxes to derive baseline revenue growth rates for the states. Annual issues of the National Conference of State Legislatures' *State Tax Actions* publication was used for data on these legislated changes, and in some cases state offices provided information on the effects of tax changes that are phasing in over the next few years. More detailed information on sources is given in the footnotes to Table 2.

This report uses data from national sources like NASBO and NCSL to provide consistent measures across states. As a result, the information in this report on revenues, expenditures, and surpluses may differ slightly from budget numbers used in specific states. In particular, states may now be using fiscal year 1999 figures that have been revised based on final accounting since NASBO published its *Fiscal Survey of the States* in December 1999. These differences should not, however, affect the import of the findings materially.

Background

State governments have distinctive fiscal structures that pose particular problems during economic recessions. As the economy enters a downturn, falling employment slows growth in state revenues, while rising poverty and unemployment increase the demand for state expenditures. Together, these effects create large budget deficits that disrupt the state budgeting process. Because most states have some form of balanced budget requirement, the economic disruptions often force states to enact large tax increases or spending cuts at a time when their residents are least able to deal with such measures.

The most recent recession began in July 1990. Although that recession was considered relatively mild and officially lasted only nine months at the national level, many states faced fiscal shortfalls beginning in 1989 and continuing into 1992. By the middle of state fiscal year 1991, 30 states faced a cumulative gap of nearly $15 billion between projected revenues and expenditures. As the national economy began to gather strength during state fiscal year 1992, state budget shortfalls persisted; some 35 states that had enacted balanced budgets faced mid-year deficits because revenues continued to lag behind projections, expenditures were higher than expected, or both. This budget turmoil defined a period that state finance experts call "the fiscal crisis of the states."[3]

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[3] For example, see: *The Fiscal Crisis of the State*s, Steven Gold, ed., Georgetown University Press, Washington, 1995.

Projecting Recessionary Deficits: Methodology Used in this Report

This report projects how each state's finances would fare if a recession similar in duration and severity to the recession earlier this decade began in the middle of the year 2001, which is the start of state fiscal year 2002.

This report assumes that the next recession will slow revenue growth for three years, from the end of FY 2001 to the end of FY 2004, analogous to the duration of lagging state revenue growth in the recession of the early 1990s.

Beginning with a balanced budget in FY 2001, each state's annual revenue growth from FY 2001 to FY 2004 is projected to equal 43 percent of the state's annual growth in the period of economic recovery from FY 1993 to FY 1999. Adjustments are made both to historical revenue trends and projected revenue trends to remove the effects of legislated tax changes. The 43 percent figure is based on the experience of states during the last recession; it is the ratio of total state revenue growth during the FY 1989 to FY 1992 period to state revenue growth from FY 1993 to FY 1998.

Each state is assumed to experience the same proportional slowdown. This assumption is made because there is no way to predict the economic sectors, and thus the types of taxes and other revenues, that will be most affected by the next recession. Similarly, there is no way to project the regional pattern of the next recession.

State general fund expenditures from FY 2001 to FY 2004 are projected to continue to grow at their historical annual rate, measured from 1989, the peak of economic growth prior of the last recession, to 1999. Maintaining the average historical expenditure growth rate would in most states allow maintenance of programs and services at their current levels, but would not account for any additional state expenditures necessitated by higher unemployment and poverty during the recession.

The budget reserve necessary at the beginning of the recession is calculated for each state as the cumulative three-year gap between projected expenditures and projected revenues. This is the amount a state would have to have on hand in budget surpluses and "rainy day funds" to weather the hypothetical recession without either raising taxes or cutting spending.

For additional information on the methodology used in this report, please see Chapter III of *When It Rains It Pours*, Center on Budget and Policy Priorities, March 1999.

States reacted to this crisis by raising taxes and cutting spending. From fiscal year 1989 to fiscal year 1992, states enacted over $27 billion in tax increases. At the same time, they cut or froze spending in many areas, often making dramatic reductions in income assistance and health programs for the poor. In a number of states, these tax and spending measures were adopted after the year's budget had passed, greatly disrupting the provision of state services. In addition, many states augmented deficit-closing tax increases and budget cuts by using budget "gimmicks," such as accelerating tax collections or deferring expenditures, and by shifting costs to local government. Shifts to local governments, in turn, often led to reductions in locally-provided programs and assistance. It was not until fiscal year 1993, when economic recovery spurred growth in their revenues, that states finally began to emerge from this crisis.

The fiscal crisis forced states to adopt these tax hikes, spending cuts and budget gimmicks in spite of the fact that states began the recessionary period with significant surplus balances. At the end of fiscal year 1989, they had nearly $12 billion in year-end general fund balances and "rainy day funds," equivalent to approximately 4.7 percent of their general fund expenditures. This balance was in line with recommendations from the National Conference of State Legislatures and Wall Street analysts that states keep five percent of their budgets on hand in preparation for normal economic contingencies. As large budget shortfalls rapidly depleted state surplus balances, however, it became apparent that the five percent reserve balance was not sufficient to counteract even the relatively mild recession of the early 1990s.

In the years since 1992, most states have reaped the benefits of the economic expansion. Strong revenue growth has allowed states to pursue a fiscal agenda of tax cuts, targeted spending increases, and accumulation of surplus funds. However, this fiscal agenda has been developed in the context of the currently healthy economic conditions. Very little attention has been paid to the impact of these policies on a state's ability to continue to provide the current level of services during an economic downturn.

Specifically, this report focuses on the impact of tax cuts enacted during good times on a state's ability to weather a recession. The report looks at five states — Delaware, Indiana, Massachusetts, Michigan and Minnesota — that were found to have adequate reserves in our previous report but have since enacted large tax cuts.

Results

Enacted tax cuts and changes in expenditure and revenue trends have weakened the ability of each of the five states analyzed in this report to weather a recession.[4] In Massachusetts and Michigan, the majority of the increase in the projected budget gap is the result of the enacted tax cuts that are phased-in over several years. In Delaware, Indiana and Minnesota, the combination of tax cuts and spending increases has weakened their ability to weather a recession.

The reserves that each state would require to maintain services during the projected recession are shown on Table 2. The budget gap shown for each state is the budget reserve that would be necessary at the beginning of the recession to weather the recession without raising taxes or cutting spending. This is the cumulative three-year gap between projected expenditures

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[4] For a comparison to the results from last year's report, see Table A in the Appendix.

Table 2
Projected Budget Gaps During FY 2002-2004 Recession

	Average Annual Growth Rates			Budget Gaps	
	Baseline Revenue Growth		Expenditure Growth	Total	% of FY 00
With Enacted Tax Cuts	**FY 93 - FY 99**	**FY 01 - FY 04**	**FY 00 - FY 04**	**(millions of $)**	**Budget**
Delaware	9.6%	4.1%	7.0%	636	27.6%
Indiana	6.5%	2.8%	5.3%	2,116	22.1%
Massachusetts	5.4%	2.3%	3.3%	2,245	11.3%
Michigan	4.2%	1.8%	2.2%	2,313	25.0%
Minnesota	6.7%	2.9%	6.5%	2,751	23.7%
With Enacted and Proposed Tax Cuts					
Massachusetts	5.4%	2.3%	3.3%	6,533	33.0%

Footnotes

The baseline revenue growth rates for FY 93- FY 99 and FY 01 - FY 04 represent revenue growth in the absence of legislated tax changes. States in which tax cuts are phasing in during the FY 01 **-** FY 04 period will have lower revenue growth than shown. The budget gaps reflect the impact of both the lower recessionary revenue growth rates and phased-in tax cuts.

The primary data source for the calculations in Tables 1-3 is NASBO data, with NCSL data used to adjust the revenue trends for enacted tax changes. Other data sources that were used include:

Delaware - Estimated costs of future tax reductions from Delaware Finance Office. Updated estimates of revenues, expenditures and fund balances for FY 2000 from Delaware Office of the Budget.

Indiana - Estimated costs of future tax reductions from Center on Budget and Policy Priorities analysis of the fiscal notes pertaining to the tax changes. Updated estimates of revenues, expenditures and fund balances for FY 2000 from the State Budget Agency.

Massachusetts - General fund revenue data FY 1993 to FY 1999 from Massachusetts Office of the State Comptroller. For consistency with NASBO figures, these revenues include general fund, local aid fund and highway fund revenues. Expenditure data FY 1989 to FY 1999 from Massachusetts Office of the State Comptroller. Updated general fund revenue, expenditure and fund balance data for FY 2000 from Massachusetts Fiscal Affairs Division. Estimated costs of future tax reductions from Massachusetts Department of Revenue.

Michigan - Estimated costs of future tax reductions from Michigan Department of Treasury. Updated estimates of revenues, expenditures and fund balances for FY 2000 from Michigan Department of Management and Budget.

and projected revenues.[5] Table 3 compares what each state would need to weather the hypothetical recession — the budget gap — with each state's total reserves — the sum of budget balances and rainy day funds. The shortfall shown is the difference between what states have and what they need.

By the end of fiscal year 2000, the five states that are the focus of this report — Delaware, Indiana, Massachusetts, Michigan and Minnesota — anticipate reserves ranging from 8.6 percent to 23.5 percent of expenditures. However, in each of the states the amount of funds needed to sustain current spending during a three year recession exceeds the size of their current reserves.

Based on actions already taken in 1999 and 2000, Michigan and Minnesota would face shortfalls of 10.4 and 9.0 percent in the projected recession, respectively. Indiana's shortfall would be about 8.0 percent. Delaware and Massachusetts would face smaller shortfalls of 4.1 percent and 2.7 percent, respectively.

Massachusetts is currently considering additional tax cuts. The impact of the proposed tax cuts would be to further weaken their ability to weather a recession. Massachusetts' shortfall would increase to almost 25 percent under the income tax rate reduction and other tax cuts currently being considered.

Delaware

In the 1999 legislative session, Delaware enacted a large income tax cut that included reducing income tax rates for all brackets, increasing the standard deduction, increasing personal credits, increasing the pension exclusion, and other tax cuts. The total cost of these personal income tax cuts and other smaller tax cuts is expected to be $34.4 million in FY 2000 and $94.4 million in FY 2001. Delaware also increased expenditures by over 10 percent from 1998 to 1999.[6] In fact, even if economic conditions continue to be healthy, Delaware's budget is expected to be out of balance in FY 2000 and FY 2001; annual expenditures are projected to exceed annual revenues.

The combination of tax cuts and spending increases has reduced Delaware's ability to weather a recession. At the end of FY 2000, Delaware reserves are projected to equal $541

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[5] The annual growth rates used to project revenues and expenditures are also shown in Table 2. These growth rates simulate the effect of a three year recession and were calculated using the methodology described in the box on page 8.

[6] National Conference of State Legislatures, *State Tax Actions*, 1999; National Association of State Budget Officers, *Fiscal Survey of the States*, December 1999.

Table 3
Projected Shortfalls During FY 2002 - FY 2004 Recession

	Budget Gaps (What States Need)		Total Reserves (What States Have)		Shortfall	
With Enacted Tax Cuts	FY 02 - FY 04 (Projected) (millions of $)	Percent of FY 00 Budget	FY 00 (Projected) (millions of $)	Percent of FY 00 Budget	Total (millions of $)	Percent of FY 00 Budget
Delaware	636	27.6%	541	23.5%	95	4.1%
Indiana	2,116	22.1%	1,350	14.1%	766	8.0%
Massachusetts	2,245	11.3%	1,705	8.6%	540	2.7%
Michigan	2,313	25.0%	1,353	14.6%	960	10.4%
Minnesota	2,751	23.7%	1,713	14.8%	1,038	9.0%
With Enacted and Proposed Tax Cuts						
Massachusetts	6,533	33.0%	1,705	8.6%	4,828	24.4%

million (23.5 percent of FY 2000 general fund expenditures). Total reserves in excess of 20 percent of a state's budget would normally be considered a more than adequate contingency against an economic downturn. However, Delaware is rapidly drawing down these reserves. In fact, the fiscal overview included in the Governor's FY 2001 proposed budget indicates that total reserves will drop from $577.2 million at the end of FY 1999 to $378.4 million at the end of FY 2001 — a 34 percent reduction in total reserves over the three-year period.

Delaware's level of reserves is not adequate to continue providing services at the current level during a recession. Delaware would need reserves of $636 million (27.6 percent of general fund expenditures) to maintain services during a three year recession. As reflected in Table 3, the resources that Delaware would need to maintain services during the projected three-year recession are estimated to exceed the state's current reserves by $95 million, or 4.1 percent of general fund expenditures. The resulting $95 million shortfall is not a large one compared to other states. Nevertheless, the state should proceed with caution as it considers future changes in taxes and spending.

Indiana

In the 1999 legislative session, Indiana reduced personal income taxes by increasing several deductions and also enacted property tax relief at a total cost of $222 million in FY 2000, growing to

$290 million by FY 2004.[7] As a result, similar to Delaware, Indiana's annual expenditures are projected to exceed annual revenues in FY 2000 and FY 2001 even if the economy remains steady.[8]

These large tax cuts along with growing expenditures have reduced Indiana's ability to weather a recession. Indiana would need resources of $2.1 billion (22.1 percent of FY 2000, general fund expenditures) to maintain services during the projected three year recession.

As of the end of FY 2000, Indiana's reserves are projected to equal $1.4 billion, (14.1 percent of general fund expenditures). However, due to the recently enacted tax cuts, Indiana is using these reserves to fund annual appropriations. The state's general fund statements indicate that total reserves were $1.7 billion at the end of FY 1999 and are projected to be $972 million at the end of FY 2001 — a 44 percent reduction in total reserves over the three-year period.[9]

Indiana's level of reserves is not adequate to continue providing services at the current level during a recession. As reflected in Table 3, the amount of reserves needed to maintain current services during the projected three-year recession are estimated to exceed Indiana's current reserves by $766 million, or 8.0 percent of general fund expenditures.

Massachusetts

In 1999, Massachusetts enacted several tax cuts, the largest of which was a reduction of the personal income tax rate from 5.95 to 5.75 percent over three calendar years.[10] The total cost of the rate reduction and other tax cuts is $116 million in FY 2000 growing to $565 million in FY 2004.[11] A plan proposed by the governor to further reduce the income tax rate to 5 percent over three years has been rejected by the legislature. If the legislature does not pass an alternative income tax cut that is

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[7] Center on Budget and Policy Priorities analysis of fiscal notes pertaining to tax changes.

[8] For additional information on the impact of tax cuts on Indiana's reserves see *Shattering Indiana's Piggy Bank*, Center on Budget and Policy Priorities, April 1999.

[9] Consistent with NASBO reporting, these reserve figures exclude the dedicated Tuition Reserve. The Tuition Reserve is the amount from the general fund reserved for the July tuition support distribution to local elementary and secondary schools.

[10] Four fiscal years.

[11] Massachusetts Department of Revenue. This analysis also incorporates the continued phasing-in of the capital gains tax cut that was enacted in 1994.

acceptable to the governor, the governor's proposal along with other tax cuts will likely be put by initiative on the November ballot.[12]

These large tax cuts have reduced Massachusetts' ability to weather a recession. To address expenditure needs during an economic downturn, Massachusetts has reserves projected to equal $1.7 billion by the end of FY 2000 (8.6 percent of general fund expenditures). The amount of funds that Massachusetts needs to a weather a projected three-year recession starting in the middle of 2001 is $2.2 billion. After factoring in the tax cuts that were enacted in 1999, Massachusetts' current resources fall short of what would be required to maintain services during the projected recession by $540 million or 2.7 percent of general fund expenditures. This shortfall is relatively small and would likely be manageable.

If the proposed tax cuts, however, are included in the analysis, the projected budget shortfall grows to $4.8 billion — 24.4 percent of general fund expenditures.[13] A budget shortfall representing almost one-quarter of the general fund budget would require dramatic tax increases or service reductions that would likely have a disproportionate impact on the state's most vulnerable citizens.

Michigan

In 1999 and 2000 Michigan enacted large tax cuts including the reduction of the personal income tax rate from 4.4 to 3.9 percent by FY 2004 and the phase-out of the state's major business tax — the Single Business Tax[14]. The total cost of the rate reduction and other tax cuts is over $500 million in FY 2000 growing to $1.9 billion in FY 2004.[15]

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[12] Additional tax cuts that will likely appear on the ballot include establishing a state income tax deduction for charitable contributions; establishing a non-refundable tax credit for tolls paid on the Massachusetts Turnpike, the harbor tunnels in Boston, and the Tobin Bridge; and establishing a non-refundable state tax credit for the auto excise tax, which is a property tax on cars paid to local governments.

[13] As shown in Table 3 Massachusetts' budget gap - the amount of resources required to maintain current service levels during the projected recession - increases dramatically from $2.2 billion to $6.5 billion when the proposed tax cuts are included in the analysis. This occurs because the proposed tax cut would be phased-in over three years. Thus, it would further reduce the state's revenue each year beyond the reduction resulting from slower revenue growth during a recession.

[14] The Single Business Tax rate is 2.3 percent and the phase-out will reduce the rate by 0.1% each year for 23 years.

[15] Michigan Department of Treasury.

These large tax cuts have reduced Michigan's ability to weather a recession. Michigan has reserves projected to total $1.4 billion by the end of fiscal year 2000 (14.6 percent of general fund expenditures).[16] The amount of funds that Michigan needs to weather a projected three-year recession starting in the middle of 2001 is $2.3 billion. The $2.3 billion needed exceeds current reserves of $1.4 billion by $960 million, leading to a budget shortfall during the projected recession of 10.4 percent of general fund expenditures. Michigan's 10.4 percent projected shortfall is significant and points to the potential fiscal problems caused by enacting large phased-in tax cuts.

Michigan's phase-out of the Single Business Tax includes a trigger. If Michigan's Budget Stabilization Fund drops below $250 million at the end of a fiscal year, the next year's reduction in the Single Business Tax would not take place. This analysis projects that the balance in Michigan's rainy day fund would fall below $250 million after the second year of the recession; the start of FY 2004. Consequently, we assume that the scheduled Single Business Tax reduction will not occur in FY 2004. However, even with the safeguards of a trigger Michigan still faces a significant shortfall during the recession. The required Budget Stabilization Fund balance of $250 million included in Michigan's trigger provision is not sufficient to prevent budget shortfalls in a recession.

Minnesota

In the 1999 legislative session, Minnesota enacted a one-time $1.3 billion sales tax rebate and several permanent tax cuts, the largest of which was a personal income tax rate reduction. The total cost of the permanent tax cuts is $835 million in FY 2000. The rate reduction was not phased-in, so the cost of the tax cut does not grow substantially beyond the first year. The Minnesota legislature recently approved a one-time sales tax rebate costing about $650 million in FY 2000. The legislature also approved permanent tax cuts, including an income tax rate reduction and motor vehicle registration tax reduction, that will cost about $400 million beginning in FY 2001.

Consecutive years of large sales tax rebates have reduced Minnesota's reserves. Minnesota has reserves projected to equal $1.71 billion by the end of FY 2000 (14.8 percent of general fund expenditures).[17] The amount of funds that Minnesota needs to a weather a projected three-year recession starting in the middle of 2001 is $2.75 billion. Thus the projected shortfall would be $1.04 billion, or 9.0 percent of general fund expenditures. This shortfall is relatively large and shows the potential problems caused by Minnesota aggressively using reserves to fund large tax rebates.

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[16] The amount of total reserves has been adjusted to reflect the impact of the additional tax cuts that were signed into law this year, including an acceleration of the personal income tax rate cut. These tax cuts, along with additional supplemental appropriations, will use the majority of the projected additional surplus funds resulting from improved revenue performance this fiscal year.

[17] The amount of total reserves has been adjusted to reflect the impact of the sales tax rebate that was recently passed by the legislature this year.

Conclusion

Currently, most states are enjoying the best fiscal health they have in years. Starting in the mid-1990s, states have seen strong revenue growth. In addition, many states have budgeted expenditures relatively conservatively. Indeed, a number of government programs that had been cut or eroded during the recession have not been restored to their pre-recession funding levels. As a result of these trends, most states have been experiencing substantial annual budget surpluses, and some have accumulated growing fund balances.

Many states have chosen to cut taxes over the last five years, and states continue to debate additional tax cuts. The decisions to use budget surpluses to finance tax cuts often appear to be based on the assumption — not generally explicit — that the good times will continue indefinitely. For much of the public and many state policymakers, the memories of the severity of the service reductions and tax increases required during the last recession have faded. In states with term limits, the majority of policymakers that were in office during the last recession are no longer involved. However, the next economic downturn is likely to bring a similar level of fiscal crisis and distress unless states are better prepared when the next downturn hits than they were in the early 1990s.

APPENDIX

Table A
Comparison of Budget Gaps

	Budget Gaps			
	May 2000 Report		March 1999 Report	
With Enacted Tax Cuts	FY 02 - FY 04 (Projected) (millions of $)	Percent of FY 00 Budget	FY 01- FY 03 (Projected) (millions of $)	Percent of FY 99 Budget
Delaware	636	27.6%	332	14.8%
Indiana	2,116	22.1%	1,253	14.9%
Massachusetts	2,245	11.3%	1,092	6.2%
Michigan	2,313	25.0%	444	5.1%
Minnesota	2,751	23.7%	1,958	17.2%
With Enacted and Proposed Tax Cuts				
Massachusetts	6,533	33.0%	NA	NA