THE RESEARCH ROOM
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WISCONSIN'S FISCAL HEALTH

Are We Ready for the Next Recession?

Be prepared. That short phrase is the motto of the Boy Scouts and the Girl Scouts. While we cannot predict everything that comes our way, we can always do more to prepare for the inevitable.

The same goes for government finances. History tells us the economy will, at some point, move into recession. As it does, consumers will become more cautious and workers will be laid off, resulting in fewer tax dollars to pay for government services. At the same time, demand for some government services will increase. If we want the state government to continue providing public services with as little disruption as possible, we must be prepared. That includes having sufficient reserves available for these "surprises."

An unprepared history

Two recessions devastated state finances in the early 1980s, resulting in cuts to some state programs and tax increases to fill budget holes. Due mainly to these events, the state created an emergency fund in 1985 to prepare for future recessions. Officially called the Budget Stabilization Fund, it is more commonly referred to as the state's rainy-day fund.

Unfortunately, it was not funded for the first 21 years. However, a little-noticed addition to the 2001-03 state budget created a mandatory funding mechanism. Whenever tax collections exceed budgeted amounts, half of the excess must be transferred to the fund. The transfer is not required once the balance reaches 5% of general fund spending.

This law was first triggered in 2007 when tax revenues exceeded budgeted amounts by more than $110 million. In the fall of that year, $55.6 million was transferred to the rainy-day fund. However, as the Great Recession commenced, the state soon faced a shortfall in the 2007-09 biennium.

Tax revenues during those two years came in $1.57 billion below estimates. This deficit was nearly 11% of 2009 budgeted spending. The recession lasted longer than expected, and tax revenues in 2010 were more than $200 million (2%) below budgeted amounts. The 2009-11 state budget was smaller than it would have been had there been no recession. If 2010 finances are compared to the budgeted amounts for 2009 (a conservative proxy for budgeted revenues had the recession not occurred), tax collections were 11% short.

A decade of saving

As the economy began to recover, tax collections in 2011 exceeded expectations by nearly $30 million, triggering a $14.8 million deposit that year. Six additional deposits have been made due to excess tax collections since then, four

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of which occurred from 2018 to 2021. The $967 million deposit in 2021 was the largest ever and pushed the fund over the statutory 5% threshold. No deposits have been made since then. The fund's balance is currently $1.9 billion, or about 8% of 2024 spending.

The additional good news is that since only half of the excess revenue flowed to the rainy-day fund, the other half remained in the state's general fund. At the end of fiscal 2023, the state had a general fund balance (or surplus) of $7 billion. Some of that was spent in the current budget, but the state is expected to end this fiscal year with a surplus of $4 billion.

Will we be prepared?

State finances have been in better shape over the past several years than at any point for at least a half-century. We have funded the Budget Stabilization Fund and expect a $4 billion surplus.

As the 2025-27 budget process plays out, there likely will be proposals to spend some of that $4 billion. Among the areas that have been put forth are tax cuts and additional spending for K-12 schools and child care. A case can be made for all of these. Indeed, Forward Analytics has written about the increase in referenda in school funding and the affordability challenges in the child care field. (Access the reports at forward-analytics.net.) When considering proposals, we must remember that this budget surplus is "one-time" money, not ongoing revenue.

We should also ask: If we use a chunk of these funds for one of the above proposals or another purpose, will we be prepared for the next recession? The answer is that we will be better prepared than we have been in the past but probably not fully prepared.

REVIEW THE REPORTS

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The Government Finance Officers Association recommends a minimum rainy-day fund of two months (approximately 16%) of spending. Moreover, recall that during the Great Recession, tax collections were short by 11% of annual spending in 2009 and another 2% to 11% in 2010. That supports the 16% GFOA recommendation.

Most states have taken the GFOA recommendation to heart. In 2023, rainy-day funds in 18 states exceeded the 16% threshold, and another eight exceeded 12% of spending. Wisconsin ranked 40th on this measure of preparedness.

What would it take to get to those levels? Although we don't know precisely what spending will look like over the next two years, it will likely be in the $23 billion range. That means it would take an investment of about $800 million to get to the 12% threshold and $1.7 billion to reach 16% of spending. At most, this would be less than half the $4 billion surplus.

This isn't a new idea. A 2022 Forward Analytics report on state finances, "Flush with Cash: Wisconsin's Growing Financial Reserves," suggested using some of the state surplus then to strengthen the rainy-day fund. Moreover, Gov. Tony Evers' 2023-25 budget requested an additional $500 million be allocated to the fund.

Fiscal prudence would say that we need to be fully prepared for the next recession first and then agree on how to use the remainder to benefit the citizens of this great state. ■

Forward Analytics is a Wisconsin-based research organization that provides state and local policymakers with nonpartisan analysis of issues affecting the state.