

How States Can Manage Midyear Budget Gaps

Sound planning helps mitigate sudden shortfalls

Overview

State governments generally adopt budgets that lawmakers believe are balanced, with sufficient revenue to pay for expenses. But because states typically enact their budgets before the start of a fiscal year, policymakers must rely on forecasts of how much revenue the state will collect and how much it will spend. When states collect less revenue than expected or spend more money than planned, their leaders often must act quickly to bring revenue and spending back into balance.

To close these midyear budget shortfalls, states have limited options. They cannot easily or quickly impose a new tax to increase revenue or renegotiate a contract to reduce expenses in a matter of months. Although states almost always find a way to close midyear gaps—in most states, the law requires it—in doing so they may make indiscriminate cuts to government programs, pass the pain on to struggling municipalities, or rely on accounting maneuvers that push financial challenges to future years without a plan to address them.

For example, in the early spring of 2020, when the COVID-19 pandemic began to take hold throughout the country, state tax collections fell precipitously. Because most states were in the homestretch of their fiscal year, which ends on June 30 in 46 states, policymakers had to scramble to close midyear gaps in weeks, just as many were attempting to finalize their budgets for the following year. However, midyear gaps also occur without causes as extraordinary as a global pandemic. Any slowdown in economic activity can lead tax collections to underperform forecasts, whether as the result of a national recession or state-specific factors. On the spending side, states can't always predict how many residents will qualify for Medicaid, how many children will need foster care, how much they will spend on prisons, or whether they will need to respond to natural disasters such as floods and wildfires.

To examine how states can effectively address midyear budget gaps, The Pew Charitable Trusts reviewed state statutes, budget documents, and reports published by executive and legislative offices. Pew also conducted interviews with state leaders, budget and fiscal staff, and other policy experts. This research showed that although sometimes the shortfalls are too large to avoid undesirable outcomes, some states have succeeded in minimizing the damage to policy priorities and long-term fiscal health through careful planning and sound analysis.

Specifically, states should take two steps to reduce the disruptions caused by midyear gaps:

- **Make key decisions in advance.** Important decisions include when midyear adjustments should be initiated, who is responsible for acting, and what budget balancing options such actors can adopt. To ensure that these choices reflect the preferences of both the legislative and executive branches, states should plan for midyear gaps during their regular budget processes.
- **Plan for likely scenarios.** States' plans to close midyear shortfalls should be informed by estimates of how large the gaps could grow. States should project the size of potential gaps under multiple scenarios, then carefully monitor whether the budget is falling out of balance during the year. They should also identify in advance options for closing any gaps that occur.

Why states need to prepare for midyear budget gaps

In November 2015, Louisiana closed a \$500 million midyear gap, largely through budget cuts and by sweeping money into the general fund from accounts dedicated to specific purposes. This was just one example of the state's chronic difficulty in maintaining a balanced budget throughout the year.¹ Just a few months later, the state faced a new \$900 million shortfall, a situation so severe that Louisiana State University warned that it might need to halt classes in the middle of the school year.² Lawmakers responded in March 2016 by adopting budget cuts and tax increases that would go into effect in a matter of days, including a penny-per-dollar increase in the sales tax.³ The following year, when Louisiana lawmakers closed another \$300 million gap by cutting agency budgets and tapping the state's rainy day fund, it was the state's fifteenth midyear shortfall in just nine years.⁴

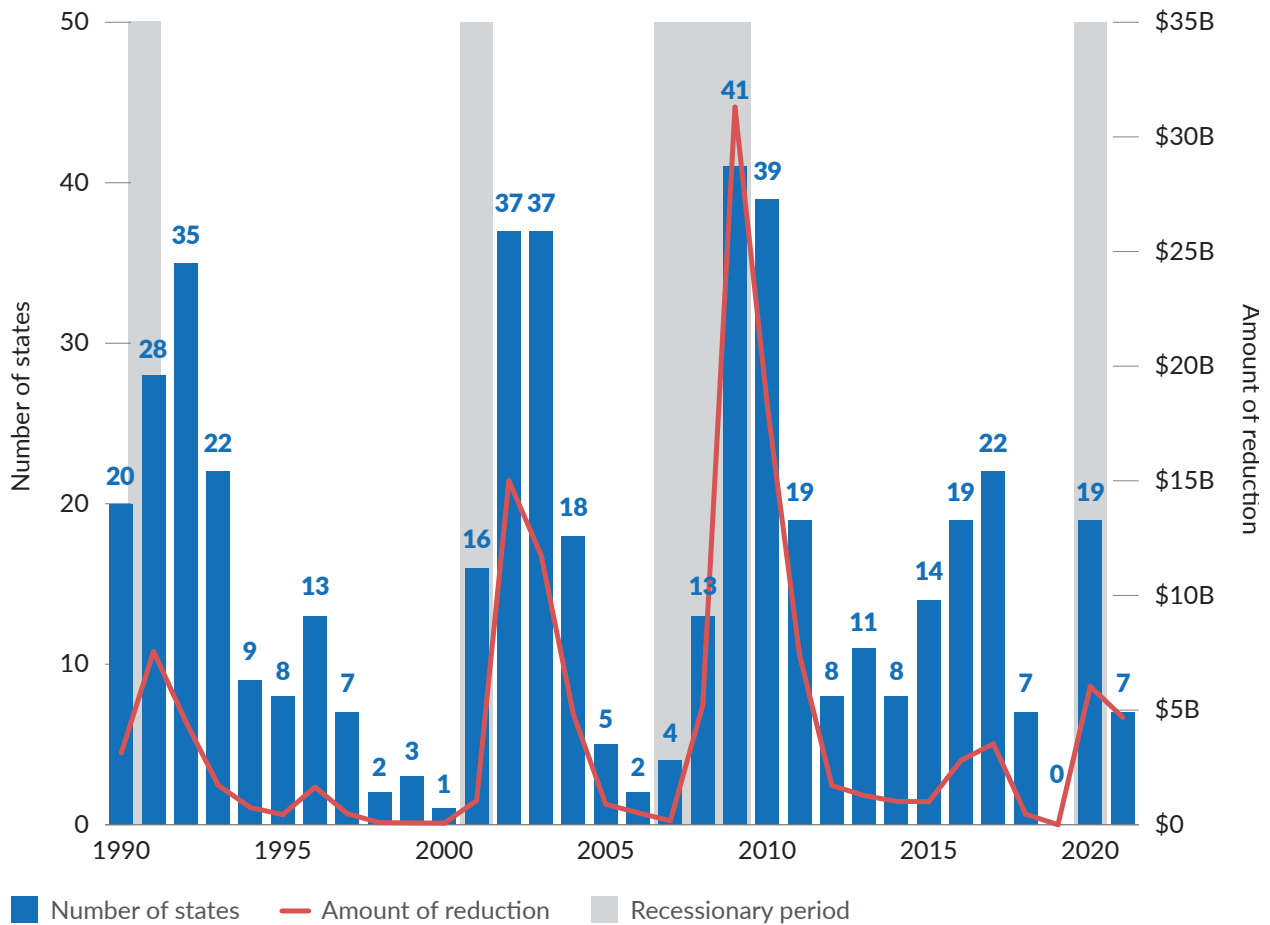
As Louisiana's experience suggests, midyear budget shortfalls are an ever-present risk for state governments. As Figure 1 shows, states are regularly forced to make midyear budget cuts. The gaps tend to be largest and most widespread during and immediately after recessions because states' primary sources of tax revenue—personal income taxes and sales taxes—are sensitive to economic conditions. But gaps can occur during economic expansions as well.⁵

In Louisiana, revenue collections regularly disappointed for much of the 2010s, in part, because of a slow recovery from the Great Recession followed by low oil prices.⁶ But midyear gaps can also result from state agencies spending more than lawmakers appropriated.

In 2019, Rhode Island lawmakers became so exasperated by chronic overspending that they inserted a provision into the budget forbidding any agency that is projected to exceed its budget for the year from paying "for additional staff, contracts, or purchases" except in the event of an emergency.⁷ Despite this edict, by December 2019 the state's Department of Children, Youth & Families was projected to overspend its budget by \$22.4 million as the agency struggled to provide services such as foster care and to run the state's juvenile justice system within the \$165.1 million the Legislature had appropriated.⁸ Whether this type of overspending results from agencies mismanaging their budgets or lawmakers providing too little funding for agencies to realistically fulfill their responsibilities is often a matter of interpretation.

Figure 1

States Make Midyear Budget Adjustments in Both Recessions and Expansions



Source: National Association of State Budget Officers “The Fiscal Survey of States” (Fall 2021)

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How states close midyear gaps

The process for closing midyear gaps is generally less deliberative than standard budget procedures. When states write budgets for the upcoming fiscal year, the process often lasts six months or more and progresses through a series of well-defined milestones. State agencies and the executive branch’s central budget office develop spending plans, economists forecast how much revenue the state will collect, the governor issues a formal budget proposal, and legislative committees question agency heads at budget hearings.⁹ Only after these steps do legislators finally negotiate, adopt a budget, and then send it to the governor to be signed or vetoed.

In contrast, when states close midyear gaps, the process often precludes engaging in a thorough reconsideration of the entire budget. Although states sometimes formally revise the budget through legislation, the legislative calendar often stands in the way. In most states, elected officials are limited in when they can meet in session during the year and for how long.¹⁰ In New Mexico, for example, where the state constitution limits regular legislative sessions to 30 days in even-numbered years and 60 days in odd-numbered years, lawmakers

adjourned their regular session for the year in February 2020—before it was clear how severe the pandemic would become, let alone before they had any idea to what degree they would need to adjust their FY 2020 and FY 2021 budgets in response.¹¹

States can and do hold special legislative sessions at other times of the year to address designated topics put forth by officials. In 2020, legislatures in 23 states convened in special sessions, with several, including New Mexico's, meeting to address budget gaps.¹² But this approach comes with difficulties. For one, the logistics of reconvening lawmakers—many of whom hold other jobs when out of session—is challenging. Furthermore, special sessions disrupt the regular balance of power between the legislative and executive branches. Governors often decide whether and when special sessions will be held and which topics lawmakers may address.¹³ In 14 states, governors have exclusive power to call special sessions. In the other 36 states, where the legislature has a role, a super-majority two-thirds or three-fifths vote is often required—rules that prevent legislatures from calling special sessions without broad consensus.¹⁴

Although special sessions tilt power toward governors, not holding them reduces the legislature's role even further in determining how to close gaps. In many states, governors can make unilateral decisions on how the budget should be cut in the case of a shortfall. In Alabama, for instance, the executive branch may reduce spending without legislative approval if revenue is not anticipated to be high enough to pay for the enacted budget.¹⁵

States have limited options

With little time for careful deliberations, states usually rely on a narrow set of options to address midyear gaps quickly without wholesale policy changes. Some states can simply carry the deficit forward to the next fiscal year. For example, when facing budget challenges from the pandemic and a three-month extension of the income tax filing deadline that delayed revenue collections, Pennsylvania carried forward a deficit from FY 2020 to FY 2021.¹⁶ However, this option isn't widely available; in 35 states, statutes or constitutions bar year-end deficits.¹⁷ Nor is it always an ideal strategy, as it may compound challenges in subsequent years.

A variation on this carryover approach is to use accounting maneuvers that kick the problem to a later date. Since FY 2012, Arizona officials have been rolling over from one fiscal year to the next roughly \$900 million in payments owed to school districts. These deferrals stem from the state's delaying some K-12 education payments to help close budget shortfalls during the Great Recession.¹⁸ Although this approach can help a state close a midyear gap once, the trade-off is that school districts will continue to face delayed payments each year unless the state is willing to spend extra money in a single year to get back on schedule. Over the past decade, Arizona has made little progress in eliminating the education rollovers, which stand at nearly \$866 million as of FY 2022.¹⁹

When states do seek to decrease spending in the current fiscal year instead of relying on these accounting maneuvers, they often adopt across-the-board budget cuts, in theory cutting the same percentage of the budget from each agency or program. In practice, some areas of government usually can't be cut because doing so would undermine services that are required by state or federal law; these program areas may be exempted from budget reductions. For example, federal funds provided through the Families First Coronavirus Response Act came with stipulations that prohibited states from changing Medicaid eligibility criteria—a budget reduction strategy historically used by policymakers to help generate savings—during the public health emergency caused by the pandemic.²⁰

States also often cut workforce costs by imposing hiring freezes or instituting furlough days. For example, in Nevada, one of the states that faced the severest economic challenges from the pandemic, Governor Steve Sisolak imposed a hiring freeze for executive branch agencies in March 2020.²¹ Then, in a July 2020 special session, lawmakers approved six unpaid furlough days for most state workers for a period of Jan. 1, 2021, through June 30, 2021, a move that was projected to save the state tens of millions of dollars.²²

The challenge with across-the-board budget reductions or broad personnel cuts such as furloughs is that, unless they are designed with well-considered exceptions, states risk unintended consequences that may jeopardize key policy priorities. In New York, low-income school districts rely more heavily on state funding than wealthier ones because they do not collect property taxes.²³ As a result, in the summer of 2020 when New York withheld the same percentage of state funding from each district, the reductions were much more significant for low-income districts.²⁴ Sometimes, furloughs and across-the-board cuts can even cost more money than they save. For example, during and after the Great Recession, these types of actions from states led to reduced revenue collections from tax departments after auditors were laid off and other self-funding agencies such as state-run liquor stores were shuttered.²⁵

Borrowing money can be another option. Illinois, for example, borrowed billions of dollars in 2020 to pay for operating expenses.²⁶ Taking on debt can buy time until revenue bounces back or officials make other policy choices, allowing services to proceed uninterrupted. But there are downsides and legal limitations. Issuing long-term bonds—which states typically sell to fund infrastructure projects that will remain in use for decades and are repaid over similar lengths of time—for immediate budgetary relief creates a lasting liability to cover short-term needs, and some states prohibit using them to close shortfalls.²⁷ Meanwhile, state laws often require prompt repayment on short-term debt within a matter of months, limiting the strategy’s appeal for closing larger midyear gaps.²⁸

Additionally, states often turn to rainy day funds—savings accounts in which states deposit money in good years—and other reserves to close midyear gaps. In the years following the Great Recession, many states built reserves in preparation for more difficult economic times. During FY 2020, 15 states tapped a total of \$12.4 billion from their rainy day funds.²⁹ State laws often impose conditions on whether withdrawals are allowed and when. Many states require specific measures of economic or fiscal stress—such as a decline in personal income or state revenue—or require legislative supermajority votes to allow withdrawals, or, in some instances, both.³⁰ These provisions can make it difficult to access rainy day funds to deal with midyear gaps.

States can also turn to informal reserves, such as general fund balances or budget surpluses carried over from the previous year, which generally lack such restrictions. However, policymakers have no guarantee that they will be able to turn to informal reserves for midyear gaps unless states are planning ahead and intentionally setting aside money.

Not only does the lack of good options lead policymakers to close gaps in ways that may worsen future budget challenges, it also can prompt states to take actions that harm organizations that depend on reliable state funding, including municipalities, school districts, and government contractors. When the North Carolina Department of Transportation (NCDOT) overspent its budget by \$742 million in FY 2019, the department delayed \$144 million in payments to contractors to help close the gap.³¹ When the state auditor investigated the problem, NCDOT officials explained that they faced practical challenges to cutting spending in the middle of a fiscal year because “for example, the Department cannot easily or safely stop a half-completed bridge.”³²

Make key decisions in advance

States cannot avoid midyear budget gaps altogether, but planning ahead can help them make better decisions. By creating contingency plans for budget gaps, policymakers can provide clear budgetary guidelines for shortfalls, if and when they occur. This means that even before financial troubles emerge, officials understand what conditions will prompt budget adjustments (such as revenue collections not meeting a certain threshold), who will execute such actions, and parameters for them to do so.

One state with a well-established process to prepare for midyear gaps is Arkansas. For decades, as a result of a state statute known as the Revenue Stabilization Law, lawmakers have placed general revenue appropriations in categories based on their level of priority.³³ Typically, there are three: Category A usually provides enough money to maintain funding at current levels or to meet minimum obligations, while categories B and C each represent distinct priority levels that generally provide for funding increases and new initiatives. These categories guide the state as it adjusts spending levels throughout the year. If revenue is falling short, the state does not provide funding for category C first, followed by category B.³⁴ When revenue forecasts looked bleak in March 2020, only months before the fiscal year concluded, the state adjusted spending accordingly.³⁵ All funding of category A was preserved, while category B was cut by 96%, and category C was eliminated entirely for the remainder of FY 2020.³⁶

Arkansas's approach holds several advantages compared to scrambling to rein in spending or racing to find ways to generate new revenue. By setting priorities during regular sessions as part of the annual budget process, lawmakers have time to carefully weigh their decisions. Both the legislative and executive branches have central roles (although the executive branch retains significant power by producing the revenue forecasts that determine which categories are funded). The approach also helps state agencies and other recipients of state funding to prepare: They know how much funding is in jeopardy and how much is virtually guaranteed. And, it has allowed Arkansas to avoid reliance on strategies such as borrowing, delayed payments, and accounting gimmicks that tend to exacerbate long-term budget challenges.³⁷ In 2021, Arkansas received an A grade from the Volcker Alliance, a nonprofit research organization focused on government management and public service, for its success in avoiding these types of budget maneuvers—a notable strength for a state that otherwise scored poorly in Volcker's budget practices report card.³⁸

States can also incorporate other key budget decisions into their plans, such as how to phase in tax cuts and whether to tap rainy day funds. For example, New Hampshire lawmakers linked business tax rates to revenue collections in the two-year budget that lawmakers approved in 2019. Under the budget, if revenue collections were at least 6% above forecasts through June 30, 2020, the tax rates would automatically drop starting in 2021; if collections were at least 6% below forecast, tax rates would automatically increase.³⁹ In this way, the state created a safety valve in which surprisingly poor revenue performance would automatically trigger additional revenue collections to close the gap. As it turned out, state revenue did underperform as a result of the pandemic but recovered just enough in June 2020 to avoid triggering the tax increase.⁴⁰

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Three key components

If other states wish to follow Arkansas’s lead, they should consider adding specificity to their rules for closing midyear gaps. Three key decisions are what budget conditions will trigger action, what process will be used for closing the gap (including who has authority to act), and what specific budget balancing actions may take place.

When states struggle with midyear gaps, it is often because one of these components—the trigger, the process, or the actions—is ill-defined or ill-conceived. For example, state statutes often grant governors broad discretion to adjust the budget to close gaps without offering much guidance on what actions are permissible—creating a recipe for governors to act unilaterally, without legislative input.

Likewise, triggers that are defined too narrowly risk preventing states from responding when budget conditions change. After the pandemic began, one of the largest sources of uncertainty for states was how much aid the federal government would provide and on what terms.⁴¹ With that in mind, some states included contingencies tied to federal aid in their budgets. California, for instance, approved \$11 billion in reductions, deferrals, and loans from special funds that would be reversed if the federal government provided aid by Oct. 15, 2020.⁴² When Congress didn’t act in time, the state kept the cuts in place—even though the state’s budget situation was already brightening significantly by then.⁴³ Had the state adopted a trigger based on the overall budget situation, not just federal aid, the state might have avoided the cuts.

This decision affected government services. For example, part of the trigger cuts was a \$150 million reduction to the state court system. After eliminating 85 jobs, San Diego County’s Superior Court had its fewest employees since the 1990s. By October 2020, court officials decided that remaining employees must take 10 unpaid furlough days.⁴⁴ The following month, nonpartisan legislative staff indicated that the state had “overcorrected,” with cuts and budget balancing maneuvers that were more drastic than necessary to bring the budget into balance.⁴⁵

One lesson from California’s experience is that if states must make midyear cuts, they should consider building in triggers to reverse the cuts if the budget situation improves before the fiscal year is over. Even with the best planning, cuts tend to be disruptive. If revenue recovers or spending pressures ease, states may have the opportunity to limit those disruptions. Planning for upside scenarios is especially important if states are making cuts early in the fiscal year, when there is still time for the situation to change.



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Incorporate planning for midyear gaps into the budget process

For states to routinely engage in comprehensive planning for midyear shortfalls, a good place to start is at the beginning of the annual budget process: agency budget requests. Just months into a new fiscal year, state agencies propose spending plans for the following year—for example, in the summer and fall of 2021, agencies made requests for the fiscal year that begins July 1, 2022.⁴⁶ These requests serve as the building blocks for governors' official budget proposals, which are typically released in winter.

Agencies usually have some discretion to include wish lists for new staff or programs, but their requests also must adhere to instructions from the central budget office. These instructions can direct state agencies to plan for a range of scenarios. For example, in 2018, Texas officials directed agencies to develop proposals for flat budgets and cuts of 2.5%, 5%, 7.5%, and 10%.⁴⁷ Likewise, in 2020, Vermont's Department of Finance & Management instructed agencies to prepare flat budgets, but also scenarios for 1%, 2%, or 3% increases.⁴⁸

By developing plans for a range of scenarios, state leaders can ensure that they have information to adjust the budget quickly in the event they face a midyear gap. This approach also gives agency leadership input and allows them to plan for potential cuts. And, in keeping with the Arkansas model, it also offers lawmakers the option of building contingencies into the enacted budget, with the ultimate amount of funding that agencies receive tied to revenue collections throughout the year.

States can also review the trigger and process they employ for rainy day withdrawals to ensure that they can use reserves to close midyear gaps if they are caused by economic downturns and other temporary shocks. Because a number of states require input from the legislature to withdraw rainy day funds, the timing of legislative sessions can present barriers.⁴⁹ However, some states have designed processes to tap the funds even when the legislature isn't in session.

Nevada's approach balances legislative and executive branch prerogatives: The Legislature's Interim Finance Committee and a state board led by the governor can jointly act to withdraw money if the legislature isn't in session.⁵⁰ Nevada used this provision to authorize a withdrawal from the rainy day fund in May 2020, without which the state would have likely needed to cut its budget even more deeply.⁵¹ Other states such as Virginia permit rainy day fund withdrawals when a revised forecast shows general fund revenue falling short of appropriations.⁵²

Plan for likely scenarios

To prepare for midyear gaps, states benefit by estimating the potential size of budget shortfalls. With that information, policymakers can identify options to cut spending or increase revenue sufficiently to close the gaps.

For example, each month Connecticut's Office of Policy and Management (OPM) updates estimates for the state's shortfall or surplus for the rest of the fiscal year.⁵³ To produce these estimates, the office revises revenue forecasts while also compiling and analyzing spending projections from agencies—documenting instances in which agencies are at risk of overspending their appropriations. Then, the state comptroller—an independently elected official—offers his or her own estimate of the gap, building on OPM's numbers.⁵⁴

The detailed, monthly updates help Connecticut's leaders determine when to take action to close a gap by, for example, withholding money from state agencies. The updates also dictate who is responsible for closing the shortfall. The governor can reduce appropriations unilaterally by up to 3%. To make reductions that are larger than 3%, but less than 5%, he or she must secure the approval of the Finance Advisory Committee, a special panel that includes a mix of statewide elected officials and legislators. Larger reductions require the approval of the full Legislature.⁵⁵

States can also analyze the potential size of their midyear gaps under multiple scenarios, recognizing that a state's midyear surplus or shortfall is a moving target. The pandemic drove home the value of this analysis: For months, states faced tremendous uncertainty about the condition of the economy and, consequently, the size of their budget gaps. Although states couldn't eliminate the ambiguity, they could estimate a reasonable range of outcomes and use that information to plan ahead.

For example, New Mexico and Oregon include analyses of optimistic and pessimistic scenarios in their forecasts of state revenue, in addition to their official baseline forecasts.⁵⁶ New Mexico's August 2021 forecast, for instance, estimated that general fund revenue would fall \$354 million below expectations in the current fiscal year under a pessimistic scenario in which low oil prices cut into tax collections.⁵⁷ Pandemic-related considerations were central to Oregon's May 2021 analysis, with its optimistic and pessimistic scenarios factoring in alternative impacts of higher and lower COVID-19 vaccination rates, for example.⁵⁸ The New Mexico and Oregon scenario analyses look out several years, providing data not only on the size of midyear gaps for the current fiscal year, but also potential shortfalls in future years.⁵⁹

One lesson from the pandemic is that states should think ahead about how they can quickly estimate the size of budget gaps as soon as economic conditions begin to deteriorate or other factors unexpectedly create the risk of a midyear gap. The sooner policymakers have an idea of how large the gaps will be, the sooner they can begin planning to close them.

Pennsylvania succeeded at doing that. Early in the pandemic, when it was unclear how long widespread business closures would last, Pennsylvania's Independent Fiscal Office produced estimates for how shutdowns of different lengths would affect state revenue for the remainder of the fiscal year.⁶⁰ As a result, in early April 2020, Pennsylvania policymakers already had data on the emerging budget gap.

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Identify options for closing the gap

Once states have estimates for how large midyear shortfalls could be, the next step is to identify options for closing gaps of various sizes. Utah has had success in this area, with fiscal staffers working with lawmakers to design a “fiscal toolkit” of budget balancing options. This toolkit offers seven options, including various revenue increases, spending cuts, and available reserves. These options are ranked on their ability to close a budget gap and ease of access based both on statutory or constitutional rules and on policymakers' preferences.⁶¹

Utah's toolkit helps the state prepare for shortfalls in future years, but the focus on ease-of-access makes it an especially valuable playbook when budget problems begin suddenly in the current year. Once the pandemic began jeopardizing state revenue collections in FY 2020, the state used ideas outlined in the toolkit. For example, lawmakers gave state agencies flexibility to use money left over from FY 2019 to pay for FY 2020 expenses. Likewise, they authorized the state to borrow to pay for infrastructure projects that the state otherwise would have paid for in cash, freeing up dollars to redirect elsewhere in the budget. As a result, they were able to avoid last-resort options from the state's fiscal toolkit, including revenue increases and rainy day fund withdrawals.⁶²

Crucially, Utah doesn't wait for budget problems to emerge to develop and refine the toolkit. Instead, it is part of the state's regular stress testing analysis: By law, once every three years, fiscal staff in the legislative and executive branches work together to analyze the potential effects of economic downturns on the state budget.⁶³

And states do not have to stop at identifying options; they can adopt policies to strengthen those options, ensuring that they will provide sufficient relief to close expected midyear gaps. Minnesota does that regularly, analyzing the size and likelihood of potential gaps and then creating savings large enough to close them.

Each year, economists in Minnesota's budget office estimate how much money the state needs to hold in its rainy day fund to be 95% confident that the reserve will have enough funds to completely cover a decline in tax revenue in the current biennium.⁶⁴ To make that estimate, the economists analyze how much Minnesota revenue collections have historically varied from year to year, through economic expansions and recessions. As a result, if Minnesota policymakers stock the rainy day fund up to the target—as they have in recent years—they can have confidence that it is likely to serve as a sufficient contingency for midyear gaps.⁶⁵ Importantly, the state's rules for withdrawing money from the rainy day fund offer enough flexibility to allow budget officials to quickly tap the reserve to close shortfalls.

Conclusion

The sudden onset of the COVID-19 pandemic and resulting economic disruptions may have been a once-in-a-lifetime crisis, but states regularly face recessions and other adverse events that can create midyear budget gaps. Because options to close these gaps are limited, planning ahead is crucial for states to maintain critical government services and avoid decisions that contribute to future budget challenges.

The pandemic tested states' rules, processes, and strategies for closing midyear gaps. Some states innovated, adopting new tools to estimate gaps and inform budget balancing plans. However, many also showed they have room to improve. State government officials should examine how well they performed under the strains of the past two years and use that experience to inform refinements. By doing so, states can be better prepared the next time they face a sudden budget shortfall.

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