
To Prepare for the Next Recession, States Take Stress Tests.

No government can be fully prepared for every economic twist and turn. Still, some are trying.

The Great Recession was uniquely devastating for states and localities because it hit all three major tax revenue sources: income, sales and property. It was a scenario that few, if any governments, were really prepared to absorb. As a result, governments were forced to make massive budget cuts.

Now, as the recovery trudges on longer than most, a growing number of states are making sure they aren't blindsided by the next downturn.

Enter stress testing. The idea, which was borrowed from the U.S. Federal Reserve, essentially throws different economic scenarios at a state budget to see how revenues would be impacted.

"We're in an environment where everyone is starting to think about the next downturn and what that's going to look like," said Emily Raimes, a Moody's Investors Service analyst. "A stress test is a tool for states to think about what types of programs they should commit to and how much to save now."

Credit rating agencies, in fact, are among the practice's biggest fans. Earlier this year, Moody's stress-tested budgets of the 20 most populous states and found that Missouri, Texas and Washington are in the best position to handle a recession because of their strong reserves, spending flexibility and lower revenue volatility. (Low revenue volatility means a state's income doesn't change too drastically from one year to the next. In other words, it's more predictable.)

California and Illinois, however, found themselves at the other end of the spectrum in Moody's stress test. California is endangered by its high revenue volatility and lower reserves, according to the report. And Illinois is vulnerable because of its extremely low reserves and inflexible governance.

S&P Global Ratings also stress-tests state budgets. In August, the agency performed a stress test on the top 10 borrowing states' fiscal 2017 budgets. The scenario focused on what would happen if global economies like the United Kingdom or China slowed down more than anticipated.

The results — some of which overlap with Moody's — show that Connecticut, Illinois, New Jersey and Pennsylvania are most likely to feel significant fiscal stress, while Florida, New York and Washington are best positioned for a downturn.

A few states are forging the way with their own stress-testing systems, while even more are looking into the idea.

Utah has the most robust practice, and it's something credit rating agencies have held up as an example. Last year, the state tested its budgets against a moderate and severe recession — think 2001 versus 2008. The results told policymakers that Utah has enough in reserves to weather a moderate downturn, but a severe one would likely require cutting nearly $1 billion in spending over two to three years in addition to using most of the state's reserves.

The process was so informative that Utah Office of Management and Budget Director Kristin Cox and her colleagues are developing additional scenarios to test. For instance, what happens to specific revenue streams if the state's biomedical industry slows down? Or if oil prices shoot back up? (Utah's stress testing is one of the reasons Governing recently awarded Cox with a Public Official of the Year award).

Minnesota also uses a form of stress testing to evaluate its revenue volatility and inform its rainy day fund policy. It's one of just four states that requires periodic evaluations to make sure its savings targets actually reflect the state's revenue volatility. It's also the only state to determine its risk tolerance — that is, the tolerance policymakers have for not fully covering a potential shortfall. Its current savings target is the amount deemed necessary to cover 90 percent of all possible downturn scenarios.

California, which saw its revenues drop 20 percent during the Great Recession, recently started using stress tests. The state Legislative Analyst's Office now includes estimates of what would happen to the state's budget under an economic growth scenario and a mild recession scenario. The most recent analysis concludes that, in the event of a mild recession in 2018, the state would have enough reserves to cover most of its operating deficits through the 2020–2021 fiscal year.

Of course, no government can be fully prepared for every economic twist and turn.

"We're trying to create certainty in an environment that is inherently uncertain," said Cox. "Instead our approach should be, how prepared are we to respond to different scenarios?"

The unusual recession and equally unusual recovery period has sent the message to budget officials that they can't afford to be caught unprepared. Since presenting Utah's stress-testing methods at a National Conference of State Legislatures meeting, Legislative Fiscal Analyst Jonathan Ball said he's gotten calls from Colorado, Nevada and Vermont, among others.

"It's gotten a lot of traction," he said. "We didn't know if it was going to work at first. We're kind of learning as we go and sharing our experience with other states."

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