CITIZENS RESEARCH COUNCIL OF MICHIGAN

# Preparing the State of Michigan's Budget for the Next Recession

## In a Nutshell

1) Michigan's rainy day fund is being refilled after sitting empty for many years at the end of the last recession.
2) Current deposits are insufficient for anything beyond a very mild economic downturn. Michigan should continue efforts to build up reserves in that fund.
3) Michigan's rainy day fund is designed very well to conserve money that has been saved for a recession, but the savings cap might limit the effectiveness of the fund. Once savings reach the fund cap, lawmakers should consider raising the amount that can be saved in the rainy day fund.

## Introduction

Nearly a decade after the Great Recession, the nation is in the midst of one of the longest national recoveries in history.[1] However, some state governments are beginning to face the next wave of budget pressures. Thirty states are experiencing or expected to experience budget shortfalls by the end of 2018.[2] While Michigan is not facing immediate budgetary problems, a series of past policy decisions will put increasing pressures on the state's budget over the next several years.

Even though a new recession does not seem imminent, it is a question of when, not if, the nation and the state will experience another economic downturn. In the face of budget problems and the inevitability of the next economic downturn, policymakers should keep a close eye on the mechanisms designed to stabilize the state budget during rough periods.

Rainy day funds, the primary savings accounts for most states, serve as a commonly employed tool to weather recessions. Forty-eight states have some form of rainy day fund, usually officially designated as the budget stabilization fund, to lessen the need for drastic program cuts or sizable tax increases during downturns.

Recent history shows that these accounts play a significant role in stabilizing budgets; more than 70 percent of states used their rainy day funds to survive the Great Recession (December 2007 through June 2009).[3] Michigan was not one of these states. Michigan's rainy day fund was emptied in the state's struggles to cope with its Single State Recession,[a] leaving no savings to deal with worsening economic conditions when the nation entered into the Great Recession. State budget makers were left to deal with a $2 billion decline in General Fund[b] revenue from FY2008 to FY2009 without budget stabilization funds.

Now that Michigan is seeing a few sunny days that translate into new savings into its rainy day fund, and given that upcoming challenges will require a variety of tools for state policymakers to manage future economic pressures, it is important to understand the capacity of the state's rainy day fund.

[a] While the rest of the nation suffered from a relatively minor recession from March to November 2001, this period served as the beginning of what was to become Michigan's Single State Recession which lasted for most of the next decade.
[b] In this piece, when the General Fund is mentioned, we are referencing the General Fund/General Purpose portion of the budget.

## The Current Economy

Both the Single State Recession and the Great Recession hit the Michigan economy hard. While most states saw sizable expansions during the early 2000s, Michigan experienced the beginnings of a decade of economic decline, causing state tax revenue to stall. After General Fund revenue increased nearly 50 percent from $7.3 billion in FY1990 to $10.4 billion in FY2000 (despite a reduction in the income tax rate), revenue growth came to a halt. In fact, during the first decade of the century, state revenue only topped FY2000 revenue totals once, and in FY2010 the General Fund and School Aid Fund combined to raise $18.5 billion dollars, $2.1 billion less than the FY2000 amount. When adjusted for inflation, this bleak record for the state's revenues seem even worse. Inflation-adjusted revenue to Michigan's two largest funds shrank in all but one year from FY2000 to FY2010. This represents a 29 percent decline in inflation-adjusted revenue.

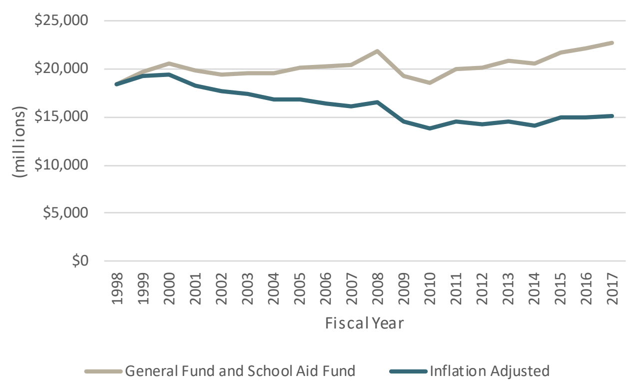
As revenues slid, a number of circumstances and policies created a structural deficit of more than half a billion dollars annually, including:

- The state was winding down the levy of the Single Business Tax;
- The economy entered a recession;
- Untaxed services were growing at a faster rate relative to taxed goods, suppressing the growth of sales tax revenue;
- Medicaid and higher education spending were increasing;
- Demand for aid programs like Medicaid began to increase as unemployment rose.[4]

As the economy improved, state revenue stabilized and Michigan was able to resolve its structural deficit issues. **Chart 1** shows state revenues rebounded after FY2010, but growth has been nowhere near as strong as it was in the 1990s. In FY2016, General Fund and School Aid Fund revenue was $22.1 billion, a 20 percent increase from FY2010 levels. When adjusted for inflation, combined General Fund and School Aid Fund revenue has increased 8.7 percent since FY2010, but remain more than 20 percent lower than the peak in FY2000.

**Chart 1**

General Fund and School Aid Fund Revenue




Source: House Fiscal Agency

Note: Consensus Revenue Estimating Conference projections are used for FY2017 data.

Along with improvements in the economy, budget problems that plagued the state were resolved and Michigan was able to pass more stable budgets, and even start stashing money away. Since the end of FY2010, Michigan's budget has not had a structural deficit.

Despite these positive developments, turbulent waters appear to be likely in Michigan's future. Slow revenue growth during the current economic expansion is starting to take a toll on the budget. The Citizens Research Council recently noted that nearly $2 billion in revenue reductions and spending increases are built into the future of the General Fund budget, and other factors outside of the state's control could increase the pressure on the state budget.[5] So while Michigan is growing in the midst of one of the longest economic expansions in the nation's history, the combination of increased revenue diversions and spending, slow revenue growth, and an economic downturn could create more problems for Michigan. Furthermore, natural economic cycles make the next downturn a question of when, not if.

## Balancing Competing Interests

As the state moves towards the next wave of budget challenges, it is important to know the risks of an economic downturn and monitor the options that the state has to manage the budget when it is out of balance. State revenues are susceptible to the effects of recessions because of the nature of economic activity upon which the state's largest sources of tax revenues are levied – consumption and income. As **Chart 1** shows, the decline in revenue caused by the Great Recession was substantial, and when adjusting for inflation, the decline in funding levels throughout the 2000s was even more severe. However, this picture misses the idea that some spending demands, like Medicaid, typically see an increase in demand during economic downturns as more people lose their job and need temporary relief.[6] This means that as revenues are declining, costs associated with some programs can increase, putting pressure on both sides of the budget equation.

Another complicating factor is the state's balanced budget requirement. Article V, Section 18 of the 1963 Michigan Constitution requires the legislature to adopt and the governor to sign a balanced budget. While the state may borrow to cover expenses within a fiscal year, the state is not allowed to borrow to cover general expenditures from one year to the next.[c] This also means that programs function in a zero-sum nature in the budget, i.e. every dollar spent on Medicaid is a dollar that cannot be spent funding prisons.

To maintain a balanced budget during a downturn, Michigan has three primary mechanisms:

1) the ability to increase revenues (i.e. tax increases),
2) the latitude to reduce spending, and
3) the capacity to rely on existing reserves.

[c] Capital expenditures and infrastructure projects are exceptions to this rule, but have specific procedures.

Obviously, Michigan can only rely on reserves to the extent that the state has saved prior to a recession. Each option has its benefits and drawbacks, but, particularly during times of growth, more attention is given to the revenue and spending questions, as those debates are fueled by political concerns and organized interests. Savings in Michigan's rainy day fund do not have a primary constituency or an organized group of interests providing advocacy, despite the future value and security they bring to the state.

### The Difficulties of Spending Reductions

During economic downturns, many services that the state offers, particularly poverty relief programs, like Medicaid or Welfare, may see increases in demand. Cutting program budgets while they see an upswing in demand could mean that a recession hits harder on lower income families (and previously middle income families affected by job loss or reductions in pay and benefits). This can have negative effects on consumption as well, as families reliant on core services will have even less to spend beyond basic needs. Cuts to other services can have more long-term effects. Reductions in school funding do not have as strong of a short-term impact, but can have a much larger cumulative economic impact if the quality of education in the state declines. Falling behind on infrastructure can also have long-term damaging effects. Raising taxes during a crisis can allow the state to maintain service levels if demand increases or revenues decline.

### The Difficulties of Generating Revenue

While there seem to be a lot of problems reducing spending during a downturn, finding new revenue to match declines can be somewhat tricky. When revenue falls by billions of dollars, as it did during the Great Recession, large scale tax increases would be necessary to maintain spending. In a sluggish economy, a large increase in taxes runs the risk of making the current downturn longer and harsher. Increasing taxes on goods and services or on individual income will lower consumption, which could deepen the crisis and harm those most at risk, while increasing taxes on businesses that are struggling to survive could magnify the effects of the recession on employment and investment, either of which could lengthen economic troubles.

## The Case for Rainy Day Savings

While neither increasing revenues nor cutting spending in a recession are ideal, a third alternative is Michigan's ability to rely on savings. By building rainy day reserves capable of balancing the budget during a downturn, Michigan can avoid the potentially economy-stalling effects of increasing tax revenue while also maintaining services to prevent the long-term effects of cuts. Devoting additional surplus revenue to state savings may also provide a strategy to constrain state spending and growth of government, preventing program spending to grow beyond its means during periods of large economic growth.

Savings serve to protect against a variety of uncertainties in state revenue sources. The law creating Michigan's rainy day fund outlines that its purpose is "to assist in stabilizing revenue and employment during periods of economic recession and high unemployment."[7] This directs how the legislature can authorize rainy day fund money to the General Fund and School Aid Fund to meet shortfalls and attempt to improve high unemployment numbers. As economic cycles naturally see periods of upswings and downswings, saving money in the rainy day fund allows the state to move some revenue from a booming economy to a slumping one. Savings can thus prevent either steep cuts or revenue spikes during a downturn, limiting the negative effects of an economic crisis.

While savings seem like a great solution once the state is in a recession, actually saving the money during times of economic expansion can create economic tradeoffs that the legislature must consider. In a booming economy, policymakers often are focused on other battles, whether it be tax reductions or funding new programs. This either-or proposition creates a zero-sum budget situation where saving money is left on the sideline. Reducing taxes and increasing spending tend to have stronger political and constituent support.

Further, during periods of economic growth, saving money might not be the best thing for the economy. Advocates of tax cuts would say that putting money in the rainy day fund could lower economic productivity by taking money out of the economy to keep in the state's bank account, while those who support increased spending would argue that savings leave fewer resources for programs that could use increased funding to set the state up for long-term success.

While Michigan's rainy day fund does leave fewer resources for possible revenue reductions or increases in spending, these savings serve other purposes that help Michigan in the long run, independent of building a bulwark for the next recession. The rainy day fund balance is a part of the state's Manageable Common Cash.[d] This cash is pooled together to manage state investments in one account, and is used to pay state costs on a day-to-day basis. This allows the state to manage cash flows during the year when collections are not evenly distributed to coincide with the periods when the state needs to spend cash. By doing so, the state can prevent the need to take out short-term loans to pay day-to-day expenses. In effect, even when not directly allocated, the rainy day fund helps smooth out revenue cycles for the General Fund and School Aid Fund.

Rainy day savings also help the state's credit position. Rating agencies pay attention to the state's available cash on hand, paying a close eye to the rainy day fund and state cash reserves. When making ratings decisions, credit agencies see the state's saving patterns as an important way to guard against the volatility of revenues during an economic contraction, while cash on hand is an important measure for the state's ability to pay bills on time in the short term.[8] The rating benefits of Michigan's rainy day

[d] Michigan's Manageable Common Cash pool is a grouping of reserves including the General Fund, the School Aid Fund, the Special Revenue and Enterprise Fund, the Internal Service Fund, and the Trust and Agency Fund. For more on the state's Manageable Common Cash, see *Stabilized State Budget and Rainy Day Fund Deposits Improve State's Cash Position*, crcmich.org/mi-state-budget/state-cash-position/

fund were on display in September when Standard and Poor's upgraded Michigan's economic outlook from "stable" to "positive", citing improvements in both the state's cash position and reserves as part of the reason for improvement.[9] While credit ratings do not have a direct impact on state finances, they can have a significant impact on long-term spending decisions. States with better credit ratings are able to borrow money at lower interest rates, which can save millions of dollars over the lifetime of capital expenditure projects.[10]

## Michigan's Rainy Day Fund

### What is the Rainy Day Fund?

Michigan's Counter-Cyclical Budget and Economic Stabilization Fund (sometimes denoted as the Budget Stabilization Fund or BSF) was created in 1977 in response to a series of economic challenges the state had faced. A recession, which caused deep declines in tax revenues and hit the auto industry particularly hard, sent the state into a scramble to keep the budget balanced. After the state recovered, policymakers created the rainy day fund to ease future declines in revenue. In 1984, the statute concerning the rainy day fund was re-codified with other laws in the Management and Budget Act, where the authorization for the rainy day fund currently exists.[11]

The rainy day fund's outlined directive is to "reserve funds during positive economic times and then have the funds available to use during times of high unemployment and economic downturns."[12] The law outlines three conditions that allow for deposits into and withdrawals from the rainy day fund (see **Table 1**):

1) changes in personal income in the state;
2) revenue and employment factors; and
3) legislative discretion.

The adjusted personal income guideline is the primary mechanism that controls the flow of rainy day funds. Under the Management and Budget Act, funds are deposited into the rainy day fund when inflation-adjusted personal income in the state increases by more than two percent and are withdrawn when inflation-adjusted personal income declines. For each percentage point adjusted personal income growth surpasses two percent, the legislature is directed to deposit one percent of General Fund revenues into the rainy day fund.

Based on projected FY2017 revenues, a three percent increase in adjusted personal income would require a

**Table 1**

Guidelines for Rainy Day Fund Deposits and Withdrawals

| | Deposits | | Withdrawals | |
|---|---|---|---|---|
| | **Condition** | **Amount** | **Condition** | **Amount** |
| **Adjusted Personal Income** | If inflation-adjusted personal income is greater than 2 percent | 1 percent of General Fund revenues per percentage point growth above 2 percent | If inflation-adjusted personal income is negative | 1 percent of General Fund revenues per percent decline |
| **Economic Factors** | State revenue exceeds constitutional revenue limits by 1 percent or less | The amount in excess of the revenue limit | State unemployment rate is higher than 8 percent | If unemployment is between 8 and 12 percent, withdrawal up to 2.5 percent of the fund; if unemployment is greater than 12 percent, up to 5 percent of the fund |
| **Legislative Appropriation** | Budgeted by the legislature | Determined by the legislature, up to the rainy day fund limit | Need for an emergency appropriation | Supermajority vote in both chambers |

Source: PA 431 of 1984 (M.C.L. 18.1351)

$101.1 million rainy day fund deposit (or one percent of projected General Fund revenue). Withdrawals function similarly, with each percentage point decline in adjusted personal income resulting in a withdrawal of one percent of General Fund revenue. Based on the Consensus Revenue Estimating Conference (CREC) projections, adjusted personal income in the state is expected to remain on an upward trajectory. CREC projects rainy day fund deposits of $52 million in both FY2018 and FY2019, due to a projected 2.5 percent increase in adjusted personal income each year.[13]

The second set of rules that allow moving funds in and out of the rainy day fund is based on economic factors. Article IX, Section 26 of the Michigan Constitution caps state revenues at 9.49 percent of personal income; if revenue exceeds this limit by one percent or more, the excess revenue is supposed to be deposited into the rainy day fund, though the legislature in practice must appropriate it. In practice, the state is unlikely to see revenue surpass the limitation in the foreseeable future. FY2000 was the last time revenues exceeded the limit, and FY2016 revenue was $8.13 billion below the limitation.

Economic-based withdrawals are tied to increases in the unemployment rate. When the unemployment rate exceeds eight percent, the legislature is able to appropriate money from the rainy day fund to supplement General Fund and School Aid Fund spending; however, that spending is limited to projects intended to improve the state's employment climate. When unemployment is in excess of eight percent but lower than 12 percent, the legislature can appropriate up to 2.5 percent of the rainy day fund balance. If unemployment is 12 percent or greater, the withdrawal limit increases to five percent of the balance.

Finally, the legislature is able to make appropriations to and withdrawals from the rainy day fund at its discretion. Appropriations in excess of those outlined above have relatively few restrictions; generally the legislature may appropriate more than required in the budget to increase the total amount in savings, as long as the balance does not exceed 10 percent of combined General Fund and School Aid Fund revenue (see *Rainy Day Fund Balance* below). Withdrawals beyond employment and income-based withdrawals, which are deemed to be an emergency appropriation, require a supermajority vote approval from both chambers.

## Rainy Day Fund Balance

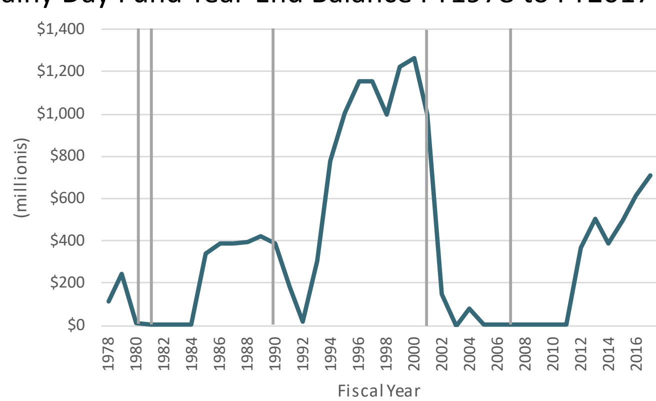
At the end of FY2017, the state's rainy day fund sat at $711 million, or about three percent of combined General Fund and School Aid Fund revenues. With the $167.5 million in deposits slated for FY2018 and interest expected to accumulate over the next year, the fund is expected to reach $890 million by the end of FY2018.[14]

As **Chart 2** shows, when the state uses rainy day fund revenues during downturns the balance has not lasted long. The state's initial fund balance of just over $200 million evaporated in a single year due to the national recession in 1980, leaving the tank on empty for five years before the state started to refuel it in the mid-1980s.

While the rainy day fund reached $400 million by 1989, the turn of the 1990s saw a quick decline in the fund balance with the economic slowdown that started the decade. Immediately after the fund nearly bottomed out in 1992, the state saved money at a rate it had not come close to before; with the expansion that began in 1992, the state was able to save more than $1 billion over three years.

**Chart 2**

Rainy Day Fund Year-End Balance FY1978 to FY2017




Source: Michigan Department of Treasury

Note: The gray lines represent the start of national recessions based on National Bureau of Economic Research classification.

However, that money was used up just as fast as it was saved—at the turn of the millennia, the state emptied the nearly $1.3 billion in reserves over three years of downturn. As the state moved from the Single State Recession in the early part of the decade into the Great Recession in 2008, reserves stayed close to empty.

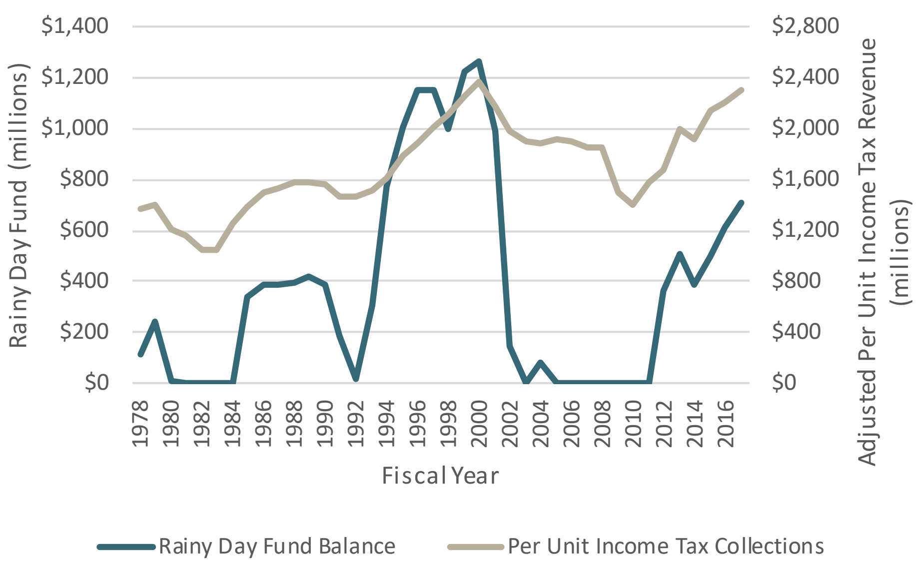
While recovery from consecutive downturns led to a slow rebuild for the rainy day fund, Michigan is finally beginning add to its main savings account.

## Rainy Day Funds and Economic Conditions

The rate at which trends in the rainy day fund track with broad economic factors determine if funds are being saved during economic expansions and used during economic downturns. **Chart 3** shows the rainy day fund balance and per unit Income Tax collections (the amount of revenue collected for each percentage point levied through the Personal Income Tax). Using per unit tax revenues provides a trend of income tax revenue, while adjusting for changes in the tax rate.

As seen in **Chart 3**, the relationship between the two is quite strong; in periods of growth in income tax collections, Michigan has experienced moderate to significant growth in the rainy day fund; when income tax collections decline, Michigan is quick to use existing fund balances to stabilize the state budget.

**Chart 3**
Rainy Day Fund Balance Compared to
Inflation-Adjusted Per-Unit Income Tax Collections

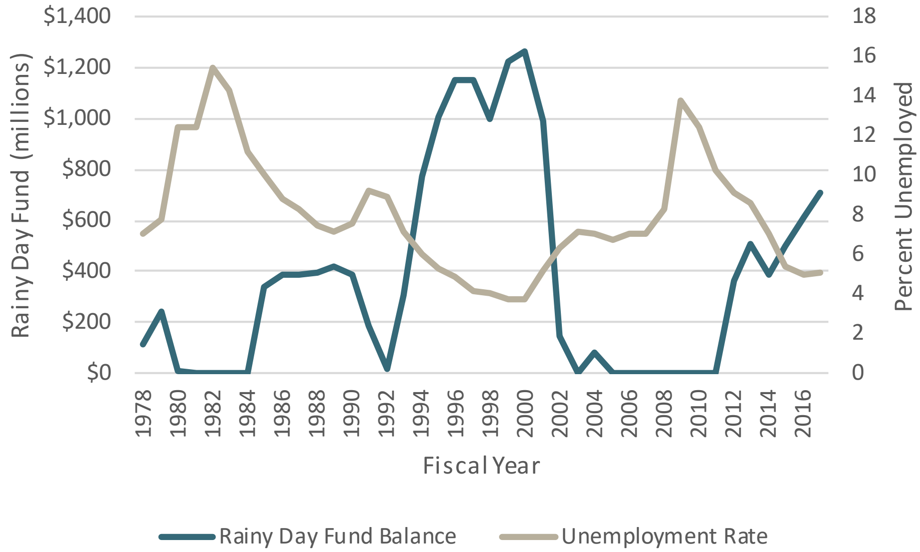



Sources: Michigan Department of Treasury, State of Michigan Comprehensive Annual Financial Reports from Various Years, Department of Commerce, and calculations by Citizens Research Council.

Similar trends are seen in the relationship between unemployment and the rainy day fund balance. When there are spikes in unemployment, rainy day fund dollars evaporate quickly, and they grow when unemployment experiences a steep downward trend (see **Chart 4**). These show the use of rainy day fund dollars typically occur during periods of increasing unemployment, which follows the intent of the fund.

**Chart 4**

Rainy Day Fund Balance Compared to the Unemployment Rate




Sources: Michigan Department of Treasury and FRED Economic Data

## Rainy Day Fund Balance Cap

When initially created in 1978, the rainy day fund balance was capped at 25 percent of General Fund revenue. At the time, school aid funding was less than a quarter of the size of the General Fund. Proposal A in 1994 revamped school financing from the state with increases in the Sales Tax (from four to six percent) and other state tax increases. Because of these changes, the School Aid Fund more than doubled in size and came to be approximately the same size as the General Fund. This lead the state to change the rainy day fund cap from 25 percent of General Fund revenues to 10 percent of combined General Fund and School Aid Fund revenues.

Based on current General Fund and School Aid Fund revenues, the 10 percent cap equates to roughly $2.2 billion. Any revenue in excess of the cap would have to be returned to taxpayers in the form of Income Tax refunds. The state has never been close to reaching this cap (see **Chart 5**). While rainy day fund balances seemed to outpace growth in revenues during the mid-1990s, the fund-to-cap ratio peaked at 61 percent in FY2000, the year the change in calculation for the fund cap took place. Estimates for FY2018 would leave rainy day fund reserves below 45 percent of the fund cap.

## Adequacy of Reserves

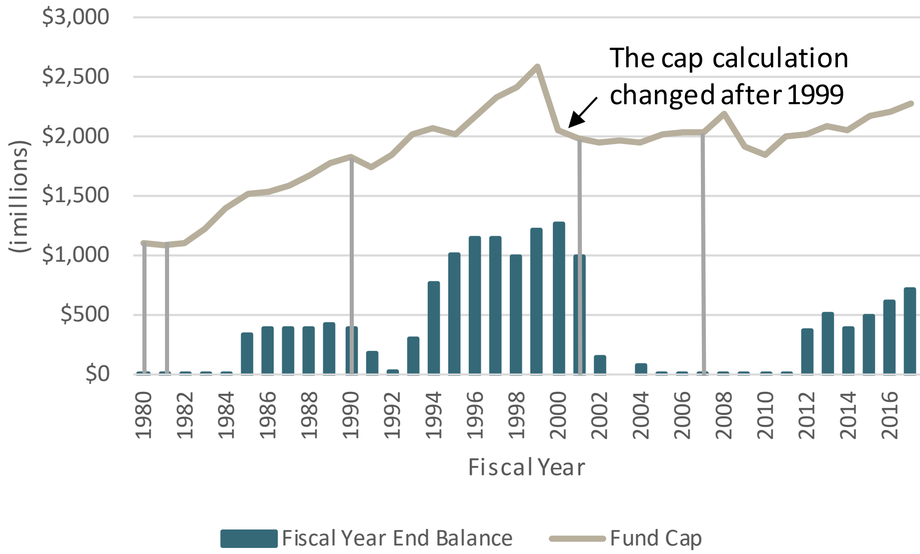
Because the state would need to rely on savings in the event of a recession to avoid budget cuts or tax increases, it's important to understand the amount of resources that would typically be needed to stabilize the budget in the case of a recession. However, the lack of general agreement on the level of savings a state should hold makes it difficult to estimate how large rainy day funds need to be to mitigate the effects of a recession.

Experts recommend that states save anywhere from five[15] to fifteen percent[16] of General Fund (and, for the case of Michigan, School Aid Fund) spending in the rainy day fund. However, in response to the Great Recession many organizations have increased their savings recommendation. The Government Finance Officers Association, for example, increased their targeted savings from one to two months of operating costs in response to the Great Recession.

It is uncertain if Michigan's current 10 percent limit would allow for a sufficient rainy day fund balance. As **Chart 5** shows, Michigan's rainy day fund has

**Chart 5**

Rainy Day Fund Balance Relative to Fund Cap




Sources: Department of Treasury and Senate Fiscal Agency

Note: The gray lines represent the start of national recessions based on National Bureau of Economic Research classification.

never been close to the limit, making it difficult to judge if there is a need to raise the cap based on recent history. However, Michigan's experience with the Single State Recession shows some concern for the state's ability to weather another downturn. At just over 60 percent of the savings limit, the rainy day fund balance was exhausted early in the Single State Recession, with savings almost entirely depleted in just a single year. Current reserves, which sit at about 35 percent of the fund cap, are lower than they were in FY2000 when the balance was at its peak.

To get a better understanding of the adequacy of both reserves and the rainy day fund balance limit, some organizations have conducted research into what individual states might need to prevent spending cuts or revenue increases during a recession. The Pew Charitable Trusts found that specific balance targets tend to be arbitrary, and are not set based on individual state's needs. They recommend looking at a range of factors including a state's revenue volatility, the size of the state budget, and the type of revenue sources the state relies on to determine how much states should save.[17]

An analysis by Moody's Analytics utilizes these factors to determine the sufficiency of state rainy day funds for state General Fund spending.[18] Their simulation found that Michigan's rainy day fund was insufficient to cover the decline in revenue and increase in Medicaid spending in the General Fund for a moderate recession, or one that is similar to typical recessions. Moody's estimates the net effect of revenue reductions and spending increases would be a $1.54 billion need in the General Fund. While their report did not estimate the needs of the School Aid Fund, the General Fund would need more than twice the current rainy day fund balance to weather the recession without revenue increases or spending cuts.

The Mercatus Center at George Mason University conducted a similar analysis using data from FY2015 and predicted that in an average-severity recession, Michigan's General Fund would require $1.4 billion in rainy day fund dollars to weather a downturn without cutting spending or increasing revenue.[19]

While there is some level of variation between the two estimates, both Moody's and the Mercatus Center predict that General Fund needs during a typical recession would require double the current rainy day fund balance, and that is before accounting for the School Aid Fund. The combination of the state's relatively weak cash position and potential upcoming budget issues make it unlikely that current rainy day fund reserves will be sufficient to smooth out revenue declines in an average recession without steep cuts or large revenue increases.

## National Comparison

While a historical analysis shows some possible issues with the state's rainy day fund, the context of the recovery from the Great Recession is absent. An analysis of where Michigan stands relative to other states can give an idea of how the recovery of Michigan's rainy day fund is fairing in the current context.

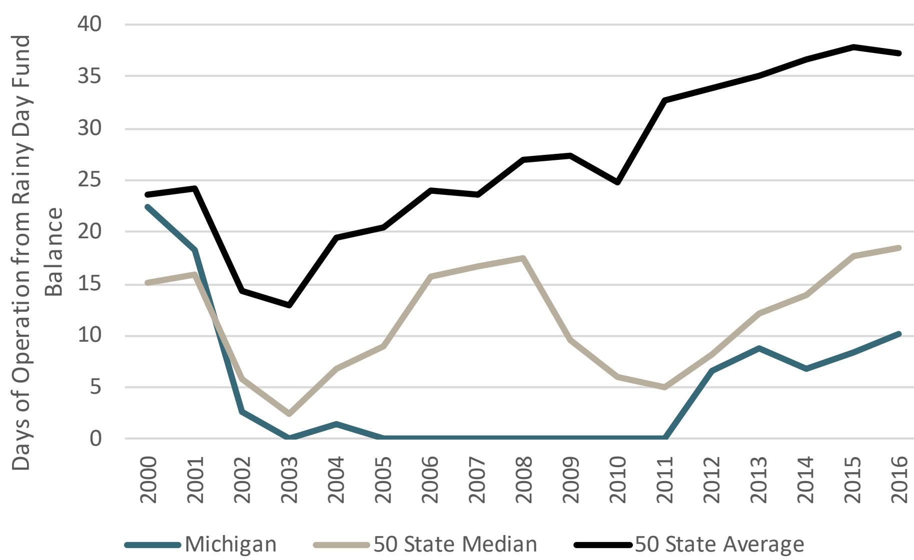
As of 2016, 48 states have some sort of rainy day fund. Colorado and Illinois are the only states without an official rainy day fund (though they have other accounts for savings). Kansas and Montana established their rainy day funds within the last few years, which limits information that can be inferred from comparing them with Michigan.

### Rainy Day Fund Balances

Interstate comparisons are best performed when normalized to reflect differences in size and economic abilities. Just knowing that the average rainy day fund balance across the states in FY2016 was just over $1 billion and that the national median was $477 million does not help to understand the level of savings relative to the size of the budgets. Averages and ranges are skewed by states with significant balances such as California, with a balance above $7 billion, or Alaska and Texas, which have significant reserves built mostly due to each states' vast supply of oil reserves.

**Chart 6**

Days of Operation Using Rainy Day Fund Balance, FY2000-FY2016




Sources: National Association of State Budget Officers, the Pew Charitable Trusts, and calculations by CRC

While the median makes Michigan's FY2016 balance of $612 million seem relatively large, ranking 17th among all states, the utility of Michigan's rainy day fund actually ranks towards the bottom. When measuring rainy day fund balances against budget size,[e] Michigan's rainy day fund balance ranks 36th among the 48 states with a rainy day fund, and many of those below it either have relatively new rainy day funds (such as Kansas), or have very little in the bank (Pennsylvania).

As of 2016, Michigan's rainy day fund could only operate state accounts for 10 days, compared to the national median of just under 19 days. **Chart 6** shows that, while Michigan's rainy day fund started the millennia above the median and close to the national average, the rainy day fund was hit hard by the Single-State Recession and because of this, Michigan's rainy day fund has yet to catch up to the national average or median.

Part of this is because Michigan's larger role in financing K-12 public education; Michigan provides the ninth largest share of K-12 education costs, representing nearly three times the median state share.[20] This means a larger portion of spending falls on the state budget in Michigan relative to most states, increasing the range of services the rainy day fund must help cover during a downturn.

[e] For all states other than Michigan this is General Fund spending. For Michigan, it is measured against General Fund and School Aid Fund Spending. Michigan is unique nationally for having a separate School Aid Fund. Activity in the SAF is reflected in the General Fund in other states; thus, we adjusted data in this section to account for the SAF because Rainy Day Funds are used to offset spending in both accounts, and ignoring that data would overstate the utility of Rainy Day Fund balances.

### Disbursement of Rainy Day Funds

Michigan has one of the tightest sets of controls on its rainy day fund, as its use is limited to specific economic and income based conditions, or by use of a legislative supermajority vote. In fact, Michigan is one of only 19 states that have an explicit purpose for the funds that is directly outlined in law.[21] The Pew Charitable Trusts list this as significant for state savings because it allows states to make more informed decisions when preparing for and experiencing a downturn.

Michigan is also one of only 11 states to link rainy day fund withdrawals to economic volatility, and is one of 14 states that requires a supermajority vote in the legislature to make discretionary withdrawals.[22] The combination of these leaves Michigan with some of the most pointed rules for rainy day fund use, which ensures that savings are used during economic downturns. Savings are thus well safeguarded while simultaneously being accessible during an economic downturn.

### Rainy Day Fund Caps

Michigan's cap on the rainy day fund is higher than the median at 10 percent; 10 other states have their cap set at 10 percent of revenues, while seven states have a cap higher than Michigan and another seven do not cap rainy day fund balances.[23] Prior to the Great Recession, 21 states had hit their revenue limit.

Given that 22 states exhausted more than two-thirds of their rainy day fund balances during the Great Recession, the dire nature of many state budgets raised several questions about the sufficiency of both rainy day fund balances and rainy day fund caps. As discussed above, the last decade has changed what is seen as a sufficient balance; modern best practices would put anything below 10 percent as a likely insufficient level of overall savings. So, while Michigan has one of the higher revenue caps nationally, evidence from the last recession show that an increased limit would improve outcomes.

## Conclusion

The current economic expansion has allowed the state to stabilize after the one-two punch of Michigan's Single State Recession and the Great Recession, but the effects of such a prolonged economic stagnation and a growing list of demands on the state budget demonstrate the importance of using this expansion to prepare for the next downturn.

The rainy day fund, as currently constituted, has the potential to provide a somewhat strong foundation for Michigan in a downturn, but can be improved in some clear areas to mitigate the potential effects of downturns. The stringent requirements for use of funds and economy-based withdrawal are strong standards that can make the fund effective, but the historically low rate of deposits have limited its utility, while the low cap on funds could further shrink the role it plays in moderate to severe downturns.

While $890 million has been saved for the next downturn, more savings could be necessary; Michigan has saved less money than it had prior to the Single State Recession, and less than the amount projected to be needed to prevent cuts during an average recession. While the $2.2 billion revenue limit under the current cap might be sufficient for an average recession, many organizations best practices recommend up to two months-worth of savings; and projections based on Michigan's General Fund alone place state needs at more than $1.5 billion to avoid cuts and revenue increases. While increasing the saving cap might be necessary for the fund to function at peak capacity in the long run, the most pressing issue for the state's reserves is a need to put more away for the next economic downturn.

## Endnotes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