

Budget Stabilization Fund

LFB Summary Items for Which an Issue Paper Has Been Prepared

<u>Item #</u>	<u>Title</u>
-	Transfer of Excess General Fund Tax Revenue (Paper #700)



Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873
Email: fiscal.bureau@legis.wisconsin.gov • Website: <http://legis.wisconsin.gov/lfb>

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Joint Committee on Finance

Paper #700

Transfer of Excess General Fund Tax Revenue (Budget Stabilization Fund)

CURRENT LAW

Wisconsin's budget stabilization fund was created by 1985 Act 120. The creation of this fund occurred after the state had endured a difficult economic downturn during the early 1980's. During that recession, the state increased general fund taxes, through permanent increases and temporary surcharges. In addition, the state reduced budgets in a number of the state's programs and agencies. This was the case in many states at the time, and it was during this period that many of the states created "rainy day" funds or budget stabilization funds. Generally, these funds were established for the purpose of setting aside funds for a time period when state revenues might grow more slowly than estimated, or actually decrease from the prior year.

Under current law, if actual general fund tax revenues in a given fiscal year exceed projected revenues as estimated in the general fund condition statement from the biennial budget act for that biennium, 50% of the additional tax revenues in that fiscal year are transferred to the budget stabilization fund. The transfer cannot reduce the balance in the general fund below the required statutory balance. If the balance in the budget stabilization fund prior to the transfer exceeds 5% of estimated general fund expenditures for that fiscal year, as reported in the Chapter 20 summary in the biennial budget act, no transfer is made.

State law also specifies that the net proceeds from the sale of state agencies' surplus supplies, materials, and equipment are deposited in the budget stabilization fund. Other sources of revenue for the fund include donations, interest earnings of the fund, and appropriations of the Legislature.

State law specifies that the budget stabilization fund is to be used to provide state revenue stability during periods of below-normal economic activity when actual state revenues are lower than estimated revenues. A specific trigger is not identified in the statutes, so use of the fund is at

the discretion of the Legislature. The transfer of monies out of the budget stabilization fund can only be accomplished by the enactment of legislation.

DISCUSSION POINTS

1. A budget reserve offers several advantages to a state. If monies are available in a budget reserve, they can be used if revenues are less than projected or expenditures exceed budgeted amounts. This can mitigate the effects of a mild economic downturn on a state's finances. If the revenue shortfall is more severe, a budget reserve can allow state policymakers more time to consider a response to the imbalance, before they are forced to adjust state revenues or expenditures to maintain a balanced budget.

2. The stabilization fund helps improve the general fund balance, as reported in the state's Comprehensive Annual Fiscal Report, prepared based on generally accepted accounting principles (GAAP). Under GAAP, the general fund balance on June 30, 2020, was \$1.5 million. This amount is improved by the balance of the budget stabilization fund, which was \$761.8 million on June 30, 2020, following the year-end transfer to the fund in that year. Therefore, without the balance of the budget stabilization fund, the state's general fund balance would have had a GAAP deficit of \$760.3 million on June 30, 2020.

3. On the other hand, there are policymakers who disagree with the idea of a "rainy day" fund. From this point of view, the potential benefits from a budget reserve are outweighed by other factors. As a matter of policy, other uses for these funds, such as reducing state taxes or increasing state spending, are viewed as having a higher priority than funding a budget reserve. Underlying this approach is the concern that monies accumulated as a reserve represent over-taxation in that year, and could better be used by the state to either support higher priority spending programs or to reduce taxes.

4. Although the budget stabilization fund was created in 1986, Wisconsin did not allocate significant monies to the fund until 2006. This is because, prior to 2001, the only mechanisms for providing money to the fund were appropriations and donations. 2001 Act 16 created the current law automatic transfer procedure, which requires 50% of general fund tax revenues collected in excess of revenue estimates included in the biennial budget act to be transferred to the budget stabilization fund. Further, 2003 Act 33 allowed for the net proceeds from the sale of surplus land and buildings, and state agency supplies and equipment, to be transferred to the fund.

5. Table 1 below presents activity within the budget stabilization fund since 2003-04. Prior to 2006-07, the largest revenue source to the fund had been the sale of surplus property. However, in the fall of 2007, the first transfer of excess tax revenue to the budget stabilization fund occurred. A year later, the first and only transfer, by law, from the budget stabilization fund to the general fund occurred to help address a budget shortfall in the 2007-09 biennium (Great Recession). As seen in Table 1, excess general fund tax revenues resulted in transfers into the budget stabilization fund in five of the last 10 fiscal years. The transfer of \$321.7 million to the fund in the fall of 2019 was the largest to date, and more than double any other transfer.

TABLE 1

**Budget Stabilization Fund Activity
2003-04 through 2019-20 (In Millions)**

	<u>Tax Revenue Transfers in</u>	<u>Other Revenue*</u>	<u>Fund Withdrawals</u>	<u>Ending Balance (As of June 30)</u>
2003-04	-	-	-	\$0.0
2004-05	-	\$0.5	-	0.5
2005-06	-	0.1	-	0.6
2006-07	\$55.6	0.2	-	56.4
2007-08	-	1.9	-\$57.0	1.3
2008-09	-	0.2	-	1.5
2009-10	-	0.2	-	1.7
2010-11	14.8	0.1	-	16.6
2011-12	108.7	0.1	-	125.4
2012-13	153.2	0.7	-	279.3
2013-14	-	0.4**	-	279.7
2014-15	-	0.6	-	280.3
2015-16	-	0.9	-	281.2
2016-17	-	1.7	-	282.9
2017-18	33.1	4.1	-	320.1
2018-19	321.7	7.3	-	649.1
2019-20	105.8	6.9	-	761.8

*Revenue from interest earnings, gifts and donations, sales of surplus land and buildings, and sales of surplus equipment.

**Pursuant to 2013 Act 20, sales of surplus land and buildings are no longer transferred to budget stabilization fund.

Source: Annual Fiscal Reports

6. Since much of the fund's growth has occurred over the last decade, Wisconsin did not have the option to draw money from the fund during the majority of the previous recessions. Therefore, Wisconsin has generally used tax and fee increases, specific expenditure reductions, one-time sources of revenue or fund transfers, and across-the-board budget reductions to state operations to balance its budget in times of economic downturns. The Great Recession represented the first time in which the state had money in its budget stabilization fund to address a large economic downturn. The Legislature responded by drawing the fund balance down by \$57 million, to nearly \$0.

7. With a current balance of \$762.4 million as of May, 2021, the state's budget stabilization fund is in a much different position. As mentioned, if the balance in the budget stabilization fund prior to a transfer exceeds 5% of estimated general fund expenditures, no transfer is made. For 2019-20 and 2020-21, 5% of net appropriations from the general fund under 2019 Act 9 would have been \$901.3 million and \$945.2 million, respectively. Based on this office's June 8, 2021, estimate of 2020-21 general fund tax revenues, it is estimated that \$807.9 million will transfer from the general fund to the budget stabilization fund in the fall of 2021. This transfer would bring the balance of the stabilization fund to \$1,570.3 million, exceeding the 2020-21 limit on the fund balance. While the

relevant limit for 2021-22 cannot be determined at this point, it is anticipated that the balance of the fund would exceed that limit if the estimated 2020-21 transfer to the fund occurs. As such, no future automatic transfers to the fund would be made, unless general fund expenditures increase enough in future years that the new limit exceeds the new fund balance.

8. Currently, 41 states (including Wisconsin) and the District of Columbia have a limit on the balance of their budget stabilization fund. These limits are typically a percentage of either revenues or expenditures. For some states, like Wisconsin, surplus funds remain in the general fund once the limit has been reached. However, a few states redirect surpluses to other funds for special projects or taxpayer relief. The Tax Policy Center notes that limits on the balance of a budget stabilization fund can help prevent unnecessary build-up of restricted funds. However, too low of a limit could mean that states do not have adequate reserves to weather an economic downturn, without large spending cuts or tax increases. Including Wisconsin, nine states and the District of Columbia specify limits of 5% or less.

9. According to the National Conference of State Legislatures (NCSL), the conventional standard for states' financial adequacy is to have 5% of total revenue or expenditures in a combination of its end-of-year balance and its budget stabilization fund. However, following the 2008-09 recession, state experts began to reconsider whether this rule provided enough financial cushion for states. NCSL further noted that the optimal fund balance varies by state, depending on each state's revenue volatility, and reported that, in general, most states limit their rainy day fund balances to between 5% and 15% of general fund revenues or expenditures.

10. However, the Government Finance Officers Association recommends that states have a balance of up to two months' worth of operating revenue or expenditures (17% of annual expenditures). According to the Tax Policy Center, only five states had rainy day fund balance at or above this level at the end of 2018.

11. Further, Pew Charitable Trusts recommends that policymakers consider three factors in determining the optimal savings level for their state's rainy day fund: (a) the fund's purpose; (b) the volatility of the state's revenues; and (c) the degree of risk the state wishes to offset. State law specifies that the purpose of Wisconsin's budget stabilization fund is to provide state revenue stability during periods of below-normal economic activity, which is identified as a time in which actual state revenues are lower than previously estimated revenues. Therefore, what remains to be determined are what portion of revenue shortfalls the state intends to offset with budget stabilization fund monies, and how much money is needed to meet this goal.

12. Looking at past revenue volatility may help determine how much money is needed in the budget stabilization fund to address future recessions. For example, during previous severe recessions, actual collections were lower than the initial estimates (January of the odd-numbered years and adjusted for subsequent state law changes) by: (a) 9.0% in 1980-81, 4.5% in 1981-82, and 7.1% in 1982-83; (b) 7.5% in 2001-02 and 10.7% in 2002-03; and (c) 11.4% in 2008-09, 5.7% in 2009-10, and 3.8% in 2010-11. In terms of a one-year annualized budget reserve, these recessions resulted in total revenue shortfalls of 20.6%, 18.5%, and 20.9%, respectively. In other words, if the entire revenue shortfall from these recessions had occurred over one year, the state would have experienced a shortfall of more than 20% in two recessions since 1980.

13. As noted, as a result of the unexpected shortfalls in collections discussed above, the Legislature was required to reduce state expenditures, increase taxes or fees, and/or use existing reserves to offset lower tax collections resulting from these economic downturns. However, even if it was known that these recessions were about to occur when initial revenue estimates were prepared, the Legislature would have had to decide how to reduce expenditures, increase revenues, and/or use existing reserves when deliberating those biennial budget bills.

14. Table 2 shows the amount of money that would need to be held in the budget stabilization fund to offset lower than estimated general fund tax revenues in the event of a future recession, if actual collections were between 1% and 20% lower in 2022-23 compared to the June 8, 2021, estimates prepared by this office.

TABLE 2
General Fund Tax Revenues as a Percentage of the June 8, 2021 Estimates
(Millions)

		<u>2022-23</u>
	1%	\$204.8
	2	409.7
	3	614.5
	4	819.3
	5	1,024.1
	6	1,229.0
	7	1,433.8
	8	1,638.6
	9	1,843.5
	10	2,048.3
	11	2,253.1
	12	2,457.9
	13	2,662.8
	14	2,867.6
	15	3,072.4
	16	3,277.2
	17	3,482.1
	18	3,686.9
	19	3,891.7
	20	4,096.6

15. As mentioned, the current balance of the budget stabilization fund is \$762.4 million. This amount currently represents about 3.7% of 2022-23 estimated tax revenues. In the event that the estimated transfer of \$807.9 million is made following 2020-21, the balance of the fund would reflect approximately 7.7% of 2022-23 estimated tax revenues. [Although not included in this analysis, prior action by the Committee recommends that an additional \$350 million be transferred to the budget stabilization fund in 2022-23.] In the first year of each recession discussed above, actual revenues were below estimated amounts by at least 7.5%. Further, history shows that a revenue shortfall as a result of a recession often lasts two to three years. Therefore, while the balance following the likely

2020-21 transfer to the stabilization fund may be sufficient to address a large portion of a revenue shortfall in the first year of a major recession, there likely would not be enough monies remaining in the fund to assist the state through the remainder of the recession.

16. The Committee could consider what role it would like the budget stabilization fund to play in addressing future economic downturns. If the Committee views the fund as a means to address mild economic downturns, or as a way to allow policymakers more time to address larger recessions through tax increases and expenditure reductions, the current limit on the fund may be sufficient for those purposes. However, if the Committee believes that the fund should be large enough to offset larger revenue shortfalls as a result of a future recession, it may want to consider increasing the limit on transfers to the budget stabilization fund.

17. As previously noted, the Government Finance Officers Association recommends that states hold two months' worth (approximately 17%, or one-sixth) of annual expenditures in their budget stabilization funds. Based on 2020-21 net GPR appropriations, this amount would be \$3,151 million for Wisconsin. The Committee could decide to set the budget stabilization fund limit at one-sixth of annual net appropriations for each fiscal year (Alternative A1).

18. On the other hand, the Committee may wish to specify the limit as a different percentage of annual expenditures. If the Committee desires to have a fund balance that would be sufficient to offset revenue shortfalls resulting from large recessions, without additional spending cuts or tax increases, it may wish to increase the current limit to reflect 20% of annual expenditures (Alternative A2.). This amount would equate to \$3,781 million in 2020-21. As mentioned, several of the state's largest economic downturns resulted in revenue shortfalls of around 20% on an annualized basis. This alternative (once the limit is met) would likely allow the state to weather most economic downturns with little to no change in state spending or taxation.

19. However, if the Committee believes a limit of 20% of annual expenditures is too high, but would still like to increase the fund limit to a level that would be sufficient to offset a large portion of potential future revenue shortfalls, it could consider a limit of 15% of net GPR appropriations (Alternative A3). At 15% of net appropriations, the limit on the budget stabilization fund balance would be \$2,836 million in 2020-21. As previously noted, most states limit their fund balances between 5% and 15% of general fund revenues or expenditures. This alternative would bring the limit more in line with other states.

20. Likewise, the Committee could increase the limit on the budget stabilization fund to 10% of annual net expenditures, which would represent \$1,890 million in 2020-21 (Alternative A4). This would provide for a balance that would offset approximately half of the revenue shortfall that resulted from prior severe recessions. This level would also likely be sufficient to weather most mild economic downturns. Finally, if the Committee decides that the current limit is sufficient to meet its desired savings level, it could take no action (Alternative A5).

21. Separate from determining the level at which to limit the balance of the budget stabilization fund, the Committee could consider what should happen to monies in the fund once the specified limit has been met. While the statutory year-end transfer from the general fund to the stabilization fund cannot occur if the balance of the budget stabilization fund prior to the transfer

meets or exceeds the current limit, the balance of the fund can exceed the limit in multiple ways. For example, if actual revenues exceed estimates (as expected) in 2020-21, and \$807.9 million is transferred to the budget stabilization fund, this would bring the ending balance of the fund to \$1,570.3 million, exceeding the 2020-21 limit of \$945.2 million. In addition, prior action by the Committee would transfer \$350 million into the fund in 2022-23, which would further increase the fund balance. Finally, even if future transfers of excess general fund tax revenues are restricted, the fund will still grow through interest earnings and the transfer of net proceeds from the sale of surplus equipment and supplies by state agencies.

22. Assuming that the limit on the fund balance reflects the state's desired savings level, it could be argued that any amount above that limit is unnecessary and could be better utilized in the general fund. The Committee could decide that if the balance of the budget stabilization fund at the close of each fiscal year, as reported by the Annual Fiscal Report, exceeds the limit on the fund balance for net GPR appropriations in the following fiscal year, any amount in excess of the limit would be transferred to the general fund (Alternative B1). Under this alternative, once the budget stabilization fund limit has been met, the fund would turn into another source of revenue for the general fund (through interest earnings and sales of surplus equipment and supplies).

ALTERNATIVES

A. Limit on Budget Stabilization Fund Balance Transfer

1. Specify that if the balance of the budget stabilization fund on June 30 of the fiscal year is at least equal to one-sixth of net appropriations from the general fund during that fiscal year, as reported in the summary in the biennial budget act, the Secretary of Administration may not make the automatic year-end transfer to the fund.

2. Specify that if the balance of the budget stabilization fund on June 30 of the fiscal year is at least equal to 20% of net appropriations from the general fund during that fiscal year, as reported in the summary in the biennial budget act, the Secretary of Administration may not make the automatic year-end transfer to the fund.

3. Specify that if the balance of the budget stabilization fund on June 30 of the fiscal year is at least equal to 15% of net appropriations from the general fund during that fiscal year, as reported in the summary in the biennial budget act, the Secretary of Administration may not make the automatic year-end transfer to the fund.

4. Specify that if the balance of the budget stabilization fund on June 30 of the fiscal year is at least equal to 10% of net appropriations from the general fund during that fiscal year, as reported in the summary in the biennial budget act, the Secretary of Administration may not make the automatic year-end transfer to the fund.

5. Take no action.

B. Transfer from Budget Stabilization Fund to General Fund

1. Specify that if the balance of the budget stabilization fund, as published in the Annual Fiscal Report, exceeds the following fiscal year's limit on the transfer of general fund tax revenues to the budget stabilization fund, the amount reported in the Annual Fiscal Report in excess of the limit is transferred to the general fund on January 1.

2. Take no action.

Prepared by: Sydney Emmerich