Testimony Of

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Chairman Yarmuth, Ranking Member Womack, and members of the Budget Committee, thank you for inviting me to discuss the topic of strengthening the nation's fiscal toolkit. My name is John Hicks. I am the Executive Director of the National Association of State Budget Officers (NASBO). For almost 75 years, NASBO has been the professional membership organization for state budget and finance officers. As chief financial advisors to our nation's governors, NASBO members are influential decision makers in state government. They guide their states in analysis of budget options and formation of sound public policy.

I am here today to talk about the state budget officers' perspective on the federal fiscal response to states during recessions. As this Committee considers policy options on improving economic resiliency, an understanding of the recent past is warranted to inform preparations for the next economic downturn.

In my testimony, I will focus on the lessons that state budget officers learned from past two recessions, with particular emphasis on the severity of the great recession, the federal fiscal relief provided through the American Recovery and Reinvestment Act of 2009 (Recovery Act) and considerations for any future federal fiscal relief efforts during economic downturns. A number of the lessons learned are sourced from a 2013 NASBO publication, *State Budgeting and Lessons Learned from the Economic Downturn, Analysis and Commentary from State Budget Officers.*

Federal Fiscal Relief to States – the Predicate

Forty-nine states have a balanced budget requirement, while the final state balances its budget in practice without a formal requirement.[1] When state revenues fall short, spending cuts are the first and most prominent action taken. Other actions that states take to balance their budgets and address budget shortfalls include the transfer of other available resources to the general fund, tapping their rainy day fund reserves, and raising revenues, the latter most typically when fiscal conditions deteriorate for a multi-year period. The general fund is the part of the state budget where most tax revenues are collected and spent. Revenues in the general fund are comprised mainly of taxes on income and consumption. The personal income tax, the sales tax and the corporate income tax comprise over 80 percent of state general fund revenues. This structure is pro-cyclical; as economic conditions improve or worsen state general fund revenues react in alignment with those changing conditions. In other words, during an economic slowdown, state revenue collections often decline sharply.

These two factors, the balanced budget requirement and the pro-cyclical nature of state revenue structures cause states to cut spending and sometimes raise revenues when revenues weaken or decline, both which can worsen the impact of declining economic conditions.

The State Government Fiscal Condition – Fiscal Years 2008 through Fiscal Years 2012

As the United States unemployment rate began rising in 2008, state general fund revenues began to show weakness. Twenty states had revenue shortfalls by the end of fiscal 2008 (46 states' fiscal years end on June 30th) and 13 states had to make mid-year spending cuts to balance their budget.

Conditions worsened substantially during fiscal years 2009 and 2010. State general fund revenues declined for two consecutive years for the first time since World War II. The depth of the revenue declines was the deepest seen over that period. Over those two years, nominal state general fund revenues dropped about 11 percent (median). Almost one-third of states had two-year revenue declines in excess of 15 percent. The fiscal 2009 state budgets were acted on during the 2007 legislative session for 20 biennial budget states and in the 2008 legislative sessions for the other 30 states. The uncertain economic conditions at that time, especially during the 2008 legislative sessions, was evident in the revenue forecasts for fiscal year 2009, which turned out to be much too optimistic. Forty-one states made mid-year budget cuts in fiscal year 2009 and the same number finished the year with revenue shortfalls compared to their original, budgeted estimates.

The weakening of state fiscal conditions was also reflected by $256 billion in combined budget gaps between fiscal year 2009 and fiscal year 2011. Of this $256 billion, states solved $73.1 billion in budget gaps during fiscal 2009 and $111.8 billion prior to the enactment of their fiscal 2010 budgets to bring them into balance with drastically declining revenues. To help close these gaps, 43 states cut their enacted fiscal 2009 budgets by $31.3 billion and 36 states cut their fiscal 2010 expenditures by $55.7 billion. Additionally, 27 states enacted tax and fee increases of $23.9 billion for fiscal 2010. In contrast, tax and fee increases in fiscal 2009 were $1.5 billion along with $6.6 billion in additional revenue increases.[2]

Federal Fiscal Relief to States in the Last Two Recessions

State budgets have received federal fiscal relief in the last two recessions. Both the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Recovery Act of 2009 highlighted the legislative intent of stabilizing state and local government fiscal conditions, providing fiscal relief to states and to prevent or mitigate more significant spending cuts and tax increases.

The Jobs Growth and Tax Relief Reconciliation Act of 2003 was enacted by Congress in May of 2003. It provided approximately $20 billion to states for fiscal years 2003 and 2004. States received a flexible grant of $10 billion and an increase in each state's federal Medicaid matching rate that resulted in a little over $10 billion. States had to agree to maintain their Medicaid eligibility levels as a requirement for receipt of the funds. The flexible grant had to be used for purposes authorized by state appropriations. Both funding streams were used by states to limit the depth of spending cuts. During this recessionary period, fiscal year 2003 was the trough for general fund spending, declining by almost 1 percent (median). States contended with budget shortfalls in fiscal year 2002 without federal fiscal relief. Thirty-seven states made mid-year budget cuts totaling about $25 billion in that year. Most states enacted their fiscal year 2003 budgets before the passage of the Jobs and Growth Tax Relief Reconciliation Act in May 2003. The first half of the flexible grant to states was made available in July 2003, just prior to timing of closing the fiscal year's accounts. The second half was released a few months later during fiscal year 2004. The timing of the Medicaid assistance was similar. Total Medicaid spending in the states rose 12.8 percent in fiscal year 2002, 9.8 percent in fiscal year 2003, and 5.5 percent in fiscal year 2004. While federal fiscal relief primarily addressed state budget shortfalls in fiscal year 2004 with some late-year relief in fiscal year 2003, the budget shortfalls that states faced in fiscal years 2003 and 2004 exceeded the $20 billion in fiscal relief.

There were two primary state fiscal relief funding streams in the Recovery Act that were targeted to stabilize state budgets and to help address the increase in enrollment in the Medicaid program brought on by the recession. One was called the State Fiscal Stabilization Fund (SFSF). Its purpose was to relieve fiscal burdens on states and local educational agencies that have experienced a precipitous decline in financial resources. The allocation formula to states included 61 percent based on their relative population of individuals aged 5 through 24 and 39 percent on the basis of their relative total population. The second federal fiscal relief program was an increase in the federal share of the Medicaid program. Each state received a 6.25 percent increase in the federal share and a second element raised the federal share based on a state's level of unemployment. The SFSF provided $48.6 billion to states, the enhanced Medicaid federal share resulted in $99.3 billion, and the combined value was $147.9 billion. The time periods covered by these two programs included a part of fiscal year 2009, all of 2010 and 2011, and a part of 2012.

The scope of the federal fiscal relief provided by the Recovery Act was significant and provided a major level of assistance to state budgets. The two federal fiscal relief programs from the Recovery Act reflected:

- An average of 2.4% of General Fund spending in FY 2009
- An average of 8.7% of General Fund spending in FY 2010
- An average of 7.4% of General Fund spending in FY 2011
- An average of 1.2% of General Fund spending in FY 2012[3]

The level of state spending cuts and tax and revenue increases that were mitigated by the federal relief was substantial. Even with this relief, states still had to impose multiple years of spending cuts, drew down the bulk of their rainy day fund reserves, and took both temporary and permanent actions to raise revenues. The lingering effects of the great recession on state budgets lasted much longer than the official end of the recession, not unlike the slow decrease in the national unemployment rate.

Without this fiscal relief, elementary and secondary education, higher education and Medicaid would have incurred substantial spending reductions just so states could balance their budgets.

In addition, states had to agree to a set of maintenance of effort requirements with both the SFSF and the Medicaid programs. Elementary and secondary education and higher education funding by the states had to be maintained at their fiscal year 2006 levels through fiscal year 2011. Medicaid eligibility had to be maintained, as it had with the 2003 federal relief.

The Recovery Act provided fiscal relief quickly after its swift passage in February 2009. The funding for the SFSF program and the increased federal Medicaid share was initially made available to states early enough for states to incorporate into their mid-year budget balancing actions, as well as their preparations for the fiscal year 2010 budgets. Forty-one states had revenue shortfalls in fiscal year 2009 and the same number made mid-year spending cuts to balance. The beginning of the federal relief was closely aligned with the worst state fiscal conditions during that time.

State budget officers were significantly involved in implementing key elements of the Recovery Act a decade ago. The Recovery Act provided authority to each state's governor for the SFSF program. This ensured that the entire state budget was taken into consideration when arraying the SFSF funds across multiple fiscal years. That appropriately helped to achieve the primary purpose of the SFSF program and ensured that the fiscal relief mitigated serious spending cuts in states' education programs.

In addition to the two main federal relief programs, the Recovery Act provided funding in excess of $100 billion through 58 existing federal grant programs that are administered by states. Another $40 billion was made available through 89 competitive programs.[4] These funds did not provide budgetary relief to states but played a critical role in implementing the purposes of the Recovery Act. The urgency to spend money quickly to intended targets and with a degree of accountability and transparency previously unmatched reflected the importance of the federal-state relationship in addressing the great recession's impacts and the extraordinary efforts of state agencies, local governments, the many subrecipients, and the federal departments that governed these many programs.

Rainy Day Funds and Other Reserves – Use during Recessions

States have varying forms of rainy day fund reserves. The primary purpose is to be one tool to address revenue shortfalls during the fiscal year and in extreme cases, forecasted revenue shortages in the development of a new budget. Entering fiscal year 2002, 43 states had a balance in their rainy day fund reserves, representing 4.6 percent (median) of state general fund spending. The following year those balances were down to 2.0 percent of state general fund spending and 18 states had exhausted their rainy day funds. Entering fiscal year 2008, 45 states had a balance in their rainy day fund reserves. These balances represented about 4.9 percent of state general fund spending. That measure dropped to 1.9 percent by the end of fiscal year 2011 and 17 states had exhausted their balances. In fiscal year 2008, 12 states drew on their rainy day funds, in fiscal years 2009 26 states used their rainy day fund, and in fiscal year 2010 23 states drew down on their rainy day fund.

States used their rainy day funds, as well as federal fiscal relief provided during the last two recessions, as bridges to mitigate deeper spending cuts and tax and revenue increases. Rainy day funds are but one piece of a budget balancing plan that states use to manage budget shortfalls. Recognizing that both rainy day reserves and federal fiscal relief funds are one-time, non-recurring sources, they occur most often after spending cuts and other available resources are applied. No state sizes their rainy day fund so that these reserves alone are enough to make up for revenue declines in a recession.

Contending with the Expiration of Recovery Act Funds

Fiscal year 2012's budget was the first that states put together after the expiration of the two primary federal relief funding streams. The economic recovery was inching forward slowly. The unemployment rate remained above eight percent. Most states' nominal general fund revenues had not yet returned to fiscal year 2008 levels. Total state general fund spending in fiscal year 2012 was 2.5 percent less than in fiscal year 2008. Rainy day fund reserves had dropped to 2.8 percent of general fund spending. The most prominent budget actions taken across the country were adding funding to Medicaid to compensate for the return to the regular federal share, a 20 percent increase over fiscal year 2011, and spending cuts throughout state government with the largest reduction occurring in higher education, nearly 10 percent (Medicaid is the second largest general fund spending item in state budgets and higher education ranks third).

The slower economic recovery from the great recession compared to past recessions continues to have lingering effects on state budgets. As of the end of fiscal year 2018, about half the states still are not spending at their fiscal year 2008 level when adjusted for inflation, and fewer states when also adjusted for population growth. The number of state employees, excluding education, dropped by 183,500 workers during the great recession, 6.5 percent lower than the August 2008 peak. Only 63,900, or about one-third, has been added back to state government's workforce as of September 2019. Over half of states had unexpected revenue shortfalls as recently as fiscal years 2016 and 2017. In the last two years, the fiscal condition of states has improved. However, there are many state government programs that have not recovered their pre-recession level of state funding, as the highest priority areas of state spending have been the recipients of the marginal improvements over the last seven years.

Lessons Learned and What are States Doing to Get Prepared?

NASBO conducted a debriefing project that culminated in a 2013 NASBO publication, *State Budgeting and Lessons Learned from the Economic Downturn, Analysis and Commentary from State Budget Officers.* In addition, the NASBO special issue topic for the 2019-20 year has again focused on preparing for the next recession, state government fiscal resiliency and has convened two panel sessions at NASBO meetings. The lessons learned and recommendations below stem from that work.

The Recovery Act - What Worked?

-The Recovery Act greatly helped to alleviate state fiscal troubles. Without the Recovery Act, state budget cuts and tax increases would have been more substantial.

-The timing of the start of the two main federal relief programs aligned well with the most difficult state budget years of the recession.

-The majority of the Recovery Act funds were delivered to states through pre-existing federal grant programs and payment systems. This facilitated the speed of spending the funds and avoided roadblocks of uncertainty that new programs and rules create.

-The Recovery Act flowed the two main streams of fiscal relief through the governor of each state.

-The Recovery Act delivered the largest amount of federal relief to state governments through the Medicaid program. This decision served the dual purposes of targeting additional federal funds to the largest health safety net program when enrollments were increasing and the Act's intent of providing fungible dollars that prevented more severe budget cuts in other parts of state government.

-The flexibility of the State Fiscal Stabilization Fund and the options for meeting the maintenance of effort requirements allowed states to comply with the purposes in the Recovery Act and aided states ability to spend the allocated funds from this program. Providing states with the discretion on how much of the SFSF funds to use across multiple fiscal years achieved the goal of targeting the funds to education programs when they were most needed. It also acknowledged the different state legislative and appropriation cycles that states must adhere to.

-Federal-state communication was one superlative highlighted at NASBO's recent panel on this topic. The level and scope of communication, cooperation and transparency among the federal Administration, the Government Accountability Office and the states was well executed. Frequent calls with governors and additional layers of continuous contacts with state budget officers, federal agencies, the National Governor's Association and the National Association of State Budget Officers created an effective problem identification and resolution process. A lot of thought went into the implementation of the Recovery Act which was unique and necessary to make it work.

-Ray Sheppach, the former Executive Director of the National Governors Association, and one of the panelists at NASBO's Fall 2019 meeting, on lessons learned: "First, the top elected officials at the federal and state level must come together to set a cooperative and positive tone. Second, effective leadership requires constant communication, so that everyone is fully informed to ensure everyone has ownership in the mission...and lastly, build in the accountability system up-front before errors are made as opposed to after the fact."

-During the Recovery Act implementation the Government Accountability Office got out in front of their oversight mission and targeted issues early, allowing for timely troubleshooting and resulted in resolution instead of after-the-fact enforcement.

What Recommendations Do State Budget Officers Have?

-The Recovery Act had multiple policy objectives, including economic stimulus, job creation, and state and local budget stabilization. This resulted in somewhat conflicting goals. Competing or adjunct objectives within the assistance package made it difficult to navigate in some cases. One example was the SFSF requirements related to improving elementary and secondary education through a set of reform principles that states had to certify to receive the funds with a long trail of non-fiscal reporting by thousands of school districts.

-The new focus on counting jobs retained and created within the accountability provisions of the Recovery Act directed an important responsibility onto grant recipients whose skill sets and capabilities did not align that responsibility. This effort took a tremendous amount of administrative time when the scale of implementing the Recovery Act's additional and new funding already required extra effort. The tracking of job counts is better suited to a centralized entity that has the analytic capabilities to ensure uniformity of measurement across all states and all Recovery Act programs.

-The federal government successfully provided additional state aid quickly; however, state tax revenues lagged improvements in the economy and spending pressures persisted long after the economy had turned around. The timing of the expiration of federal aid during recessionary periods can be improved by targeting aid based on specific metrics rather than a fixed date or the broad measures of the end of an economic cycle. The majority of flexible Recovery Act dollars expired at the end of fiscal year 2011. The aftermath of state spending cuts once the SFSF and enhanced Medicaid funding expired raises strong considerations for avoiding fiscal cliffs when economic conditions and revenues have not recovered sufficiently. The timing of federal aid could be determined by triggers set by state revenue trends or economic indicators rather than the business cycle.

-States would be interested in temporary suspension or reduction of federal maintenance of effort requirements in times of fiscal crisis, or prolonged decline to increase state budget flexibility.

-Some studies of federal fiscal relief have mentioned the "moral hazard" of the federal government assisting states during economic downturns under the assumption that states will rely on that future assistance rather than make necessary preparations to ready themselves. While the last two recessions included fiscal relief to states, which recognized the size of the state and local governments sector in the economy, the evidence shows that in the last two recessions states began taking budget balancing actions prior to the passage of federal relief. The growth in rainy day fund reserves is additional evidence that states are making their own preparations.

-A greater level of sustained, institutional contact among federal, state and local government partners is warranted. The Recovery Act implementation served as a good example of effective communication. One recent example that would advance this idea is the proposed legislation by

Representative Connelly, HR 3883, Restore the Partnership Act, which proposes to establish the Commission on Intergovernmental Relations of the United States.

What are States Doing to Prepare for the Next Recession?

Currently, no state revenue forecast for fiscal years 2020 or 2021 includes an assumption of a recession. States are closely examining any warning signs of an economic downturn even when the unemployment rate is at a historically low rate. States have learned lessons from the past two recessions and continue to make improvements to their budget processes and practices as a result.

-The last recession challenged states' assumptions regarding the right amount of rainy day fund balances to hold in reserves. Rainy day fund reserve actions have been one of the most active areas of change in state budget processes. The median rainy day fund balance entering fiscal year 2011 was 1.6 percent of state general fund spending from a previous high of 4.8 percent just prior to the last recession. Most states have increased the size of their rainy day funds since the last recession. Despite the slow recovery from the recession, states have raised the level of their rainy day fund balances to an estimated 7.5 percent at the end of fiscal year 2019. A number of states have raised the maximum allowable balances of their rainy day fund. More states are examining the historical trends of revenue volatility and using that data to inform the appropriate size of their rainy day fund balances. A few states are directing revenue surpluses from their most volatile revenue sources, such as non-withholding personal income tax receipts, and higher than average corporate income and severance taxes, to their rainy day funds instead of budgeting those resources. There are eight states with less than 3 percent in reserve currently. There were 15 states with less than 3 percent in fiscal year 2008.

-Restoring structural balance to state budgets has been a priority for many states in recent years after recovering from the recession. Matching recurring expenses with recurring revenues has always been an important fiscal principle. Governors and state legislatures have shown a heightened emphasis on ensuring structural budget balance which reduces risk in advance of an economic downturn. Another process that states have taken which contributes to structural budget balance is long-term forecasting for periods beyond the immediate annual or biennial budgets.

-More states have begun a series of stress tests of their budgets under various economic downturn scenarios. The primary goal is to evaluate revenue impacts, but some also include out-year spending forecasts of programs where demand rises during recessionary periods in addition to demographicly impacted projections.

-States have exhibited a pattern of conservative fiscal behavior when warning signs of economic downturns appear. A number of governors are establishing expectations within their government of minimal spending growth in their fiscal year 2021 budget planning.

-In the last two fiscal years, some states have rolled back budgetary actions that were taken to make it through the great recession. These efforts not only put some "tools" back in the toolkit, they also support a structurally balanced budget. Pension reforms have been ongoing in most every state with most aimed at lowering the longer-term risk to state budgets.

Summation

State governments played an important role in the last recession through the Recovery Act. The federal fiscal relief built on some of the lessons learned from the 2003 response to the 2001 recession. The Recovery Act provided another case to evaluate and improve future actions. There were successes with past federal relief to states and there are areas that warrant adjustment and improvement. Examining and considering the lessons learned ahead of the next economic downturn is a wise undertaking and will serve our federalism structure well.

[1] Vermont is the only state without a balanced budget requirement but follows a balanced budget rule in practice.

[2] NASBO Fiscal Survey of States, December 2009.

[3] NASBO calculations using federal Recovery Act spending data and NASBO's *State Expenditure Report*.

[4] *State Policy Reports*, Volume 37, Issue 17, September 2019, Federal Funds Information for States.

[5] *How Leaders Can Navigate Recession, From One Who's Been There*, October 4, 2019, UVA Today.