Study of Emergency and Budget Stabilization Funds

A Report to the Governor and the Legislature of the State of Hawaii

THE AUDITOR
STATE OF HAWAII

The Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* are conducted of professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with a schedule and criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* are conducted on bills which propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Special studies* are conducted when they are requested by both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

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STATE OF HAWAII

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Report No. 93-13 November 1993

OVERVIEW

THE AUDITOR
STATE OF HAWAII

Study of Emergency and Budget Stabilization Funds

Summary

Forty-four states have established emergency and budget stabilization funds, sometimes called rainy day funds. These funds are intended to reduce a state's vulnerability to economic fluctuations. The funds accumulate revenues during periods of strong economic growth to use during periods of economic difficulty.

We found that the characteristics of rainy day funds vary widely. Deposits, withdrawals, and limitations on fund size are achieved in many different ways. There is debate over the usefulness of rainy day funds and little empirical evidence as to the effectiveness of various fund structures. Balances in rainy day funds have generally fallen. No ideal model was found.

However, some evidence exists that rainy day funds can work, and we found that a rainy day fund may be useful for Hawaii. We note that the State's expenditure pattern has not shown a steady predictable trend. Furthermore, revenues in excess of expenditures could have been deposited into a rainy day fund instead of disappearing into an informal rainy day fund or into insignificant tax rebates.

A rainy day fund is one of Hawaii's options for budget stabilization. Others are contingent taxation, contingent spending, delegation of authority, and tax stabilization.

With surpluses disappearing in Hawaii, it would be difficult to finance a rainy day fund at this time. However, the Legislature could establish the fund now with a mechanism to trigger deposits later when revenues are more ample. Or the Legislature could establish the fund later when revenues actually increase.

Recommendations and Response

If the Legislature decides to establish a rainy day fund, we recommend that it consider clearly stating the fund's purpose and establishing requirements for deposits and withdrawals that protect the purpose. In doing so, the Legislature should determine (a) whether the fund is designed to meet short-term revenue shortfalls, unexpected emergencies, or both; and (b) whether either the Legislature or the executive would maintain control over the fund—or share control.

We recommend that the Legislature also consider other means of budget stabilization. A promising approach is contingent spending, accomplished by enacting a multi-part appropriations act designed to address unexpected revenue shortfalls and help ensure continuous funding of programs which the Legislature considers most important.

In its response, the Department of Budget and Finance said that in establishing the fund, its purpose should be limited to accommodating only non-recurring situations such as unanticipated short-term revenue shortfalls and unexpected emergencies. The department also commented that the stabilization fund will need to be compatible with constitutional and statutory requirements pertaining to the triggering of tax rebates, general fund expenditure ceilings, three-year limitations on general fund appropriations, and expenditure controls.

Concerning our recommendation that the Legislature consider other means of budget stabilization, the department notes that one alternative is maintaining a sufficiently large unencumbered balance in the general fund which can serve as an implicit rainy day fund to meet budget contingencies. The department says that our suggestion of contingent spending has been informally applied because the execution of a budget authorized by the Legislature must be sensitive to revenue conditions.

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Study of Emergency and Budget Stabilization Funds

A Report to the Governor and the Legislature of the State of Hawaii

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 93-13
November 1993

Foreword

This report was prepared in response to House Concurrent Resolution No. 423, House Draft 1 of the Regular Session of 1993. The resolution requested the State Auditor to study emergency and budget stabilization funds in other states and to assess whether these funds, also known as rainy day funds, have helped states cope with their budgets. The resolution also requested a rainy day fund model for Hawaii.

We wish to express our appreciation for the cooperation and assistance extended to us by officials of the Department of Budget and Finance. We also appreciate the assistance of other officials, experts, and organizations contacted during the course of this study.

Marion M. Higa
State Auditor

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Table of Contents

Chapter 1
Introduction

Forty-four states have established emergency and budget stabilization funds, sometimes called rainy day funds. These funds are intended to reduce a state's vulnerability to economic fluctuations. The funds accumulate revenues during periods of strong economic growth to use during periods of economic difficulty. They are tools for stabilizing budgets and for fostering planning and policy development.

In 1993, the Legislature passed House Concurrent Resolution No. 423, House Draft 1, requesting the State Auditor to study rainy day funds in other states. The request reflects legislative concern over the State's fiscal stability in the face of changing economic conditions, revenue shortfalls, cutbacks in federal funding, and natural disasters.

The resolution directed the Auditor to describe the purpose, structure, and mechanics of rainy day funds and to analyze whether the funds have helped other states cope with their budgets. It also asked for a rainy day fund model for Hawaii. This report responds to the legislative request.

Objectives of the Study

Our study had the following objectives:

1. Examine how other states have structured and used their rainy day funds and the extent to which these funds have met their purpose.

2. Evaluate rainy day funds as an option for stabilizing state budgets, and if appropriate, recommend a model rainy day fund for Hawaii.

Scope and Methodology

To accomplish these objectives, we reviewed the literature on rainy day funds and spoke with national and state budgeting experts and persons familiar with these funds. We also reviewed state revenue and expenditure patterns in Hawaii over the past 20 years. We examined relevant Hawaii constitutional and statutory provisions.

Our work was performed from June 1993 through September 1993 in accordance with generally accepted government auditing standards.

Chapter 2

Findings and Recommendations

In this chapter we describe rainy day funds in other states. We then discuss the rainy day fund as one approach to budget stabilization in Hawaii.

Summary of Findings

1. Rainy day funds in other states vary widely in their structure, size, and other characteristics; no ideal model has been found.

2. A rainy day fund is one of several budget stabilization tools that the Legislature may wish to consider.

Characteristics of Rainy Day Funds Vary Widely

The rainy day funds that have been established have diverse characteristics even though they share a common goal of budget stabilization. These funds are intended to lessen states' vulnerability to economic fluctuations, smooth the flow of revenues into the general fund, and establish steady, predictable trends in expenditures for state services. However, the rainy day funds of 44 states take many different approaches. The funds vary in size and in their methods of depositing and withdrawing moneys (see Appendix). The following discussion highlights some important characteristics.

Depositing into the funds

Most rainy day funds are separate accounts outside the general fund. Deposits are made in a variety of ways. Several states, such as Kansas, Kentucky, and Wisconsin, make direct appropriations to the fund. Other states, such as Indiana and Michigan, apply a statutory formula. Maine's deposit formula is 4 percent of the prior fiscal year's general fund revenues. Other states link deposits to growth in personal income or to revenues that are in excess of expenditures.

Withdrawing from the funds

Mechanisms for withdrawals from rainy day funds also vary. In some states, such as California and Florida, the legislature appropriates withdrawals. Withdrawals may be conditional, for example, the appropriation may be limited in use to cover unanticipated revenue shortfalls or budget deficits.

In some states, withdrawals are triggered automatically when revenue shortfalls and budget deficits occur. Alaska, California, New Jersey, and North Dakota allow their governor to withdraw moneys to avoid a negative general fund balance or to meet emergencies.

Some states share legislative-executive control over withdrawals. They require legislative approval of executive branch withdrawals. New Jersey authorizes withdrawals by the governor when the governor declares an emergency and approval is given by the legislature's Joint Budget Oversight Committee. Oklahoma and Pennsylvania authorize appropriations when the governor declares an emergency and the legislature concurs with a two-thirds vote of each house.

Limits on fund size

To prevent the accumulation of large surpluses, half of the states limit the size of their rainy day fund by establishing a cap. Connecticut, South Dakota, and Vermont set their cap at 5 percent of general fund appropriations. Several states cap their funds at a percentage of their general fund revenues or their state's annual operating budget (ranging from 2 to 15 percent). Virginia determines its cap annually based on 10 percent of the averaged income and retail tax revenue for the past three years. Rhode Island's rainy day fund is capped at 3 percent of general fund revenues, with the excess going to the capital fund.

No ideal model

An ideal rainy day fund has yet to be found. The National Conference of State Legislatures (NCSL) tracks rainy day funds and reports that there is debate over their usefulness and little empirical evidence as to the effectiveness of various fund structures. NCSL questions whether the funds are designed for effectiveness. NCSL is concerned that rainy day funds have not been structured to ensure that sufficient moneys accumulate in the fund and points out that many rainy day funds currently have little or no money in them.

Insufficient accumulation of funds

NCSL and Wall Street analysts recommend that states maintain reserves of 5 percent of general fund expenditures. Some states cap their rainy day funds at less than 5 percent. For 1992, only 3 out of 44 states estimated that their funds would consist of at least 5 percent of general fund expenditures. In addition, most funds have not reached their cap. For example, in 1987, New York's Legislative Commission on Expenditure Review found that the size of the state's rainy day fund never came close to the maximum allowed by law; that state officials had used fund moneys to pay for current debts; and that the fund had never achieved its purpose of stabilizing the state's revenues.[1] Michigan's statutory formula was designed to trigger rainy day fund withdrawals which would be limited to the amount necessary to balance the budget. However, the Michigan legislature recently amended the statute temporarily to allow withdrawals to build prison facilities.

Declining balances

Balances in rainy day funds have generally fallen. At the end of FY1990-91, the amounts in rainy day funds ranged from $0 in 14 states to $719.5 million in Alaska. Total moneys in rainy day funds nationwide fell from $4 billion in FY1988-89 to $3.2 billion in FY1990-91.[2] A decrease to $2.2 billion was estimated for FY1991-92. However, with improving state economies, an increase to $2.4 billion is projected for FY1992-93.[3]

A Rainy Day Fund Is One of Hawaii's Options for Budget Stabilization

NCSL believes that "the concept of a budget stabilization fund is a good one, particularly in view of economic uncertainties and potential federal policies."[4] Some evidence exists that rainy day funds can work. For example, in 1991 the Indiana legislature authorized withdrawals up to $200 million from its rainy day fund to meet revenue shortfalls. Already $47.9 million has been used for this purpose.

A rainy day fund may be useful for Hawaii. We found no constitutional or statutory provisions that would prohibit such a fund. We note that Hawaii's expenditure pattern has not been consistent over the long term. We also note that revenues in excess of expenditures could have been deposited into a rainy day fund, but instead a portion of these funds has disappeared, partly into an informal rainy day fund and partly to insignificant tax rebates. A rainy day fund, however, is only one of several tools the Legislature may wish to consider to stabilize the budget.

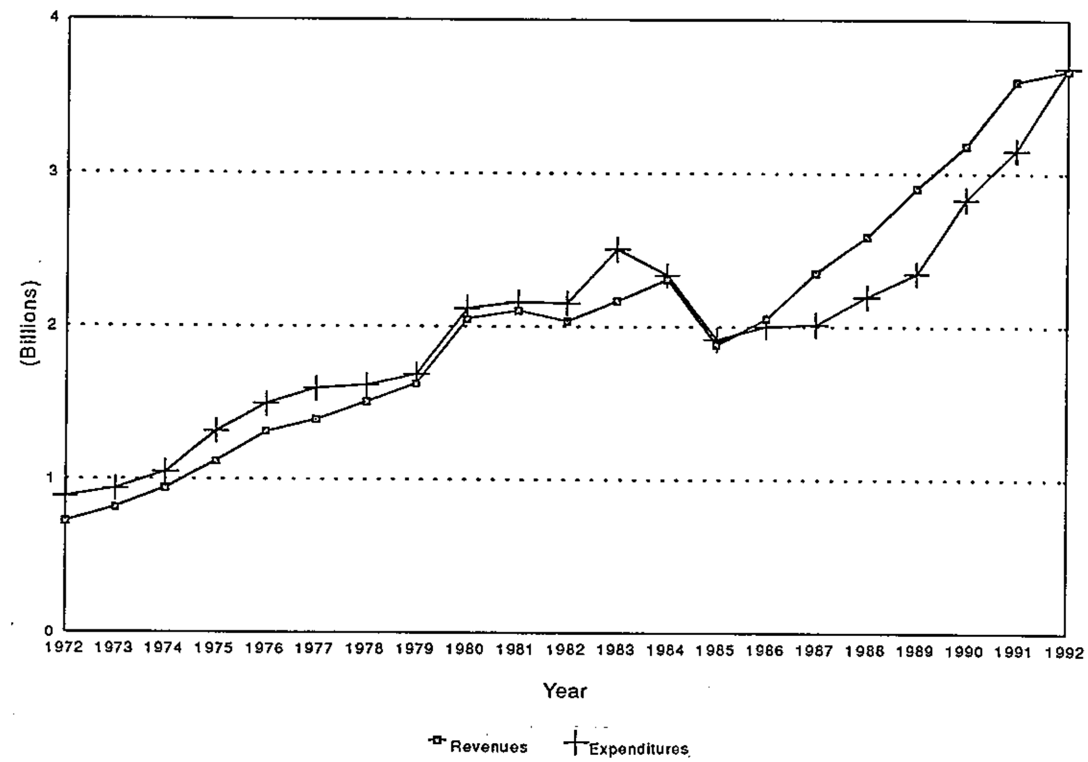
Hawaii's inconsistent expenditure pattern

Hawaii's expenditure pattern has not shown a steady predictable trend. This suggests that a rainy day fund or some other form of budget stabilization may be appropriate. Figure 2.1 shows state general fund expenditures grew relatively evenly from 1972 through 1979 before jumping substantially in 1980. In 1983 expenditures jumped again, but showed a sharp decline before gradually climbing between 1985 and 1992.

Instead of following revenue fluctuations, expenditures may follow a more stable trend with a rainy day fund. During recessionary periods, a rainy day fund could help to maintain essential programs at consistent levels, restore facilities damaged by natural disasters, or prevent tax increases.

Depositing excess moneys into a rainy day fund during times of strong revenue growth would also promote fiscal discipline. Instead of using

Figure 2.1
General Fund Revenues and Expenditures
State of Hawaii, FY1971-72 through FY1991-92



Source: Annual Financial Reports of the State of Hawaii, 1978-1992, Comptroller, State of Hawaii.

the moneys to expand existing programs or add new programs which could not be sustained without new taxes should revenues fall, the extra moneys would be held in reserve.

Hawaii's "informal" rainy day fund

Between 1985 and 1992 the State enjoyed increasing revenues and cash surpluses. The State at times used general fund cash appropriations to finance capital improvement projects (CIP) instead of financing them through the customary method of issuing bonds. Unexpended CIP appropriations have served as an informal rainy day fund. In 1993, the Legislature converted the financing of $87 million of CIP from cash to general obligation bonds.[5] This conversion made cash that had been committed to CIP available to the Legislature. In essence these general fund cash appropriations served as a source to be tapped when the State was faced with revenue shortfalls, slower economic growth, and increasing program needs.

The Legislature could consider depositing cash surpluses into a formal rainy day fund instead of using surplus funds for CIPs.

Insignificant tax rebates

Article VII, Section 6, of the State Constitution requires that a tax refund or credit be given to taxpayers whenever the general fund balance at the close of two successive fiscal years exceeds 5 percent of general fund revenues. The Legislature determines the amount to be rebated.

During the last 12 years, taxpayers have received tax rebates ranging from $1 to $125 per person. In 8 of the 12 years, the rebate has been $1.[6] For example, the State credited $877,000 to taxpayers during the 1991 tax year and estimates it will credit taxpayers with the same amount during the 1992 tax year.[7]

Rather than providing taxpayers with tax credits, it may be beneficial to place surplus funds into a rainy day fund. Such a fund may receive more public support than the current practice of rebating $1 to taxpayers. It could help reduce uncertainty in funding state programs and foster long-term planning. The fund could be used during a recession to avoid sudden program cuts and tax increases. Depositing surplus revenues in the fund may also reduce the likelihood of spending more and lowering taxes which could later cause shortfalls during hard times.

Alternative budget stabilization tools

In addition to rainy day funds, several other budget stabilization tools can help soften the impact of revenue shortfalls. Some of the tools may be useful during the transition to a rainy day fund or in coping with long-term budget crises that rainy day funds are not designed to address. These tools include contingent taxation, contingent spending, delegation of authority, and tax stabilization.

Contingent taxation

Contingent taxation is a strategy that maintains predictable tax revenues despite poor economic conditions. It triggers higher tax rates during slow economies and lowers tax rates during growth economies. For example, North Dakota's contingent tax raised sales tax rates when general revenues fell below a specified amount.[8] (In contrast, after raising its income tax in 1983, Michigan adopted a contingent tax system designed to decrease taxes when the state unemployment rate falls.)[9]

Although contingent taxation can stabilize the budget, it also creates taxpayer uncertainty about future tax rates. Also, NCSL believes that raising taxes during recessions can slow economic recovery.[10]

Contingent spending

Contingent spending is a promising approach in which spending is contingent upon the fiscal condition of the State. It can help ensure continuous funding of programs which the Legislature considers most important. For example, Arkansas has used a multi-tiered budget since the 1940s. Its legislature established five budget levels reflecting its priorities and has currently funded up to 94 percent of the third level.[11]

In Kentucky, when revenues are between 2.5 and 5 percent short of estimated revenues, the governor is required to adhere to a budget reduction plan as set forth in the appropriation bill. This plan has ranged from a detailed sequence for spending reductions at the line item level to very broad directives which delegate the authority to make budget cuts to the executive.[12]

In our recent report, *Study of the Fiscal Relationship Between Hawaii's Legislative and Executive Branches*, we recommended that the Legislature consider adopting a multi-part budget that could accommodate revenue shortfalls while keeping legislative priorities intact. We noted that the 1979 Legislature enacted a multi-part appropriations act based on this principle.

Delegation of authority

Some legislatures have attempted to stabilize their budgets by delegating authority to the executive branch to reduce appropriations during the interim between legislative sessions. Fifteen states, including Hawaii, give the executive branch unlimited authority to make budget cuts.[13] Hawaii's allotment system authorizes the governor and the director of finance to reduce appropriations in order to promote savings and efficient management. The purpose of the allotment system is to give the executive branch the flexibility to meet unforeseen changes in the economy when revenues may be less than anticipated. This alternative, however, weakens legislative authority over the enacted budget.

Tax stabilization

Another approach to budget stabilization is stabilizing the tax system by increasing its reliance on more stable and reliable sources of income. However, there is little evidence or consensus on methods to achieve this.

Characteristics that promote successful rainy day funds

Should the Legislature choose to establish a rainy day fund, certain approaches may increase the likelihood of a successful fund. Key issues include defining the purpose of the fund, determining its size and methods of depositing and withdrawing funds, and timing the fund's start-up.

Defining fund purpose

Any measure establishing a rainy day fund should clearly state its purpose. This includes whether it is intended to cope with short-term revenue shortfalls, emergencies, or both. It may help to include a purpose clause in the law explaining the intended benefits such as enhancing long-term planning and policy development.

The fund should be structured to protect its purpose but not so stringently as to prevent its use. For example, Indiana intended its fund to be used for unanticipated revenue shortfalls, but until recently the withdrawal mechanism only provided for withdrawals during severe economic downturns.

Determining fund size

The minimum size of a rainy fund for Hawaii is a matter of legislative discretion. The NCSL recommends budget reserves equal to 5 percent of a state's general fund budget.[14] Generally, larger funds are suitable for states with frequent and wide swings in revenues. Also, the appropriate fund size depends on the degree of stability desired and the length and severity of the fiscal problems that the rainy day fund is expected to address. The size also depends on what the public will accept as reserves for future needs.

Another consideration is whether the fund should have a cap. A cap is meant to prevent the fund from becoming too large and supports the notion of fiscal discipline. Half of the states with rainy day funds have established a maximum size. Caps range from 2 to 15 percent of general fund revenues or expenditures.[15]

Some states apply a formula to determine their cap. Virginia's formula for its maximum fund size is 10 percent of income and retail tax revenues averaged for the last three fiscal years. This annual calculation allows the fund to keep pace with inflation and economic growth.

Methods of deposits and withdrawals

A variety of methods are used for making deposits to and withdrawals from rainy day funds. In establishing deposit and withdrawal methods, the enacting legislation should ensure that adequate fund balances are maintained and declining fund balances are prevented. It may be appropriate to (1) require that all year-end surpluses be deposited in the fund and (2) develop a formula which triggers automatic deposits during growth periods. The formula could be based on revenues, appropriations, or personal income growth. However, a formula based on rising revenues appears more closely linked to the purpose of meeting later revenue shortfalls. It may also be appropriate to state that the purpose of withdrawals is restricted to meeting revenue shortfalls or unplanned emergencies and no other expenditures.

Timing fund start-up

With surpluses disappearing in Hawaii, it would be difficult to finance a rainy day fund at this time. However, the Legislature should consider two approaches. The Legislature could establish the fund now with a mechanism to trigger deposits later when revenues are more ample. Or the Legislature could establish the fund later when revenues actually increase.

Conclusion

A rainy day fund may be useful for Hawaii in softening the impact of revenue shortfalls; but it should be one of several tools the Legislature considers to stabilize the budget. Rainy day funds have generally been underfunded and are meant to be temporary measures. In addition to rainy day funds, the Legislature could consider contingent spending and creating multi-part budgets.

Recommendations

1. If the Legislature decides to create a rainy day fund, it should consider clearly stating the fund's purpose and establishing requirements for deposits and withdrawals that protect the purpose. In establishing the fund's purpose, the Legislature should determine:

   a. Whether the fund is designed to meet short-term revenue shortfalls, unexpected emergencies, or both; and

   b. Whether either the Legislature or the Executive would maintain control over the fund—or share control.

2. The Legislature should also consider other means of budget stabilization. A promising approach is contingent spending, accomplished by enacting a multi-part appropriations act designed to address unexpected revenue shortfalls.

Notes

Chapter 2

1. New York Legislative Commission on Expenditure Review, Memorandum Report to the Legislature, *Research Report: Tax Stabilization Reserve Fund*, May 1987, p. 1.

2. Corina L. Eckl, "Rainy Day Funds," *Legisbrief*, Vol. 1, No. 9, March 1993, and "Budget Stabilization Fund" compiled by NCSL, Fall 1992.

3. Corina L. Eckl, "Rainy Day Funds," *Legisbrief*, Vol. 1, No. 9, March 1993.

4. Corina L. Eckl, "Planning Ahead with Budget Stabilization Funds," *The Fiscal Letter*, National Conference of State Legislatures, March/April, 1990, p. 6.

5. Information obtained from our review of Act 296, SLH 1991; Act 300, SLH 1992; and Act 289, SLH 1993.

6. Interview with Richard Kahle, Director, Department of Taxation, Hawaii, July 23, 1993.

7. Interview with Robert Koike, Tax Research and Planning Officer, Department of Taxation, Hawaii, July 23, 1993.

8. Steven Gold, *Contingency Measures and Fiscal Limitations; the Real World Significance of Some Recent State Budget Innovations*, National Conference of State Legislatures, Denver, Colorado, May 1984, pp. 5-6.

9. Ibid.

10. National Conference of State Legislatures, *State Legislative Report, State Fiscal Outlook for 1992*, Denver, Colorado, January 1992.

11. Interview with John Kunkel, Assistant Budget Administrator, State Budget Office, Arkansas, July 19, 1993.

12. Interview with Ron Carson, Deputy State Budget Director, Office of the Budget, Kentucky, July 19, 1993.

13. Hawaii, The Auditor, *Study of the Fiscal Relationship Between Hawaii's Legislative and Executive Branches*, Report No. 93-2, Honolulu, January 1993, p. 17.

14. Steven Gold, *Contingency Measures and Fiscal Limitations; the Real World Significance of Some Recent State Budget Innovations*, National Conference of State Legislatures, Denver, Colorado, May 1984, p. 12.

15. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Vol. 1, February 1993, pp. 8-11.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Budget and Finance on October 19, 1993. A copy of the transmittal letter to the department is included as Attachment 1 and the department's response is included as Attachment 2.

We recommended that if the Legislature creates a rainy day fund it should consider clearly stating the fund's purpose. In response, the department commented that the fund should be limited to accommodating only non-recurring situations such as unanticipated short-term revenue shortfalls and unexpected emergencies. The department also endorsed the inclusion of specific codified limitations discouraging the arbitrary use of the fund for ongoing or recurring expenditures.

The department commented that deposit and withdrawal methods for a rainy day fund need to be compatible with existing constitutional and statutory requirements pertaining to the triggering of mandatory tax rebates and with general fund expenditure ceiling provisions that limit the growth of general fund appropriations. The department also commented that if all year-end surpluses must be deposited in the fund or if deposits are triggered automatically during growth periods, policymakers must insure that the implementation methodology does not violate constitutional three-year limitations on general fund appropriations or conflict with constitutional provisions that say no public money shall be expended except as appropriated by law.

With respect to our recommendation that the Legislature consider other means of budget stabilization, the department commented that one alternative is to maintain a sufficiently large unencumbered balance in the general fund. Such a balance would serve as an implicit rainy day fund to meet budget difficulties (a practice that has been employed in recent years). The department also said that contingent spending has been informally applied because the execution of a budget authorized by the Legislature must be sensitive to revenue conditions. When revenue shortfalls were projected, budgetary restrictions were imposed to control the level of expenditures.

ATTACHMENT 1

STATE OF HAWAII
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October 19, 1993

COPY

The Honorable Yukio Takemoto
Director of Finance
Department of Budget and Finance
Hemmeter Building, 3rd Floor
Honolulu, Hawaii 96813

Dear Mr. Takemoto:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Study of Emergency and Budget Stabilization Funds*. We ask that you telephone us by Thursday, October 21, 1993, on whether you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Tuesday, November 2, 1993.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

JOHN WAIHEE
GOVERNOR

YUKIO TAKEMOTO
DIRECTOR

EUGENE S. IMAI
DEPUTY DIRECTOR

BARBARA KIM STANTON
DEPUTY DIRECTOR

EMPLOYEES' RETIREMENT SYSTEM
HAWAII INC
HAWAII PUBLIC EMPLOYEES HEALTH FUND
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BUDGET, PROGRAM PLANNING AND MANAGEMENT DIVISION
FINANCIAL PLANNING AND POLICY DEVELOPMENT DIVISION
INFORMATION AND COMMUNICATION SERVICES DIVISION
TREASURY OPERATIONS DIVISION

November 4, 1993

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
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Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the draft report on the "Study of Emergency and Budget Stabilization Funds." We would like to submit the following comments:

1. In establishing the fund's purpose, we agree that it should be limited to accommodating only non-recurring situations such as unanticipated short term revenue shortfalls and/or unexpected emergencies. In addition, we would endorse the inclusion of specific codified limitations discouraging the arbitrary use of such funds for ongoing or recurring expenditures, since such uses would clearly undermine the intent of such a mechanism.

2. With respect to your discussion on "Methods of deposits and withdrawals," we note that any policy decision or accounting treatment of the placement of the stabilization fund inside or outside of the general fund (i.e., in a special fund), including its resultant effect on the inflows and outflows of the fund, will need to be compatible with existing constitutional and statutory requirements which pertain to the triggering of mandatory tax rebates, and to general fund expenditure ceiling provisions that limit the rate of grwoth of general fund appropriations. Specifically, should the selected structure provide for "rainy day funds" to remain <u>within</u> the general fund, total year-end general fund balances would be artificially inflated, thereby continuously triggering rebate requirements. While

rebate amounts are discretionary, the visibility of large, unearmarked (i.e., appropriated) balances would result in considerable pressures from interest groups for the use of such funds.

Should the selected structure entail appropriating specified amounts <u>out of</u> the general fund and into a separate "Rainy Day Fund," policymakers should be reminded that such an appropriation would be counted against the State's general fund expenditure ceiling, and therefore subject to all procedures and requirements provided pursuant to Article VII, Section 9 of the Hawaii State Constitution, and Section 37-93 of the Hawaii Revised Statutes.

Further, should your suggestions (page 9) to ". . . (1) require all year-end surpluses be deposited in the fund and (2) develop a formula which triggers automatic deposits during growth periods . . ." be considered for legislation, policymakers must insure that the implementation methodology would not contravene constitutional three-year limitations on general fund appropriations (Article VII, Section 11); or conflict with expenditure controls pursuant to Article VII, Section 5 which require that ". . . No public money shall be expended except pursuant to appropriations made by law . . ."

3. With respect to other means of budget stabilization, one alternative is the maintenance of a sufficiently large unencumbered balance in the general fund which can serve as an implicit rainy day fund to meet budget contingencies. This approach maintains a large degree of flexibility in the management of public resources and has been the practice employed in recent years.

4. The suggestion of contingent spending has also been informally applied. The execution of a budget authorized by the Legislature must, in reality, be sensitive to revenue conditions. When revenue shortfalls were projected, budgetary restrictions have been imposed to control the level of expenditures.

We would also like to offer the following comments on the findings included in the report:

1. In establishing a trend line for general fund expenditures, it may be appropriate to distinguish operating requirements from the capital outlay for the reason that the latter fluctuates widely from year to year.

2. The alternative of contingent taxation as a stabilization tool can create many problems because of its counter-cyclical nature and can result in unintended impact on the economy.

We appreciate the opportunity to comment on your draft report.

Sincerely,

YUKIO TAKEMOTO
Director of Finance

APPENDIX

STATES WITH RAINY DAY FUNDS

STATE	FUND SIZE* (In millions) FY91	FY92	FY93	% OF G.F. APPROPRIATION FY91**	FY92	FY93	DETERMIN. OF FUND SIZE	DEPOSIT METHODS	WITHDRAWAL METHODS
Alabama	0	0	0		0	0	$21 million first year; $8 million second year. Up to $75 million maximum, thereafter		(1) By governor's declaration of proration or (2) Legislature's declaration of emergency
Alaska	719.5	218	161		7.8	5.9		By appropriation	By appropriation by the governor to meet a disaster
Arizona	NA	0	10.9		0	0.3	Capped at 15% of General Fund Revenue	By formula comparing real net personal income growth to 7 year trend	(1) By formula with majority legislative appropriation or (2) Non-Formula with 2/3 Legislative approval
California	0	0	31		0	0.1		By year-end surplus or appropriation	(1) By appropriation in the budget act, special statutes, or continuous appropriation by the constitution or statutes (2) Executive order can allocate funds for additional fire fighting or response needs
Colorado	43.5	63.9	77.3		2.3	2.6		By statute: 3% of General Fund appropriation and supplemental funds are automatically deposited	By automatic expenditures when revenue estimates fall below targets; fund used only to cover appropriation already authorized
Connecticut	0	0	0		0	0	Capped at 5% of net General Fund appropriation for fiscal year	Year-end surplus	By automatic expenditure to cover budget deficit to the extent that funds are available
Delaware	65.4	67.7	68.1		5.5	5.3	Capped at 5% of estimated General Fund revenues	Automatic deposit of previous year's unencumbered funds	By appropriation to cover unanticipated budget deficit or to compensate for revenue reductions; requires 3/5 vote of each house
Florida	145.2	92.5	150		0.8	1.3	Capped at 10% of previous year's General Fund	Year-end surplus	By appropriation when revenue collections are insufficient to meet appropriations
Georgia	0	0	0		0	0	Capped at 3% of net revenues	Year-end surplus	By automatic expenditure to cover revenue shortfalls

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Idaho	35.2	33	33		3.3	3.3		By appropriation	By appropriation
Indiana	323	324.7	213.4		5.6	3.4	Capped at 7% of prior year's General Fund revenue	Statutory formula (Annual growth rate in personal income minus 2%) X (previous year's General Fund revenues)	By fund transfers to general fund when adjusted personal income declines by more than 2%; Legislature may also authorize withdrawals
Iowa	0	0	60		0	1.8	Capped at 10% of funds appropri-ated from the General Fund during the preceding FY	Year-end surplus	By appropriation limited to covering appropria-tions already authorized by the General Assembly
Kansas	NA	NA	75		0	2.7		By appropriation	By approval of State Finance Council
Kentucky	20	23.5	5		0.5	0.1		By appropriation	By allotment to the Governor to meet a revenue shortfall; governor must notify the Legislature
Louisiana	NA	0	0		0	0		Revenues exceeding $750,000,000 from production and exploration of minerals	By legislative approval of up to 1/3 of fund
Maine	0.1	0.1	0.8		0	0.1		4% of General Fund revenues received in prior FY	By legislation
Maryland	0.2	0.6	51		0	0.8		By appropriation, for fiscal years 1994 and 1995. Amount should be equal to at least the estimate of revenues made by the Board of Revenue Estimates, for the FY and attributable to the increased state income tax rate	By governor's transfer to general fund revenues if state unemployment rate is greater than 6.5% and greater than the prior year's rate. Amount of transfer is limited by legislative budget restrictions
Massachusetts	59.2	59.2	59.2		0.4	0.4	Capped at 5% of current fiscal year revenues	Year-end surplus	By appropriation

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Michigan	182.2	23.3	24.5		0.3	0.3		Statutory Formula: (Annual growth rate in real personal income in excess of 2%) X (general fund revenues of the fiscal year) ending in the current calendar year	Statutory formula: If annual growth rate in real personal income is negative withdrawal equals (deficiency) X General Fund revenues), but no more than needed to balance budget; withdrawals are allowed in year that pay-in is made if actual revenue collections fall below level on which budget was based
Minnesota	400	264	240		3.7	3.3		By direct appropriation $240 million; by contingent appropriation an amount to bring the reserve up to 5% of General Fund appropriation for the biennium	By appropriation or transfer by the commissioner of finance with the approval of the governor in consultation with Legislative Advisory Commission
Mississippi	0	32.7	57.7		1.7	2.9		Automatic transfer of 25% of annual surplus, with fund not to exceed 5% of previous year's General Fund reserve	By transfer by Fiscal Management Board to cover revenue shortfall
Missouri	0	17.2	17.2		0.4	0.4	Not to exceed 5% of General Fund receipts for the preceding FY	By appropriation	By appropriation to the Governor to meet budget shortfalls
Nebraska	31.9	26.9	17.4		1.7	1.1		By statute	By transfer to General Fund when obligations exceed balance
Nevada	NA	0	0		0	0		By comptroller when determining year's fund balance	

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New Hampshire	0	0	0		0	0		Audited year-end surplus	By comptroller's transfer with approval of the Advisory Budget Control Committee and the governor when: (1) General Fund operating deficit occurred for the most recently completed fiscal year, and (2) unrestricted General Fund revenues in the most recently completed FY were below budget forecast
New Jersey	0	0	0		0	0		50% of revenue collections in excess of governor's certification of revenues	(1) By appropriation when revenues are less than certified; or (2) By the governor in event of an emergency identified by the governor, on approval by the legislature's Joint Budget Oversight Committee
New Mexico	78.6	100.6	99.6		4.9	4.7	Not to exceed 8% of aggregate recurring appropriation from the General Fund for the previous year	Excess revenues	By appropriation to cover insufficient revenues that fund authorized appropriation
New York	201	201	201		0.7	0.7	Not to exceed 2% of General Fund disbursements for the FY	By statute: Year-end surplus up to .2% of aggregate General Fund disbursements	By appropriation to cover state deficits and temporary loans
North Carolina	0.4	40	85		0.5	1	Capped at maximum 5% of General Fund Operating Budget	25% of year-end General Fund credit balance	By approval of the General Assembly
North Dakota	22	23	24		3.8	4		Biennium end surplus in excess of $40 million	By governor's transfer to avoid negative General Fund balance

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Ohio	300.4	0	0		0	0		By statute stating the Legislature intends to maintain 4% of GRF revenues from the preceding FY in the fund and that the fund retain its own interest earnings. A repayment plan in temporary law gives Director of Budget and Management discretion to use GRF to repay fund. Temporary law also designates that the fund's interest earnings are to be credited to the GRF	By legislative action
Oklahoma	202.7	140.8	140.8		4.4	4.3	Capped at 10% of General Fund revenue of preceding fiscal year	Automatic transfer of revenue in excess of official revenue projection	By appropriation. Up to 1/2 of balance may be appropriated if the forthcoming fiscal year General Revenue Fund is less than that of current FY certification; the other 1/2 of balance may be appropriated by (1) Emergency declaration by the governor with concurrence with a 2/3 vote of each house or (2) Joint emergency declaration by speaker and president pro tempore with concurrence by 3/4 vote from each house
Pennsylvania	1.9	2	2.2		0	0		By appropriation after certification by the budget secretary, 10% of the General Fund surplus deposited into the fund by the end of the next succeeding quarter	By appropriation when the governor declares an emergency or downturn in the economy; requires a 2/3 vote of each house
Rhode Island	0	8.5	23.8		0.5	1.6	Not to exceed 3% of general revenues, excess goes to the capital fund	.5% of General Fund revenues in FY92; 1% in FY93; 1.5% in FY94; 2% in FY95 and thereafter	By appropriation to meet shortfall
South Carolina	0	0	33		0	0.9	Capped at 3% of General Fund revenue last FY	Revenues in excess of annual operating expenditures must be transferred to the fund	By Budget and Control Board transfers to cover year-end operating budget deficits

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South Dakota	NA	20	25		3.8	4.4	Capped at 5% of General Fund appropriations	Year-end surplus	By legislative act
Tennessee	7.2	30	40		0.8	0.9	By appropriation	By appropriation in the event revenues are insufficient to meet the authorized expenditures	By appropriation to cover insufficient revenues that fund authorized expenditures
Texas	0	163.9	176.1		1	1	Capped at 10% of General Revenue fund deposits (excluding interest and investment of income preceding biennium)	1/2 of cash balance on the last day of the preceding biennium is transferred by the comptroller to the fund. Also receives % of oil or natural gas product tax	By 3/5 vote of each house to cover budget deficit withdrawals; for other purposes requires a 2/3 vote
Utah	56.7	58.3	58.3		3.1	3	Not to exceed 6% of General Fund appropriation for the FY in which the surplus occurred	Up to 3% of general fund surplus	By appropriation to cover operating deficits
Vermont	8.2	0	0		0	0	Capped at 5% of General Fund appropriation from last FY	Undesignated General Fund surplus	To the extent necessary to cover a General Fund deficit
Virginia	0	15	1.8		0.2	0	Cap is annually determined by taking 10% of the average of the income and retail tax revenue for the past three years	Formula: (.5 X[above average growth rate] X [most recent FY collection from income and retail sales tax] = minimum appropriation)	By appropriation. No more than 1/2 of the fund may be withdrawn in any fiscal year. Withdrawals limited to covering no more than 1/2 of a projected shortfall. Projected shortfall must exceed a threshold amount prior to withdrawal
Washington	260	100	100		1.3	1.3		By appropriation based on formula: (projected growth in real personal income minus 3%) X (prior fiscal year revenues)	By appropriation with 60% vote required, when revenue is below forecast. Also for labor force training, or for purposes the Legislature determines would reduce unemployment caused by state's economic cycle

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Wisconsin	0	0	0		0	0		By appropriation	By appropriation
Wyoming	35.2	24.6	12.6		5.9	3.2		By year-end surplus and appropriations	By appropriation
AVERAGE	72.7	49.4	49.3		1.5	1.5			

*Fund sizes for FY91 actual, FY92 estimated, FY93 projected.
**Information on the fund's percent of General Fund Appropriations unavailable for FY91.

Source: Advisory Commission on Intergovernmental Relations, "Significant Features of Fiscal Federalism," Volume 1; National Conference of State Legislatures; National Association of State Budget Officers, "Budget Processes in the States 1992;" Joint Legislative Audit and Review Commission, "Proposal for a Revenue Stabilization Fund in Virginia," 1991.