APPENDIX G

HAWAII'S STATE BUDGET PROCESS AND BUDGET STABILIZATION FUNDS

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A Report by the Department of Budget and Finance

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This report was prepared in response to a request by the 2005-2007 Tax Review Commission which asked the Department of Budget and Finance to provide "a report describing the State's current budget process and conditions, with emphasis on budget stabilization."

I. The Budget Process

The State Budget contains information on the costs and financing plans of all programs, services, and activities supported by State government. The budget structure and processes are governed by many legal requirements established by the State Constitution and Hawaii statutes, among which the most important is a constitutional mandate for a balanced budget. Article VII of the Hawaii Constitution requires, among other things, that **general fund expenditures must not exceed general fund revenues**, except in an emergency declared by the Governor (Section 5). Section 37-69 of the Hawaii Revised Statutes further requires the Governor to prepare a Six-Year Program and Financial Plan and to include proposals for changes in revenues in every case where the total proposed State expenditures exceed the total anticipated resources.

Hawaii has a biennial budget covering two fiscal years at a time within a planning period that extends to six years. The fiscal year begins on July 1 of each year and concludes on June 30 of the following year.

The budget process runs through four principal stages:

1. Formulation of program requirements by department and agencies (August, September, October, November)

The budget cycle starts in August with the Department of Budget and Finance (B&F) issuing budget guidelines for the upcoming period to departments and agencies within the Executive Branch. Taking into account a) the economic and financial conditions of the State, and b) the Administration's fiscal policies, the instructions establish overall parameters for preparing departmental budget requests. For example, the guidelines may put a limit on the number of positions, set a ceiling for funding, or allow for growth in certain areas.

Revenue conditions (actual and projected) are critical at this stage because they impose certain limits on the level of resources that can be expected. Bound by the balanced budget requirement of the Hawaii Constitution, the State must ensure that **general fund expenditures must not exceed general fund revenues**. The task of revenue estimation falls on the Council on Revenues (COR), a non-partisan body established by law to prepare revenue estimates for the State four times a year. These estimates must be considered by the Governor in preparing the budget and by the Legislature in appropriating funds.

Budget requests submitted by departments identify the services and activities being proposed for the programs, together with the costs for them. The requests go through a formal process of review and evaluation that includes the departments, B&F, and the Governor. After the Governor makes her final decisions, budget documents are prepared to be delivered to the Legislature by a statutory deadline, which is 30 days before the legislative session begins in each January.

2. Submission of budget requests to the Legislature (December)

The Governor's budget proposals to the Legislature are contained in a document entitled "*The Multi-Year Program and Financial Plan and Executive Budget.*" This document displays program and financial requirements of the Executive Branch for the two years in the next fiscal biennium and the four out-years in the planning period. A six-year financial plan is also provided to show the fiscal implications of the recommended programs.

3. Appropriation of moneys by the Legislature (January to May)

The State Constitution requires that **expenditures of public money must be made through legislative appropriations**. Upon receiving the Governor's proposed budget, the Legislature applies its own review and evaluation process to executive recommendations as well as to other legislative proposals. The Legislature authorizes funding for programs in the General Appropriations Act for the fiscal biennium, also taking into account revenue conditions as projected by the COR. In addition to budget appropriations, spending authorizations may also be provided in specific, off-budget legislations.

4. Execution of the budget by departments and agencies (July 1 to June 30)

The General Appropriations Act becomes law with the approval of the Governor (or if not vetoed by the Governor). Before the new fiscal year begins, the Governor issues budget execution policies and instructions to the departments to guide their implementation of programs and funding as authorized by the Legislature. Again, revenue considerations are critical at this point. Depending on revenue conditions, programs may receive full allocations of the moneys appropriated, or budget restrictions may be imposed to ensure that expenditures do not exceed available revenues, as required by law.

II. The Need for Budget Reserves

Budget preparations take place many months before the actual fiscal year begins. Therefore, budget formulation often has to rely on estimated data and projections of future developments. Between the planning and implementation stages, program costs can be greatly affected by inflation, changes in target populations, or new federal mandates, while revenue projections can fluctuate widely with changing economic conditions. Because of this characteristic, fiscal prudence must be exercised to ensure that the State's obligations are adequately covered by actual revenues. While this requirement is important for all categories of funding (such as general funds, special funds, trust funds, etc.), it is paramount in the management of the General Fund because of the requirement for a balanced budget. The focus of this report is thus on the General Fund.

An effective way to exercise fiscal prudence is to build and maintain an adequate cushion in the General Fund to help even out wide fluctuations in both revenues and expenditures that may happen from time to time. Historically, growth in expenditures tends to rise quickly in an economic upswing when revenues are abundant. When the economy goes into a downturn, tax collections generally decline and may not be sufficient to support on-going expenses. Without an adequate reserve, the continuing budget deficits can lead to a condition of fiscal stress that will eventually call for more drastic responses such as cutting programs and/or raising taxes. These actions often produce negative economic consequences at a time when the State can least support them. Furthermore, frequent budget adjustments due to the boom and bust cycles can be disruptive and damaging to program operations. In short, budget stabilization is an important goal and a critical component of the State's overall fiscal management. Within the general parameters set by careful policy considerations, departments and programs know what to expect from one year to the next and management at all levels can focus on producing the results and measuring their progress.

Another means to provide for budget stability is to establish a formal rainy day fund as a source of supplemental reserves during lean times. A rainy day fund provides a counter balance to the cyclical changes in the economy and tax collections, where extra revenues in good times are set aside to provide supplemental resources for bad times. The inflow and outflow of these reserves work to lessen the wide fluctuations in tax revenues and act to stabilize the size and direction of the budget.

Hawaii has adopted both concepts to provide a degree of stability to its budget.

1. The General Fund Balance

Historically, the State Budget has been actively managed to produce a positive balance in the General Fund at the end of each fiscal year (see Table 1).

Table 1. General Fund Revenues, Expenditures and Balances
& the Emergency and Budget Stabilization Fund
(in $Millions)

FY	GF REVENUES	GF EXPEND.	REV. OVER EXPEND.	GF BALANCE	**GF BAL/EXP**	EBRF BAL.	**EBRF/ EXP**
1976	$684.6	$726.3	($41.7)	$41.8	**5.8%**		
1977	$737.4	$744.0	($6.6)	$35.2	**4.7%**		
1978	$816.1	$848.9	($32.8)	$2.4	**0.3%**		
1979	$942.5	$878.0	$64.5	$66.9	**7.6%**		
1980	$1,084.9	$972.8	$112.1	$179.0	**18.4%**		
1981	$1,198.7	$1,146.0	$52.7	$231.7	**20.2%**		
1982	$1,185.8	$1,207.4	($21.6)	$210.0	**17.4%**		
1983	$1,252.5	$1,333.1	($80.6)	$129.5	**9.7%**		
1984	$1,354.6	$1,379.0	($24.4)	$105.1	**7.6%**		
1985	$1,475.5	$1,451.1	$24.4	$129.5	**8.9%**		
1986	$1,605.3	$1,597.8	$7.5	$137.0	**8.6%**		
1987	$1,889.8	$1,687.7	$202.1	$339.1	**20.1%**		
1988	$2,075.7	$1,944.2	$131.5	$470.6	**24.2%**		
1989	$2,378.1	$2,219.5	$158.6	$629.2	**28.3%**		
1990	$2,451.5	$2,624.4	($172.9)	$456.3	**17.4%**		
1991	$2,689.5	$2,799.3	($109.8)	$346.5	**12.4%**		
1992	$2,708.3	$2,680.8	$27.5	$374.0	**14.0%**		
1993	$2,953.0	$3,063.1	($110.1)	$263.9	**8.6%**		
1994	$3,086.4	$3,059.4	$27.0	$290.9	**9.5%**		
1995	$2,968.5	$3,169.1	($200.6)	$90.3	**2.8%**		
1996	$3,194.4	$3,123.7	$70.7	$161.0	**5.2%**		
1997	$3,161.0	$3,186.3	($25.3)	$135.7	**4.3%**		
1998	$3,231.6	$3,213.5	$18.1	$153.8	**4.8%**		
1999	$3,286.3	$3,251.1	$35.2	$189.0	**5.8%**		
2000	$3,284.1	$3,201.0	$83.1	$272.1	**8.5%**	$19.4	**0.6%**
2001	$3,441.6	$3,364.6	$77.0	$349.1	**10.4%**	$33.9	**1.0%**
2002	$3,441.0	$3,656.1	($215.1)	$134.0	**3.7%**	$49.9	**1.4%**
2003	$3,788.9	$3,805.7	($16.8)	$117.2	**3.1%**	$53.1	**1.4%**
2004	$3,907.7	$3,840.3	$67.4	$184.6	**4.8%**	$54.0	**1.4%**
2005	$4,486.4	$4,184.6	$301.8	$486.4	**11.6%**	$54.1	**1.3%**
2006	$4,925.0	$4,679.1	$245.9	$732.3	**15.7%**	$53.5	**1.1%**
2007	$5,178.3	$5,427.7	($249.4)	$482.9	**8.9%**	$61.6	**1.1%**

Note: FY 2007 amounts are estimates.
Source: Department of Budget and Finance.

In the past 32 years since 1976, the year-end balances have ranged from a low of $2.4 million in FY 1978 to a high of $629.2 million in FY 1989. The highest level to date, $732.3 million, was achieved this year, at the end of FY 2006. As a percentage of expenditures, the year-end balances were above 10% in 12 years and above 5% in 24 years out of 32.

It is worth noting that during this period, the State was also able to: a) provide substantial tax refunds to its residents in a number of years, b) permanently reduce the income tax rates, and c) institute tax changes to provide tax relief or incentives for economic development.

The general fund balance is estimated to be $482.9 million when the current fiscal biennium ends on June 30, 2007. While this represents a comfortable 8.9% reserve level, it should be pointed out that budget preparations for the upcoming fiscal biennium are currently in the making and showing a need for considerable funding commitments in the next two years. On the revenue side, the September 11, 2006 report from the COR projected a slowdown in the economy for the near term compared to the robust growth of recent years.

2. The Emergency and Budget Reserve Fund (EBRF)

The Legislature established the Emergency and Budget Reserve Fund in 1999 as a rainy day fund to provide a supplemental source of funding for the State during times of emergency, economic downturn, or unforeseen revenue reduction. The Fund receives an annual allocation from the tobacco settlement payments to the State of Hawaii each year. The allocation was initially set at 40% of the total payments but was revised to 24.5% in 2002.

To date, $88 million has been deposited to the Fund as of June 30, 2006. Allocations in future years are projected to be about $12 million each year from 2008 to 2017 and $9 million each year between 2018 and 2027. In the past five years, the Legislature authorized a total of $35 million from these reserves to be spent for various health and human services programs. The cumulative balance in the Fund was $53.5 million on June 30, 2006 and is expected to be $61.6 million at the end of Fiscal Year 2007.

III. Adequacy of Reserves

The need for an adequate reserve of funds to address economic downturns and their attendant fiscal stress has long been recognized by many states. According to a report by the National Governors Association and the National Association of State Budget Officers,[1] 47 states have budget stabilization funds, which may include budget reserve funds, revenue shortfall accounts, or cash-flow accounts. The conventional wisdom has been to build up budget reserve balances to a level equal to at least 5% of total expenditures. A more cautious view would require 10%.

[1] *The Fiscal Survey of States: June 2006.*

The same report shows that in FY 2005, the average balance for all states was 8.7% of total expenditures. The distribution is as follows[2]:

- 14 states had balances below 5%.
- 16 states had balances between 5% and 10%.
- 20 states had balances above 10%.

On a historical basis, over the past 27 years, the average balance for all states hit the lowest (1.1%) in FY 1991 and the highest (10.4%) in FY 2000. The average was below 5% in 14 years and above 5% in 13 years (see Table 2).

Table 2. Total Year-End Balances of All States, Fiscal 1979 to Fiscal 2007
(Percentage of Expenditures)

FY	BALANCE AS % OF EXPENDITURES
1979	8.7%
1980	9.0
1981	4.4
1982	2.9
1983	1.5
1984	3.8
1985	5.2
1986	3.5
1987	3.1
1988	4.2
1989	4.8
1990	3.4
1991	1.1
1992	1.8
1993	4.2
1994	5.1
1995	5.8
1996	6.8
1997	7.9
1998	9.2
1999	8.4
2000	10.4
2001	9.1
2002	3.7
2003	3.2
2004	5.1
2005	8.7

[2] *The Fiscal Survey of States: June 2006,* page 46.

IV. Conclusions

A major concern in managing the State Budget is to ensure that revenues are in line with expenditures. Historically, Hawaii has always built a de facto rainy day fund into its budget by striving to maintain a sufficient balance in the General Fund as a cushion for unanticipated budget developments. Budget stabilization was further enhanced by the formal establishment of the Emergency and Budget Stabilization Fund in 1999 where the State sets aside a portion of its annual tobacco payments for this purpose. Both actions have served to strengthen the State Budget and enabled Hawaii to weather various economic cycles without major disruption to its basic tax and expenditure structures.