FLUSH WITH CASH

WISCONSIN'S GROWING FINANCIAL RESERVES

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Executive Summary

Flush With Cash: Wisconsin's Growing Financial Reserves

In 2007, as in each of the prior five years, Wisconsin state government had few financial reserves set aside to cushion its general fund should tax revenues fall during an economic downturn. The only states less prepared were Arkansas and Michigan. The next year, the Great Recession caused Wisconsin tax revenues to plunge, leading to unwelcome tax increases and spending cuts.

Fast forward 14 years and the state is flush with cash. At the end of the 2021 fiscal year, the state had $1.7 billion in its budget stabilization fund (rainy day fund) and a $2.6 billion general fund balance. Combined, state reserves totalled $4.3 billion, or 22% of annual spending. State officials are projecting reserves to rise to $5.6 billion by 2023.

There are two main reasons why state finances have shifted so dramatically. The first was a change to state law as part of the 2001-03 state budget that required half of excess tax revenues be deposited into the budget stabilization fund until the balance reached 5% of spending. Prior to that, no general fund dollars had been allocated to the fund.

Second, from 2011 through 2021, state tax revenues exceeded budgeted amounts in eight of 11 years. Cumulatively, excess tax revenues totalled $3.4 billion. Half of these dollars were shifted to the budget stabilization fund and the other half bolstered the general fund balance.

This improved financial position is welcome. However, the fact that the general fund balance accounts for 60% of 2021 reserves makes the total reserve figure somewhat precarious. Ten of the past 14 state budgets, including the current one, proposed to draw down the general fund balance to pay for state spending. Leaders from both major political parties have recently discussed ways in which these funds might be used now or in the next budget.

If the general fund balance is unreliable as a long-term cushion against recession, then the state might consider bolstering its budget stabilization fund, which is designed specifically for that purpose. Currently, the $1.7 billion in that fund is 8.4% of spending, above the 5% target in state law. However, most budget experts argue that a 5% target is too low. The Government Finance Officers Association recommends holding at least 16% of spending in reserve.

The state's experience during the 2008-09 recession supports this higher figure. In 2009, tax revenues were $1.5 billion, or 11%, below budgeted amounts. Over the ensuing two years, tax collections were an estimated $4 billion less than they would have been without recession.

Although not currently on the radar, a prudent use of some of the general fund balance would be to bolster the budget stabilization fund to an amount at or near the GFOA recommendation. This would ensure the state is well prepared for the next recession as state law restricts the use these dollars. And, it would still leave a general fund balance between $1.3 and $2.6 billion to use for other priorities.

Flush With Cash

Wisconsin's Growing Financial Reserves

Dale Knapp, Director

When the "Great Recession" of 2008-09 hit, Wisconsin was ill-prepared in terms of state government finances. Only Arkansas and Michigan were less prepared for recession than Wisconsin.

Governments "prepare" for recessions by setting aside some level of savings or reserves to supplement declining tax revenues during an economic decline. The 2008-09 recession led to the unemployment rate more than doubling between early 2008 and mid-2009 and caused two-year declines in both state income and sales tax collections. With few reserves, the state had to raise taxes and cut programs to balance the next two budgets.

Since 2013 (fiscal year), Wisconsin's financial health has improved significantly. State tax revenues have soared, particularly of late, causing reserves to increase significantly. As of June 2021, state reserves, and thus state preparedness, were at record highs. This change of fortune is a welcome reprieve from more than a decade of insufficient funds available to weather a recession.

Reserves are now 22% of state spending, above the 5% target of Wisconsin's rainy day fund and higher than the 16% recommended by the Government Finance Officers Association (GFOA). This raises questions for state policymakers:

- What level of reserves should the state target as sufficient to be prepared for the next recession?
- If that target is less than the 22% the state currently has, how should the excess reserves be used?

These questions will not be addressed this year. However, barring a significant recession, lawmakers will likely begin addressing them next spring as they deliberate on the 2023-25 state biennial (two-year) budget.

UNDERSTANDING STATE RESERVES

When discussing state finances in Wisconsin, the focus typically is on the state's general fund. Proceeds from the individual and corporate income tax, the state sales tax, taxes on alcohol and tobacco, and several other smaller taxes are deposited into the general fund. Those dollars are then available for any expenditure agreed upon by the state legislature and governor.

The fiscal health of Wisconsin's general fund can be measured in several ways, some more complicated than others. This report focuses on state reserves, which are the sum of the general fund balance and the budget stabilization fund.

General Fund Balance

The general fund balance is the amount of available funds that go unspent in a year. It is akin to the ending monthly balance in a checking account. At the end of a fiscal year, this balance carries over to the next year as dollars available to spend.

A minimum required general fund balance is set in state statutes. Historically, required balances have been either a percent of spending or a set dollar amount and have been small. From 1985 until 1995, with the exception of two years, the required balance was 1% of gross appropriations. Beginning in 1996, it was 1% of the sum of gross appropriations and compensation reserves (dollars set aside for increases in state compensation).[1] In 2001, the percentage was increased

1 *For ease of exposition, the remainder of this report will refer to this sum as spending.*

Wisconsin's rainy day fund, called the budget stabilization fund, was created in 1986 without any funding. The first major deposit did not occur until 2007.

to 1.2%. The required reserve was eliminated for 2002 before being reinstated at 1.2% for 2003.

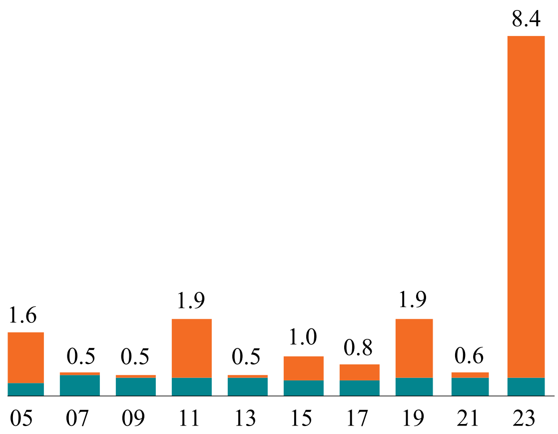
Since 2004, the requirement has been a specific dollar amount:

- 2004 and 2005: $35 million and $40 million, respectively.
- 2006-2017: $65 million each year.
- 2018 to present: $70 million in 2018 and increasing by $5 million each year. In 2022 the required amount is $90 million.

While these were the amounts required in state law, lawmakers often budgeted higher balances. However, even with these additions, ending balances were typically small.

In each of the nine biennial budgets from 2003-05 through 2019-21, budgeted ending balances were less than 2% of spending (see Figure 1).

FIGURE 1: Budgeted General Fund Balances
Required (Teal) & Additional (Orange), % of Spending



In six of the nine, ending balances were 1% of spending or less.

The 2021-23 budget was an outlier to the previous nine. However, the large budgeted balance (8.5% of spending) was not due to lawmakers purposefully padding the ending balance. Rather, as discussed below, 2020 and 2021 tax revenues significantly exceeded expected amounts. Thus, rather than a 2021 ending balance of 0.6% of budgeted spending, the actual ending balance was 13.2% of spending. That balance was carried over into the 2021-23 budget where some of it was used to fund ongoing spending.

Budget Stabilization Fund

Maintaining a healthy general fund balance is one way to remain prepared for a recession. Historically, though, Wisconsin has been poor at maintaining balances sufficient to replace lost revenue during recessions.

Most states, including Wisconsin, maintain a separate "rainy day fund," the sole purpose of which is to supplement general fund revenues during economic downturns. An important feature of most rainy day funds is a restriction on when such funds can be spent.

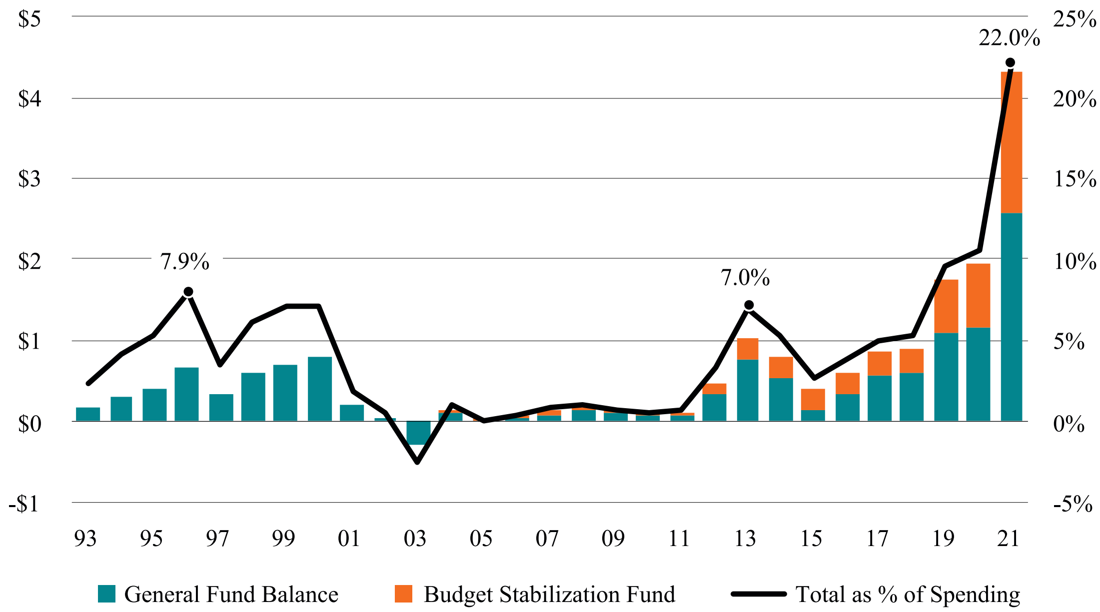
Wisconsin's rainy day fund is called the budget stabilization fund and was created during a special legislative session in early 1986. State statutes restrict spending of stabilization fund dollars to times "when actual state revenues are lower than estimated revenues."

While the fund was created in 1986, no state funds were put into it. In fact, the only deposits over the ensuing 21 years were small individual donations and, after 2003, net revenues from the sale of surplus state land or buildings.

The 2001-03 state budget (2001 Wisconsin Act 16) made a significant change to the budget stabilization fund. It required that, subject to a few limitations, in years in which general fund tax revenues exceed amounts budgeted, half of the excess must be deposited into the budget stabilization fund. That requirement set the stage for multiple deposits, some large, over the past decade.

The first deposit resulting from this law change occurred in 2007 when $55.6 million was added to the fund. Less than a year later, nearly all of the money was returned to the general fund to

FIGURE 1: Wisconsin General Fund Reserves
By Type ($ Billions) and Total as % of Spending



address a revenue shortfall in the 2007-09 state budget.

The next deposit, albeit a small one ($14.8 million), was made in 2012. Since then, six deposits have occurred due to the requirements of 2001 Act 16, including transfers of $321.7 million in 2019 and $967.4 million in 2021.

FISCAL FLUCTUATIONS

Wisconsin's fiscal preparedness, measured by the sum of the balances in its general fund and budget stabilization fund, has fluctuated since the early 1990s. With no deposits to the stabilization fund until 2007, the state's readiness to withstand a recession in prior years depended solely on the size of the general fund balance.

Boom to Bust

State tax revenues rose rapidly from 1992 to 2000, increasing an average of 7.1% per year. This growth exceeded expectations in most years and the state's general fund balance climbed from $74 million in 1992 to $806 million, or 7.1% of spending in 2000 (see Figure 2).

That large ending balance was short-lived as it was drawn down in the 1999-2001 state budget,[2] due largely to a one-time $700 million tax rebate.

2 Budget bill 1999 Wisconsin Act 9 and companion 1999 Wisconsin Act 10, which was enacted following a special legislative session after the governor vetoed parts of the budget bill.

When a recession hit in early 2001, the state had little cushion to deal with a large budget deficit. By 2003, the state's general fund balance was in the red at negative $282 million.

The state had opportunities over the next several years to replenish the general fund balance as revenue growth was strong, averaging 5.5% annual increases from 2003 to 2007. Despite this growth, little was set aside to cushion the state budget during the next recession. The exception was the required deposit to the stabilization fund in 2007 that was quickly spent the following year as the 2008-09 recession commenced.

With few reserves and tax collections falling, the state struggled to balance its 2009-11 and 2011-13 budgets. The result was unwelcome tax increases and spending cuts.

Return to Fiscal Health

As the state dealt with fallout from the 2008-09 recession, its fiscal health continued to be precarious. However, as the economy recovered, the impact of the 2001 budget stabilization fund change was felt. Unexpected increases in tax revenues in 2011 and 2012 led to transfers to the stabilization fund of $14.8 million and $108.7 million, respectively.

Over the ensuing nine years, state tax collections rose an average of 4.2% per year despite major

In 10 of the last 14 budgets, lawmakers and governors have drawn down the general fund balance to pay for ongoing expenditures

income tax reductions.[3] In six of those nine years, tax collections exceeded budgeted amounts. Deposits to the state's stabilization fund ranged from $33.1 million in 2018 to $967.4 million in 2021. In that year, the fund's balance was more than $1.7 billion, or 8.8% of spending.

At the same time, general fund balances generally increased. The state ended 2012 with a general fund balance of $342 million. Two years later, the balance had more than doubled to $759 million. The state spent most of that during 2014 and 2015. As tax revenues exceeded budgeted amounts from 2016 to 2021, the general fund balance rose from $136 million in 2015 to $2.6 billion in 2021.

Taken together, the budget stabilization fund and general fund balance increased from $102 million in 2011 to $4.3 billion 10 years later. As a percent of spending, total reserves climbed from 0.7% to 22.0%.

Looking Ahead

The 2021-23 state budget, as approved last summer, proposed to spend down the general fund balance by nearly $850 million, from $2.52 billion in June 2021 to $1.67 billion in June 2023. The budget would have reduced total state reserves to 17.1% of spending.

However, that potentially changed in January 2022 when the state's Legislative Fiscal Bureau updated its revenue estimates for the biennium. In that report, the bureau said it expected tax revenues over the two-year budget cycle to be $2.5 billion more than budgeted and spending to be $339 million less than budgeted. Should that occur, the state would end fiscal 2023 with a general fund balance of $3.9 billion and total reserves of $5.6 billion, or 28.1% of annual spending.

Whether the state ends this budget cycle with 17% or 28% of spending in reserves, it is better positioned than ever to deal with an economic downturn. Yet, the total reserves percentage should be viewed cautiously. Wisconsin has a long history of spending down general fund balances on programs or tax cuts.

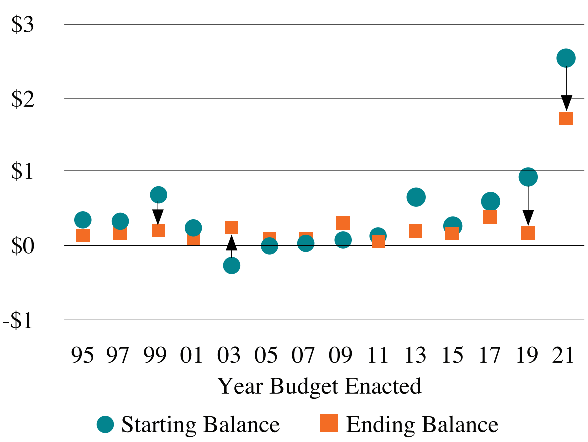
In 10 of the past 14 budgets since 1995, the state used some of the general fund balance to pay for its spending (see Figure 3). The four exceptions were the budgets enacted in 2003, 2005, 2007 and 2009. In these budgets, it was virtually impossible to spend down the balances as the starting balances were negative, below the minimum amount required by state law, or barely above that amount.

This history highlights the unreliability of that portion of state reserves. It also informs the question of what lawmakers ought to do with a portion of the state's large general fund balance.

A SURPLUS OF OPTIONS

Following the bureau's revised revenue estimates, leaders of both major political parties expressed interest in using some of the general fund surplus, either this spring or in the next state budget. Governor Tony Evers (D) issued Executive Order #156 that called for a special session of the Legislature to take up a plan to spend $1.7 billion of the state's balance on tax relief and education funding. Legislative Republicans rejected his

FIGURE 3: Most Budgets Draw Down Balances
Starting and Ending Budgeted Balances, $ Billions



3 *Without the tax cuts, growth would have averaged more than 5% annually and tax collections in 2021 would have been an estimated $1.7 billion higher.*

plan, with some saying they preferred to wait until the spring 2023 budget deliberations and use the money for long-term tax reform.

With the special session lasting only moments and the legislative session now over, the issue of the general fund balance will be on hold until spring of 2023 when 2023-25 budget deliberations begin. Lawmakers will have many available options for those dollars.

General Guidelines

While the state Legislature has free reign to use the general fund balance on anything it pleases, fiscal prudence suggests some guidelines.

The general fund balance has grown over the past decade due to tax collections increasing more than expected, with the largest excesses occurring over the past several years. History tells us that this is not likely to continue; future collections likely will be more in line with budgeted amounts. Thus, the balance should be viewed as one-time money.

One-time money is typically treated differently than ongoing revenues. The Pew Charitable Trusts noted in a recent letter to state officials in Colorado regarding uses of their American Rescue Plan Act funds that: "A general principle of state budgeting...is that states shouldn't use one-time money to increase ongoing expenses to a level that is unsustainable over the long term." In other words, it is often unwise to spend one-time dollars on continuing programs that require ongoing funding.

Strengthen the Budget Stabilization Fund?

While not currently on the radar, a further strengthening of the budget stabilization fund might be a wise use of some of the general fund balance. Shifting dollars from the general fund to the stabilization fund does not create an ongoing financial commitment and will help to ensure the state is better prepared for the next recession.

The question then becomes: What is an appropriate balance in a rainy day fund? Wisconsin's experience during the 2008-09 recession can be used as a guide for determining what reasonable reserves might be.

In 2009, tax collections were $1.5 billion less than the amount budgeted. That $1.5 billion was 11% of budgeted 2009 spending. The recession's impact on tax revenues continued in subsequent years. Collections in 2010 and 2011 combined were an estimated $4.0 billion less than they would have been had the recession not occurred. In fact, it took four years for tax revenues to return to 2008 levels.

State reserves are not meant to eliminate a recession's impact on state finances. Rather, they are meant to lessen the need for drastic spending cuts or tax increases. Wisconsin's history during the 2008-09 recession supports recommendations by budget experts that state reserves should be 16% or more of state spending.

While Wisconsin is at that level in total reserves, most of that is in the general fund balance, which is unreliable as long-term financial protection against recessions. Legislators and governors have consistently spent down these balances in state budgets.

Two actions would immediately strengthen Wisconsin's ability to withstand the next recession. First, increase the state's budget stabilization target from 5% of spending to 15% or more of spending. This would not make Wisconsin an outlier in terms of a relatively high rainy day fund target. Rather, Wisconsin would join 21 other states with targets at least that high or with no restrictions on rainy day fund deposits.

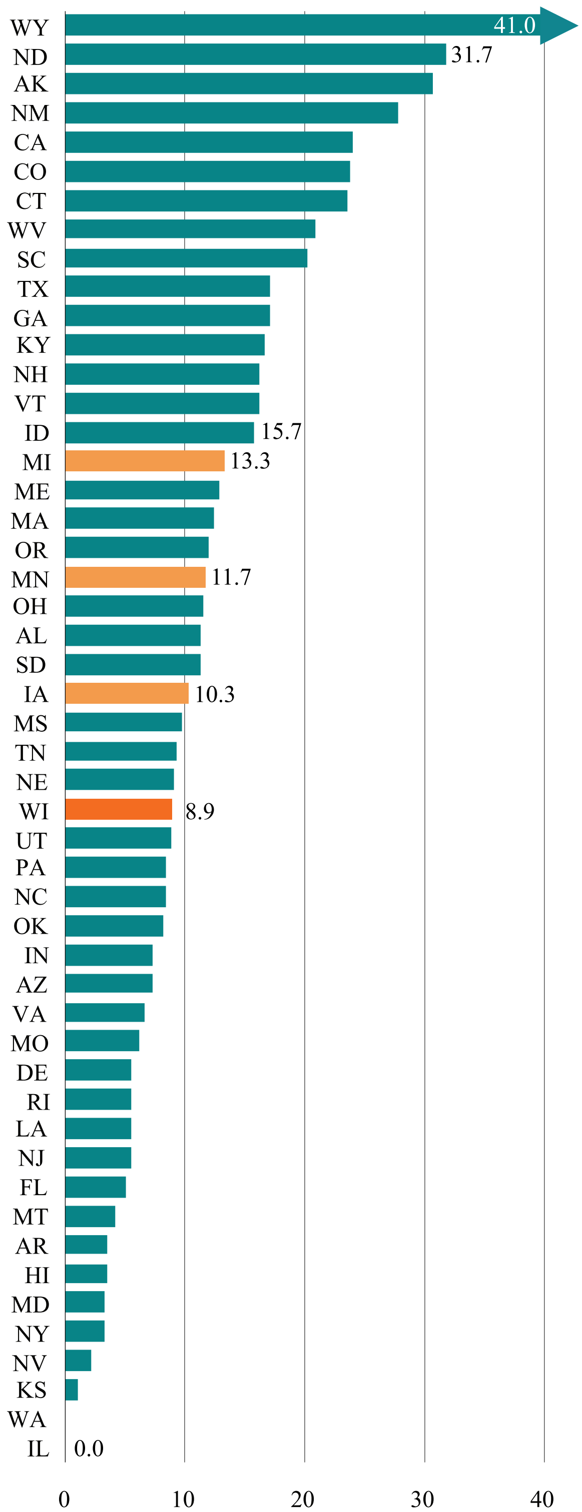
Second, the state now has a sufficiently large general fund balance that it could shift at least $1.25 billion of those dollars to the budget stabilization fund. Wisconsin would join 15 other states as the most prepared with rainy day fund balances of at least 15% of spending (see Table 1 on page 10).

A third action would help ensure a sufficient balance once the budget stabilization fund is used during a recession. In the 36-year history of the fund, lawmakers have never voluntarily appropriated dollars to the stabilization fund. Transfers have only come via the state law on shifting excess tax collections. Lawmakers might consider some level of mandatory annual appropriations to the fund until it again reaches 15% of spending or whatever target is chosen for the fund.

These actions would leave a 2023 ending balance of $1.29 billion if tax revenues and spending are as budgeted. The ending balance would be $2.6 billion if revenues and spending are as forecasted by the Legislative Fiscal Bureau in January. In both scenarios, there will likely be a high balance that could be used for other priorities.

Table 1: Rainy Day Funds by State

% of Spending, 2021



Source: "The Fiscal Survey of the States," National Association of State Business Officers, Fall 2021.

Secondary Options

Broadly speaking, the other options for using the general fund balance are (1) tax cuts or rebates, (2) one-time funding of a state need, or (3) one-time funding of a local (school, municipal or county) need.

Leaders of both major political parties have discussed tax relief as a possible use of some of the general fund balance. Using these dollars to provide tax relief should adhere to the same principles discussed above. It should not create unaffordable future obligations. Thus, one time tax rebates, which can be structured in a variety of ways, are preferable to permanent tax cuts which have long-term revenue impacts.

Space limitations preclude examination of pressing state or local needs for which these dollars might be used. However, lawmakers would be wise look closely at the cost of each project and the estimated return on that "investment."

CONCLUSION

An unexpected surge in state tax revenues over the past decade has allowed the state to greatly improve its financial condition. Total reserves now top 22% of spending, a number which may increase by the end of the next fiscal year. This level of financial reserves is unprecedented over the last 30 years.

That said, there are reasons to be cautious. Research from the state's Department of Workforce Development shows that within the next few years inflation-adjusted per capita income will likely slow significantly. Since general fund taxes ebb and flow with incomes, this will put pressure on state revenues, making it unlikely that reserves will climb much further.

In addition, the general fund balance accounts for 60% of current state reserves and potentially 67% by 2023. General fund balances have a long history of being spent, making these funds unreliable as long-term insurance against recession.

At 8% of spending, the balance in Wisconsin's budget stabilization fund is at its highest level ever. Yet, it is only half of what is recommended by many budget experts.

Wisconsin has a unique opportunity to fully fund its rainy day fund so it is prepared for the next economic downturn. And, it will still have dollars available to fund critical state or local needs.

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