CBO MEMORANDUM

STATES' USE OF SURPLUS FUNDS

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This memorandum presents the Congressional Budget Office's (CBO's) analysis of states' use of surplus funds. The memorandum, which responds to a request from the Senate Committee on the Budget, examines how states manage surplus funds and whether their experiences in this area may be applied to the federal government's budget.

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INTRODUCTION

Nearly all of the states, as well as the federal government, are enjoying the benefits of a prosperous economy. With revenues exceeding estimates in most states, general fund and reserve balances have grown to their highest levels in over 20 years.[1] Those excess funds present states with the choice of reducing taxes, increasing program spending, reducing debt, or banking the unexpected resources for later use. Meanwhile, the federal government has realized a surplus for the first time in decades.

As states have seen in the past, how they use surplus revenues can significantly affect their ability to weather future economic downturns. The federal government and the states, however, have different fiscal constraints and goals. Moreover, because of the federal government's important role in the U.S. economy, how it uses surplus funds has consequences for achieving national policy goals and financial flexibility.

1. The general fund is essentially the operating portion of a state budget, which, although it accounts for only about half of total state spending, is the source of funding over which state lawmakers exercise the greatest control. Reserve funds are statutorily or constitutionally created segregations of moneys that may be either in a separate account within the general fund or in a separate fund. In most cases, access to reserve fund moneys depends upon economic conditions or legislative action.

METHOD OF ANALYSIS

The Congressional Budget Office (CBO) examined in depth two states, Illinois and Maryland, that have significantly different methods of managing state finances. CBO chose those states because they exemplify the use of different methods of controlling state expenditures and planning for future obligations—not because they are representative of all states. Both states had surplus revenues after a number of years of tight budgets in the early 1990s. Illinois's use of cash budgeting allows the state to delay the timing of expenditures depending on available revenues. Maryland's strong executive control over the budget coupled with legislative oversight provided an interesting example of budget process. Its use of reserve funds during times of fiscal constraint exemplifies the advantages and disadvantages of such a strategy. In contrast, Illinois has not implemented a reserve fund, an approach that also has advantages and disadvantages.

CBO asked budget leaders in those states a variety of questions, including how they defined surplus, how they have managed financial shortfalls in the past, what efforts they employ to reduce future imbalances, and what plans they have for using higher-than-expected revenues. CBO augmented those discussions with additional conversations with budget leaders from other states.

In contrast to the economy of the late 1980s through the early to mid-1990s, today's strong economy has bolstered the financial positions of most states in recent years. State and local tax revenues have grown, while demands on welfare programs have declined dramatically. The growth in Medicaid caseloads, once the bane of state budgets because it resulted in financial shortfalls, declined at the same time that states implemented cost-control measures to limit their exposure to Medicaid expenditures. Consequently, states have ended their fiscal years with general fund balances at record levels.

During the past three fiscal years, states' reserve and ending balances for general funds have consistently exceeded expectations. States ended fiscal year 1996 with a total of $25 billion in general and reserve funds and 1997 with $27 billion. In addition, the most recent estimates indicate that states will end fiscal year 1998 with balances totaling over $30 billion.[2] In all, those balances represent between 6 percent and 9 percent of states' annual expenditures, a healthy reserve level given that financial analysts regard a 5 percent balance as a reliable indicator of fiscal well-

2. National Association of State Budget Officers, *The Fiscal Survey of the States* (Washington, D.C.: National Association of State Budget Officers, 1997 and 1998); and National Conference of State Legislatures, *News Release: State Budget and Tax Actions, 1998* (Denver, Colo.: National Conference of State Legislatures, July 21, 1998).

being. Those are total balances, of course, and individual states' balances vary. With the exception of Hawaii, however, no state faces an overall shortfall in revenues or unexpected demands for expenditures.

Illinois's Fiscal Condition

Illinois benefits from a diverse economy and a broad tax base. Constitutional and statutory requirements governing the management of the state's finances are less restrictive than those in other states. The state constitution requires that budgeted expenditures for a fiscal year not exceed funds available. Those funds may include a balance from the prior fiscal year, allowing the state to cover a projected deficit in the next fiscal year. Illinois budgets on a cash basis, recording revenues when they are received and expenditures when an outlay occurs. Financial managers in the state can delay payments to creditors and maintain a cash balance at any point in time.

Although extending a payment cycle may preserve balance on a cash flow basis, it does nothing to limit the future liability of obligated spending. In the early to mid-1990s, for example, it took the state of Illinois up to 180 days to pay some vendors. Strong growth in tax revenues in the past few years has enabled the state to shorten the length of time it carries those liabilities, and it now pays all vendors within 30 days. In addition to shortening its payment cycle, Illinois has accrued record-breaking ending balances in the general fund.

Maryland's Fiscal Condition

Although Illinois's economy is more diverse than Maryland's, Maryland benefits from a strong tax base. Maryland has historically practiced conservative fiscal management through strong executive control and legislative oversight. Maryland's constitution established an executive budget process that allows the governor to react quickly to budget shortfalls by reducing certain appropriations by up to 25 percent.[3] In addition, budgetary and accounting reserves provide the state with resources for addressing unforeseen liabilities. Finally, Maryland's General Assembly has established a "spending affordability process" that limits the growth of the state's operating budget.[4]

Those procedures and controls have provided Maryland with a measure of financial stability. Even though the state's employment growth has been below average for most of the 1990s, Maryland's financial position has steadily improved.

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3. The governor used that authority, among other actions, to balance the operating budget from fiscal years 1991 through 1993.

4. Under that process, a legislative committee makes recommendations to the governor about growth in the state's operating budget. Although those recommendations are not binding, the General Assembly has adopted only one operating budget that exceeded the committee's recommendations.

Significant growth in income tax collections during the last two fiscal years, mainly due to strong economic conditions, has allowed the state to set aside additional reserves and reduce income taxes.[5]

STATES' STRATEGIES FOR USING SURPLUS FUNDS

A surplus of available funds (balances plus revenues) over what is needed to cover expenditures in any given year gives states the opportunity to adjust their current or projected year budgets in addressing ongoing tax or expenditure policies. An accumulated surplus, one carried over from the prior year's budget, allows a state to increase expenditures or decrease taxes in the current year by essentially using the surplus to cover the current year deficit. Similarly, a projected surplus in any given year allows a state to adjust its budget plans for revenues and expenditures in the upcoming year. Statutory or constitutional requirements (some of which may require tax rebates or deposits into reserve funds) often guide states' decisions on using surpluses. Ultimately, however, surplus funds provide states with flexibility in addressing the demands of their operating budget. Using surplus funds for the early retirement of debt is one strategy that states do not typically use because most states incur debt for long-term capital projects rather than for operating expenses.

5. Maryland Department of Legislative Services, Board of Revenue Estimates, "Income Tax Revenue," *Fiscal and Policy Update* (September 18, 1998).

Although a robust economy has fueled an increase in state tax collections, memories of the financial challenges of the late 1980s and early 1990s have tempered proposals for using surplus funds. Therefore, states have generally sought to make budget decisions that they can sustain over time. They have done that mainly by using the following five strategies: funding one-time expenditures, cutting taxes strategically, establishing rainy-day funds to preserve flexibility, maintaining high general fund balances, and creating special reserve funds.[6] Whatever method states use, however, depends as much on the surrounding political environment and economic projections as it does on states' financial situations.

Strategy One: Using Surplus Funds for One-Time Expenditures

States commonly use surplus funds for new spending; however, following the recessions of the 1980s and early 1990s, states have generally avoided making long-term commitments when spending funds from surplus revenues. One of the most effective ways states have found to use surplus funds while avoiding long-term commitments is by funding one-time expenditures. Those expenditures may be for capital projects that can be completed in a short time, for the reduction of a long-term liability, or for a project that is expected to be self-sustaining over time. In Maryland,

6. For ongoing studies of states' economic conditions and policy choices, see the following two publications: *State Policy Reports,* published by State Policy Research, Inc. in Hilton Head, South Carolina, and *State Fiscal Brief,* published by the Center for the Study of the States at the State University of New York in Albany.

policymakers have used recent surplus funds to increase public school construction. Although that construction had been planned in advance, additional resources in recent years have enabled the state to shorten the time for completing the projects. In addition, because Maryland's local jurisdictions will be responsible for the operating expenses of those new schools, the state's expenditures for construction will not create long-term commitments.

Illinois chose to use additional revenues to speed up payments to Medicaid providers. During the recession of the early 1990s, Illinois managed its cash flow by lengthening the amount of time it took to reimburse Medicaid providers. At its worst, that payment lag was approximately 180 days long. Higher-than-expected revenues in recent years, however, have allowed the state to reduce the payment cycle to less than 15 days. An overly long payment lag creates several financial problems by constraining the options available to financial managers when they face unexpected budgetary demands, and it poses daily challenges in deciding which bills are to be paid and to whom. When certain vendors (for example, health care providers of Medicaid services) do not get paid for nearly six months, their willingness to provide services to the state declines dramatically, and their own financial well-being may be jeopardized. Conversely, a short payment cycle builds in the opportunity for lengthening the amount of time it takes to pay bills. A payment cycle of 30 days may be acceptable to most vendors, so a process of paying bills within 15 days builds a cash flow cushion that can be used (albeit only once) if the state faces a revenue shortfall or unexpected demands on expenditures.

Sometimes states use additional resources as seed money for programs that are expected to be self-sustaining over time. Typically, those programs operate as revolving loan programs within the state budget. The state acts as the administrator and financial manager of the program, or it distributes grants to outside entities that will use future revenues for operations and expenses. Many conservation programs, for example, begin with such an outlay of funds for capital projects. After the initial investment, fees and other sources of income pay for those projects' continuing operations and possibly the repayment of any long-term debt. Similarly, a state may provide grants to local governments for infrastructure improvements, and then the locality assumes responsibility for collecting taxes and fees to support ongoing operations.

Although states may provide such grants to local governments with broad latitude for spending, the grants often contain specific guidelines and restrictions on spending, depending upon policy goals determined at the state level. By clearly defining those arrangements, states can guard against requests for additional resources and avoid an implicit obligation to cover any revenue shortfall. Moreover, funding such projects has allowed some states to achieve specific policy goals, while avoiding future administrative or financial responsibilities.

Strategy Two: Cutting Taxes Strategically

Surplus funds sometimes prompt state policymakers to reduce taxes instead of or in addition to increasing spending for selected programs. Just as states make spending commitments carefully, their plans for reducing taxes often consider that future resources may be limited. Surging tax revenues could result from short-term economic growth that may level off or even decline in future years. If increased revenues do not result from broad, sustainable growth in the tax base, an overly aggressive tax reduction may result in greater-than-expected revenue losses in future years. After personal income tax reductions in 22 states in fiscal year 1997, 16 states were expected to consider additional tax cuts during their 1998 legislative sessions. Despite the frequency of those tax cut proposals, a number of state legislators have expressed concern about the sustainability of underlying revenue growth.[7] Consequently, states have considered several methods for hedging against unexpected losses resulting from tax cuts.

For example, by tying the amount and duration of a tax cut to the underlying type of revenue surplus, states have avoided overcommitting one-time resources that may not recur in future years. A state may receive additional short-term revenues in a number of forms: an unusually large increase in inheritance tax collections, lawsuit

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7. Kevin Sack, "Eager and Flush, Many States Plan Yet More Tax Cuts," *New York Times*, January 4, 1998, pp. A1, A13.

awards that may have been held in trust before resolution, or transfers from funds held outside the state's general operating budget, among others. Using those and similar revenues as a basis for a long-term cut in taxes could create substantial problems in the future because the increased revenues may not recur with certainty. In some states, however, economic changes may have created a strong base for tax collections, in which case a long-term reduction in taxes could be accomplished successfully if done with care. Maryland, for example, enacted a 10 percent income tax cut in 1997 that is to be phased in over five years. Currently established reserves and growth in the income tax base are expected to support most of that cut. By phasing in the cut over a period of years, the state will have the opportunity to monitor underlying growth and make adjustments if necessary.[8] Tax cuts occurring over a number of years are usually tied to projections of future growth in the tax base. Enacting a tax cut that assigns most of the revenue losses to future years could precipitate shortfalls in the out-years if estimates of growth fail to materialize.

Finally, one of the easiest ways for states to provide tax relief without over-committing future resources is by offering one-time rebates rather than tax cuts. Several states (including Colorado, Michigan, Ohio, and Oregon) have statutory or constitutional requirements that limit either revenue growth or ending balances. Once a state exceeds the limits for those benchmarks, it is obligated to return money

8. In 1998, Maryland did just that by speeding up the phase-in of the income tax cut because of strong income tax collections.

to taxpayers. Whether done as a cash payment or as a credit against future tax obligations, a tax rebate plan ensures that a one-time surplus will be used for tax relief for only one year. If the surplus recurs in future years, taxpayers may again receive rebates.

Strategy Three: Establishing Rainy-Day Funds to Preserve Flexibility

Most states have to balance their operating budget annually. Forty-four states have established some form of rainy-day fund or reserve fund. Maintaining a balance from year to year by using such funds allows a state to shift revenues from one year to another, which permits states' current expenditures to exceed receipts. States finance rainy-day funds in a variety of ways, including annual appropriations, automatic deposits from tax collections, or transfers from other funds.

Maryland established its rainy-day fund in the mid-1980s, mainly in response to the savings and loan crisis. (Maryland had its own state-run system of deposit insurance.) The financial challenges of that crisis not only placed budgetary pressures on the state but also precipitated questions about Maryland's Aaa bond rating, a hallmark that the state had maintained consistently since the early 1970s.[9]

9. Bond ratings (published by Moody's Investors Service, Standard & Poors, and Fitch IBCA) are one measure of a state's financial condition and ultimately an indicator of a state's ability to pay the interest and principal on its debt.

The Aaa bond rating has allowed Maryland to borrow funds at the most competitive rates because of its strong financial condition. A downgrade in the bond rating would have indicated that the state's financial condition had deteriorated, resulting in higher borrowing costs. Maintaining a high bond rating not only has a financial benefit for borrowing purposes but also is an outside measure of the success of political leaders in managing state finances.

Maryland officials believed establishing a nonlapsing rainy-day fund would help guard against future financial challenges: it would enable the state to retain a portion of current revenues for future needs and provide a resource for smoothing the effects of any tax losses resulting from an economic downturn. In fiscal year 1987, Maryland's rainy-day fund received an initial appropriation of $50 million. The state required further appropriations of at least $5 million a year to be made to the fund until its balance equaled 2 percent of estimated revenues. When the rainy-day fund's balance reached 2 percent of estimated revenues in fiscal year 1991, Maryland faced a recession and used the fund balance to supplement the state's operating budget. The 2 percent reserve provided a limited resource, however, and was exhausted within a single fiscal year. Consequently, in fiscal year 1994, lawmakers increased the minimum appropriation to the rainy-day fund to $50 million annually until the fund balance equaled 5 percent of estimated revenues.

A reserve fund provides a limited cushion for states when they face long-term reductions in revenues. Under some circumstances, such as a natural disaster that requires additional but largely one-time state expenditures, a reserve fund can provide a reliable source of funds for an unexpected emergency. States generally use reserve funds, however, to address budget shortfalls resulting from economic downturns (see Box 1). Nonetheless, reserve funds have a broader purpose than providing emergency funds: they provide flexibility. Unlike an unexpected emergency, a prolonged recession may require a state to change its spending and revenue policies. Although a reserve fund may not solve the problem of a prolonged financial crisis, it can provide flexibility—a financial cushion—that gives legislators and governors enough time to reasonably amend the state's budget and to avoid taking severe actions.

BOX 1.
EMERGENCY AND DISASTER FUNDS

Most states have established special funds dedicated to expenditures for natural disasters or other emergencies. Those funds should not be confused with rainy-day funds. States generally regard emergency funds as initial sources of funds for natural disasters; rainy-day funds are intended as a resource for general state expenditures if economic changes should cause revenue shortfalls.

States generally appropriate a small amount of money annually to emergency funds to address unforeseen small-scale needs. States may make additional appropriations from general funds for large-scale disasters, but many of those expenses are often covered by federal assistance.

Rainy-day funds or high general fund balances may provide a reliable resource for states in the event of an emergency or disaster, but expenditures from those funds are not specifically limited to those purposes.

Strategy Four: Maintaining High General Fund Balances

States that do not establish rainy-day funds may instead maintain high balances in their general funds to provide a similar financial cushion. By not segregating those funds, states with high balances preserve the greatest amount of administrative flexibility for managing the state's finances. Furthermore, because the funds are readily available in the general fund, no further legislative action is required beyond appropriations if those funds are needed. In Kansas, for example, a state without a formal rainy-day fund, the governor must submit and the legislature must approve a budget that projects an ending balance equal to at least 7.5 percent of appropriated expenditures. That requirement essentially reserves funds and helps the state manage cyclical revenue and expenditure streams. States with rainy-day funds may require certain economic or fiscal thresholds to be met before reserved funds may be used for expenditures. In either case, appropriations—whether from balances in the general fund or from the rainy-day fund—limit expenditures.

Although high general fund balances may preserve some administrative flexibility, that method also can pose political challenges. One of the main reasons that states establish rainy-day funds is because those funds impose a discipline on policymakers by clearly segregating funds and by highlighting situations when those funds might be used. Spending from fund balances may not create headlines, but using funds from a segregated account explicitly reserved for fiscally hard times will probably draw public attention—helping to reinforce discipline on the management of state finances. In contrast, states that rely on high ending balances must exercise fiscal restraint routinely, both administratively and politically, to maintain a level of flexibility that hedges against revenue shortfalls or unexpected expenditure needs. That restraint involves not spending money that may appear to be available in the general fund or conservatively estimating future revenues and expenditures.

Strategy Five: Creating Special Reserve Funds

Special reserve funds provide states another way to build up reserves in funds outside the general operating budget. Unlike rainy-day funds, which provide a fiscal cushion for the general fund budget, special reserve funds are designated to fund specific purposes, such as a capital project or short-term operating program, and the funds may receive revenues regularly from sources outside the state's budget. As those funds' balances increase, states may transfer the excess to the general operating budget in times of need.

Illinois uses such a fund to finance capital projects: the Build Illinois Fund is a complicated funding mechanism designed to supplement the state's ongoing capital program without issuing more general obligation debt. The fund relies on revenue bonds that are backed by a dedicated stream of sales tax revenues. Every month, the state deposits a portion of state sales tax collections into one of the fund's subaccounts designated for paying debt service. If the balance in that subaccount exceeds certain thresholds at the end of the fiscal year, the governor may direct the trustee to transfer the excess to the state general fund. Because the fund's assets are held outside the state treasury (pursuant to legal, binding trustee agreements), they are protected from political pressures for spending and provide a useful source of funding.

Maryland specifically established a special reserve fund, the Dedicated Purpose Account, to retain funds for major multiyear expenditures or for expenses resulting from changes in federal law. The state has used that account many times since establishing it in 1986. In the late 1980s, Maryland set aside funds over several years to repay depositors who had lost money in the state's savings and loan crisis. In fiscal year 1996, the state appropriated $50 million to the Dedicated Purpose Account to guard against possible reductions in federal aid. After the General Assembly appropriates funds from the account, any expenditures from the account must be approved by the state's Legislative Policy Committee.[10] If those funds are not expended within four years of the appropriation, they transfer to the state's rainy-day fund.

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10. The Legislative Policy Committee, a bipartisan body of leaders from both houses of the state legislature, coordinates and supervises the work of the General Assembly's standing committees, as well as approves certain reserve fund transactions.

IMPLICATIONS FOR THE FEDERAL GOVERNMENT

As this memorandum has shown, states employ a variety of methods for establishing and preserving financial flexibility. They use surplus funds for short-term expenditures or limited tax reductions. They create rainy-day funds to segregate moneys during economically prosperous times, providing a financial cushion for times when tax collections fall or unexpected expenditure pressures rise. In addition, they maintain high ending balances as a ready resource for such circumstances. Finally, they create special reserves out of which excess balances may be transferred to the general fund if needed. Whatever the method, or combination of methods, the goal is to ensure that the state will have resources available to meet future needs, even when expenditures would otherwise exceed revenues.

The federal government can apply some of those approaches to using surplus funds to its budget. Like states, the federal government may use surplus revenues to increase spending or to reduce taxes. Just as increases in state spending or reductions in taxes are often constrained by constitutional or statutory limits, however, federal law imposes procedural hurdles for legislation that would tap projected surpluses. The Budget Enforcement Act of 1990 established limits on discretionary appropriations and a pay-as-you-go requirement for new entitlement or tax legislation. Although devised to control deficits, the act's procedures also generally bar policymakers from enacting laws that would reduce surpluses.

When federal budget surpluses occur, the additional resources are automatically used to reduce the level of outstanding government debt. Lower debt increases national saving, reduces federal debt-service payments, and generally provides a cushion for future economic downturns or budgetary pressures. When the federal government has budget surpluses, they serve the same broad purpose as states' reserve funds: to preserve the resources and flexibility necessary for policymakers to address future needs or problems. The federal government has no balanced budget requirement, however, so it has no need for a distinct rainy-day fund.

Because of the federal government's important role in the U.S. economy, cutting taxes when the economy is strong and raising taxes when the economy falters could exacerbate cyclical fluctuations. Therefore, the use of such actions by the federal government cannot be compared with similar actions by the states. State tax policies have a smaller economic effect and are often limited more by the fiscal standing of the state's budget than by economic considerations.

How states and the federal government use surplus funds depends on constitutional and statutory constraints, institutional budgeting procedures, and programmatic or economic goals. In some states, surplus funds moderate fluctuations in revenues from year to year. Surpluses also fund additional expenditures, allow reductions in taxes, or, particularly in the case of the federal government, reduce debt levels. The existence of a surplus generally strengthens a government's financial position and provides policymakers with flexibility when making budgetary decisions.