TENNESSEE'S BUDGET MAY NOT BE READY FOR THE NEXT RECESSION

Tennessee is likely to face a recession at some point during Gov.-Elect Bill Lee's time in office. Economists' predictions for when that recession will start range widely, but there's broad consensus that it's coming.

The question is, will Tennessee's budget be ready when the next recession strikes?

As one economist with Moody's recently told the publication *Governing*, "now's the time [for states] to make sure you're in a good position when that time hits."

KEY TAKEAWAYS

- Recent stress tests found Tennessee may not have enough rainy day reserves to withstand the next recession without tax hikes or spending cuts.
- In the last two recessions, TennCare and SNAP enrollment started growing several months before tax revenues began to fall.
- Tennessee's main rainy day reserves now offer about 40% less cushion than before the Great Recession and are about $300 million shy of the statutory target.
- Recession readiness helps states use recovery periods to move forward instead of digging out of recession-related holes.

Stress Tests Show Budget Vulnerability

Three recent analyses found Tennessee may not have enough rainy day reserves to withstand a moderate to severe recession without raising revenue or cutting spending. While none of the reports suggest an imminent recession, Tennessee policymakers may want to consider recession readiness as they work on the state budget in 2019.

University of Tennessee economists project the state's reserves may be enough for a modest recession but would be exhausted quickly during a severe recession. To prepare, they suggest continuing to build reserves, maintaining the state's current revenue structure, and limiting growth in spending.

Moody's projects Tennessee would need $1.3 billion of reserves in a moderate recession and $2.2 billion in a severe recession to offset the drop in tax revenue and growth of TennCare spending. For context, the state held $1.0 billion in its two main rain day reserves at the end of FY 2018. Tennessee was among 23 states positioned to weather a moderate recession almost or entirely on reserve balances alone.[i]

S&P projects Tennessee's reserves would only offset 69% of the fiscal shock in a moderate recession and 58% in a severe recession. S&P's report considered only how states would weather the first year of a recession and doesn't account for Tennessee's TennCare reserves, which currently represent about 20% of Tennessee's combined rainy day resources (TennCare Reserves + the Reserve for Revenue Fluctuations).

TennCare Enrollment May Reveal the Next Recession

Moody's suggests that Medicaid spending is likely to spike ahead of revenue declines when the next recession strikes. According to their report, in 2008 "there was at least one person in nearly every state who knew, or should have known that we had entered a recession […]: the state Medicaid director."

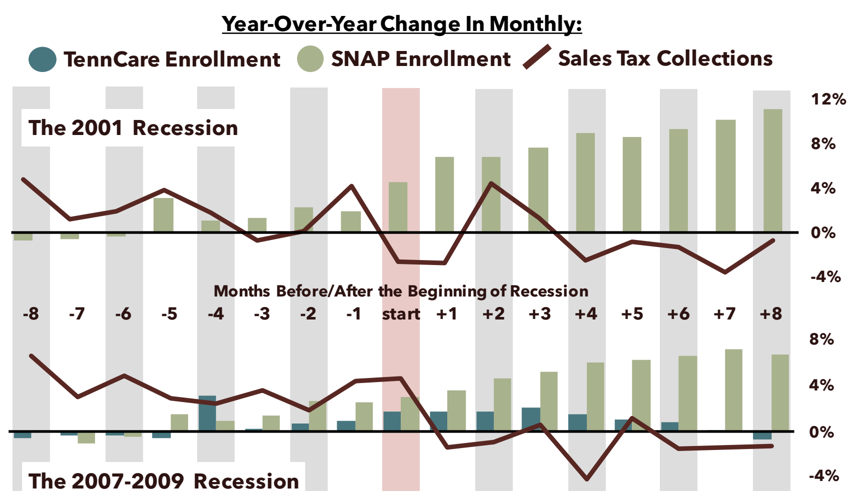
When unemployment rises and incomes fall, more people typically enroll in state- and federally-funded programs to bridge the gap. For example, TennCare (the state's Medicaid program) may see enrollment grow particularly among working-age adults with children who have lost access to or the ability to pay for private health insurance. Likewise, enrollment grows in the Supplemental Nutrition Assistance Program (SNAP, formerly known as food stamps) as more households lack the funds to maintain food security.

During recent recessions, TennCare and SNAP enrollment started to rise several months before sales tax collections faltered. Enrollment in the SNAP and TennCare started growing about 5 months before the last two recessions began (**Figure 1**). State sales tax collections began to decline closer to the beginning of each recession. While monthly TennCare enrollment data were unavailable for 2001, there is significant overlap in SNAP and TennCare eligibility.

FIGURE 1. TENNCARE AND SNAP ROLLS GREW BEFORE REVENUE FELL IN LAST TWO RECESSIONS

TennCare and SNAP enrollment started to increase about 5 months before each recession began.

Sales tax collections began to decline closer to the beginning of each recession.



Note: Data are displayed as year over year change (e.g. Apr 2007 vs. Apr 2006) to adjust for seasonal patterns. Sources: The Sycamore Institute's analysis of TennCare's Monthly Enrollment Reports (1), USDA's Monthly SNAP Data (2), and the Tennessee Department of Revenue's Monthly Collections Spreadsheets (3)

Tennessee's Rainy Day Fund

Tennessee's main rainy day reserves are the Reserve for Revenue Fluctuations and the TennCare Reserve. The Reserve for Revenue Fluctuations is specifically for unexpected changes in revenue collections. The TennCare Reserve is a separate fund that holds excess dollars for TennCare. In dire situations, the legislature can make the TennCare Reserve available to shore up both TennCare and the larger General Fund.

The combined balance of Tennessee's two main rainy day reserves will exceed $1.1 billion by the end of FY 2019, according to official projections. (1) (2) In nominal terms, that is the largest amount in years (about $61 million shy of FY 2007 levels).

In terms of purchasing power, the Budget has about 40% less cushion than before the Great Recession. In FY 2007, the combined balance was enough to cover just under 42 days of General Fund operations. In FY 2019, the combined balance would cover just over 26 days. In other words, Tennessee would exhaust these reserves about 37% faster than before the last recession.

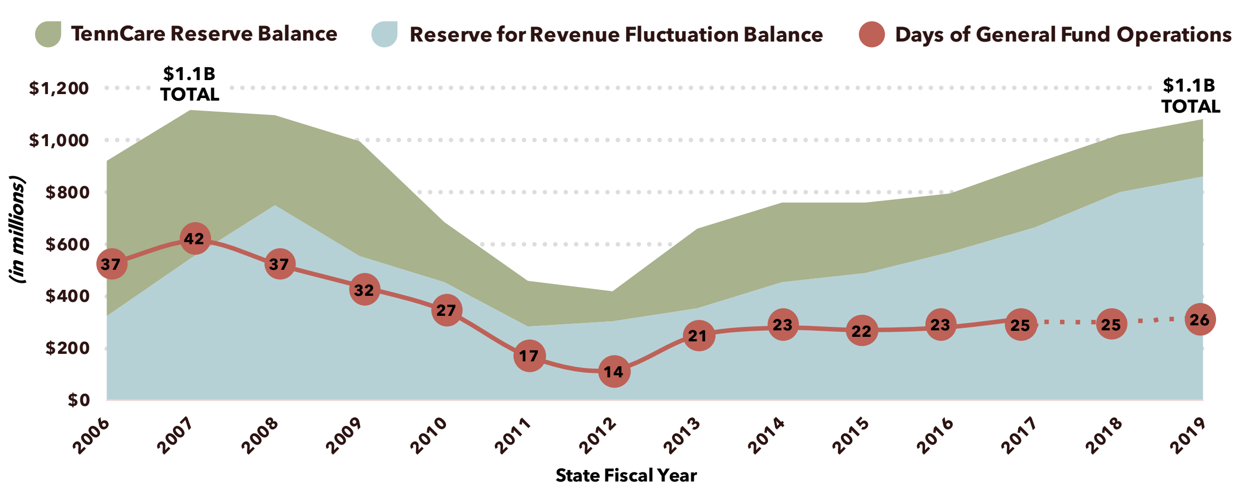
Tennessee updated its laws governing the Reserve for Revenue Fluctuations (the Reserve) in the wake of the Great Recession, in line with most common best practices for rainy day funds. (3) (4) (5) (6) (7) (8) (9) (10) For example, there is flexibility to tap the Reserve when needed. When revenues fall short, there is no statutory limit on using the Reserve for existing appropriations.

Despite the state's strong revenue growth in recent years, the Reserve was still over $300 million short of its target balance at the end of FY 2018.[ii] Tennessee follows best practices by having established rules for replenishing the Reserve that allow for bigger deposits when revenues grow. Under state law, the recommended Budget must set aside at least 10% of growth in General Fund state tax revenues until the Reserve balance equals 8% of state tax revenue collections. However, the state has not yet met this target balance.

States can also respond to revenue shortfalls by reducing spending and/or increasing taxes. However, as we explain here, the $2 billion in recurring budget reductions since FY 2007-2008 could make identifying additional cuts more of a challenge. Public policy and political appetite also limit Tennessee's ability to raise new revenues.

See our Tennessee State Budget Primer for more information on rainy day funds, deficits, and surpluses.

FIGURE 2. TENNESSEE'S RAINY DAY RESERVES



Source: The Sycamore Institute's analysis of the FY 2006-2007 - FY 2018-2019 Tennessee State Budgets and information from the General Assembly's Office of Legislative Budget Analysis (1) (2)

PARTING WORDS

There are trade-offs to putting money away for a rainy day. These savings represent less money available today for either new investments or tax relief. However, as Moody's put it, "this preparation can provide a government the fiscal resilience to help its economy thrive when others are struggling."

If unprepared, deficits can confront policymakers with difficult choices about taxing and spending to make ends meet. Rainy day funds smooth out the ups and downs of the economy – allowing for stable programs, services, and tax policy. This helps states use recovery periods to move forward instead of digging out of recession-related holes.

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[i] The Moody's analysis looked at all year-end balances as reported by the National Association of State Budget Officers, which totaled $1.2 billion for Tennessee at the end of FY 2018 — not just the estimated $1.0 billion in Tennessee's Reserve for Revenue Fluctuations and the TennCare Reserves. The report notes that all of these balances may not be available for use during a recession.

[ii] Based on historical practice, the calculation we used to determine the target Reserve balance equals 8% of both Department of Revenue and Other State Revenue taxes allocated to the General, Education, and Debt Service Funds less gas tax revenues allocated to the Debt Service Fund.