MEMORANDUM

JOINT BUDGET COMMITTEE

TO	Joint Budget Committee Members
FROM	Carolyn Kampman, JBC Staff Director
DATE	March 25, 2021
SUBJECT	Background Information Concerning State Reserve Practices

JBC RECENT ACTION RELATED TO STATE RESERVES AND PURPOSE OF MEMO

Last Friday, I presented a memo recommending that the Joint Budget Committee (JBC) consider introducing legislation to improve the State's financial condition by using a significant portion of the unanticipated revenue collections in FY 2019-20 and FY 2020-21 to restore and build up the State's reserves. The JBC authorized four bill drafts to be prepared for consideration as part of finalizing its 2021 budget proposal. These recommendations concern three types of State reserves:

- *Statutory General Fund Reserve:* A short-term reserve to mitigate revenue and expenditure uncertainty and the early impacts of an economic recession;
- *Extended Recession Recovery Account:* A new longer-term General Fund reserve to sustain State operations during a multi-year economic recession; and
- *State Emergency Reserve:* A constitutionally required emergency reserve that is used to respond to fires, floods, and other disaster emergencies.

Based on Chairman Moreno's direction, the Office of Legislative Legal Services has prepared three bill drafts for the JBC's consideration this week, and the fourth bill draft will be ready for the JBC's consideration in the next few weeks (the one concerning the Extended Recession Recovery Account).

In response to a JBC member request, this memo provides some background information about state reserves in general, and some recommended practices. Most of the information is from a July 2014 report from the PEW Charitable Trusts (Pew) concerning *Building State Rainy Day Funds: Policies to Harness Revenue Volatility, Stabilize Budgets, and Strengthen Reserves*, along with recent updates that are available on line.[1]

Highlights:

- Most state's reserves fall short of recommended levels.
- Colorado is one of 15 states identified as having above average revenue volatility, and it should thus have an above average reserve.
- As of 2019, Colorado's reserves fell short of the 50-state median when measured in terms of the number of days that the state could potentially run government operations using total balances. Colorado's reserves would cover 32.4 days of spending (8.9 percent) compared to 49.7 days of spending (13.6 percent).

[1] https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind5

Background Concerning State Reserves and Promising State Practices

Based on a review of state reserve balances and funding mechanisms from 1994 to 2012, Pew identified three general promising practices:

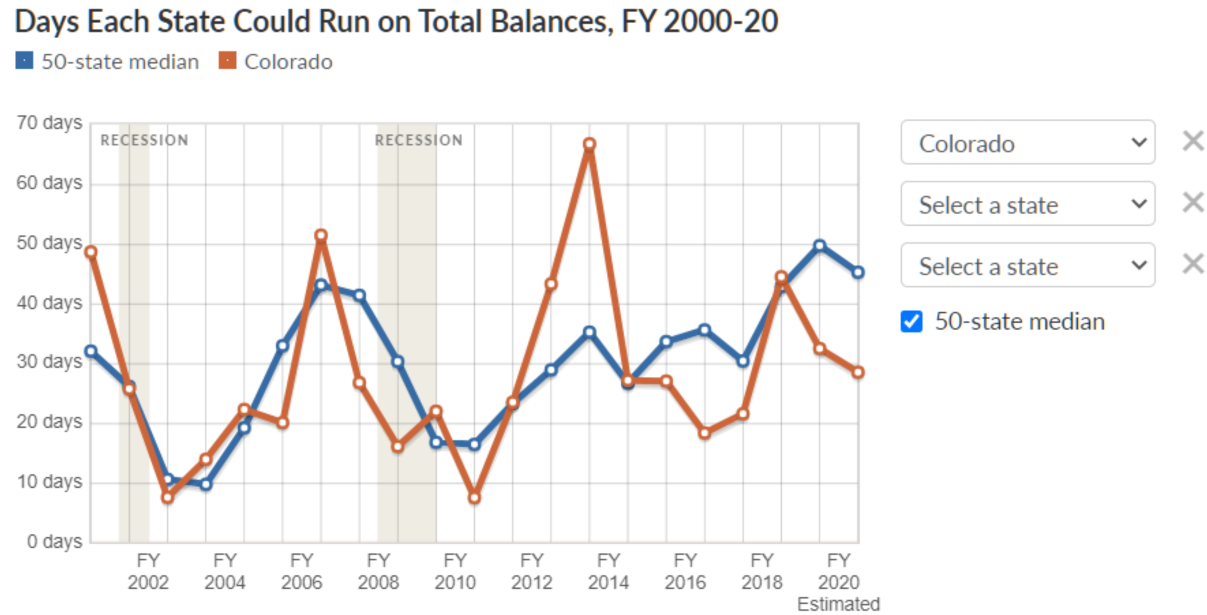
- **Budget stabilization fund policies should take into account the state's tax system volatility**, and be adjusted over time based on changes in overall revenue volatility, highly volatile revenue sources, and general economic conditions.
- **Deposits into a budget stabilization fund should be tied to the state's revenue volatility, with mechanisms that set aside a portion of one-time or unexpected revenue increases**. These funds are meant to smooth budgets over multiple years and across different phases of the business cycle. Mechanisms that direct unused funds or excess revenues into a reserve tend to be more effective than those that are left to annual policy decisions as part of the overall budget process.
- **The size of a budget stabilization fund should match the state's experience with revenue volatility.** In recent history states generally have not established reserves sufficient to weather recessions. In 2002, the median state rainy day fund balance was $95.7 million, but the median budget gap was $394.8 million. In the summer of 2008, all 50 states had about $60 billion set aside in the summer of 2008. But in fiscal 2009, during the Great Recession, budget gaps nationwide totaled $117 billion, about twice what states had in reserve. The size of a state's reserves can also affect its credit ratings. Pew indicates that:
    - Standard & Poor's and Moody's gave top scores to states with savings equal to or greater than 10 percent of annual revenue or spending.
    - The Government Finance Officers Association (GFOA) suggested up to two months worth of operating revenue or expenditures (16.5 percent).

Comparing Colorado to Other States

Colorado's current statutory General Fund reserve requirement is 2.86 percent of annual General Fund appropriations. Please note that the base to which the percentage applies excludes all non-General Fund sources, some annual operating expenditures, and all transfers and infrastructure investments. Under current law, this percent increases to 7.25 percent in FY 2022-23. **Staff recommends increasing the statutory reserve percentage to at least 7.25 percent in FY 2021-22, and a 15.0 percent reserve would be more appropriate and closer to the two months' worth of operating expenses recommended by the GFOA.**

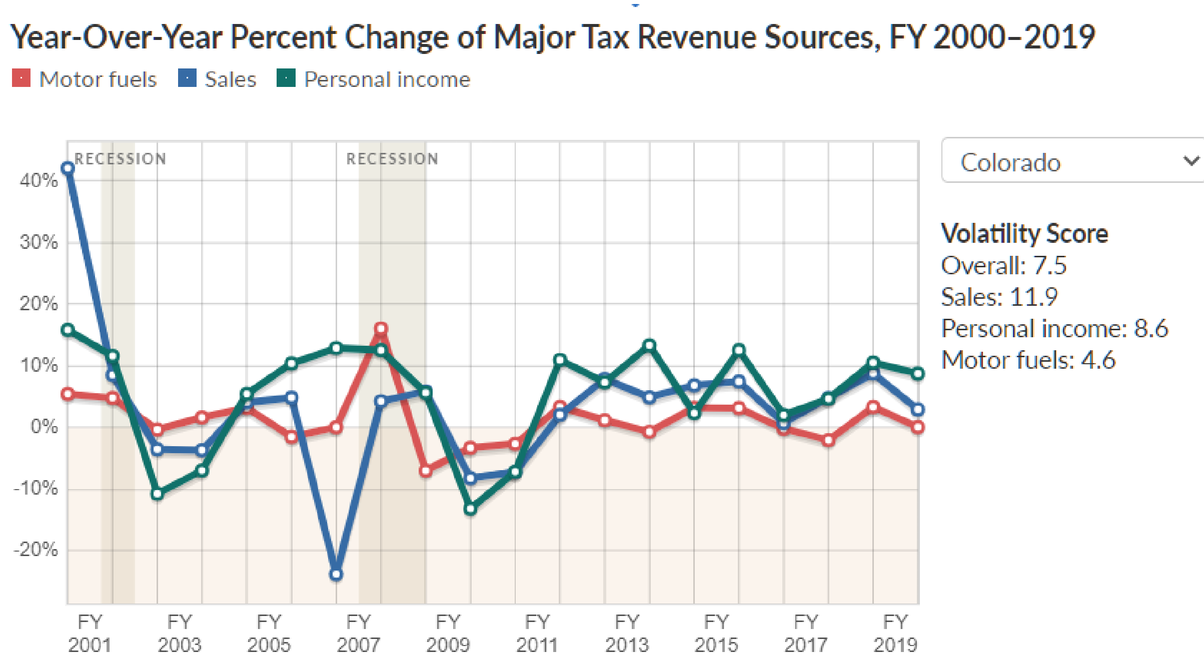
Based on data for fiscal year 2019, most states' reserves fall short of the recommended reserve levels:

- The median number of days that states could potentially run government operations using *total balances* was 49.7 (13.6 percent of spending).
- The median number of days that states could potentially run government operations using *rainy day funds only* was 26.8 days (7.3 percent of spending).
    - For both of these measures, **this study showed Colorado's reserves would allow it to operate for 32.4 days (8.9 percent of spending).**



Source: https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind5

Colorado is one of 15 states identified as having above average volatility scores, and it should thus have an above average reserve. Each state's volatility score is based on the sample standard deviation of the yearly percentage change in a state's total tax revenue from 1998 through 2017, adjusted for all known tax changes.



Source: https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind6

CONSIDER STATE'S LONG-TERM FISCAL IMBALANCES

Pew also includes recommendations related to state's general budgeting practices. **Although states can withstand periodic deficits without endangering their financial health, long-running imbalances can create an unsustainable fiscal situation**. This pushes off to future taxpayers some deferred costs for operating government and providing services. A narrow focus on annual budgets may mask deficits as they allow for shifting the timing of when states receive cash or pay off bills to reach a balance. States should focus on aggregate deficits over the long term (e.g., debt and unfunded public employee retirement liabilities).

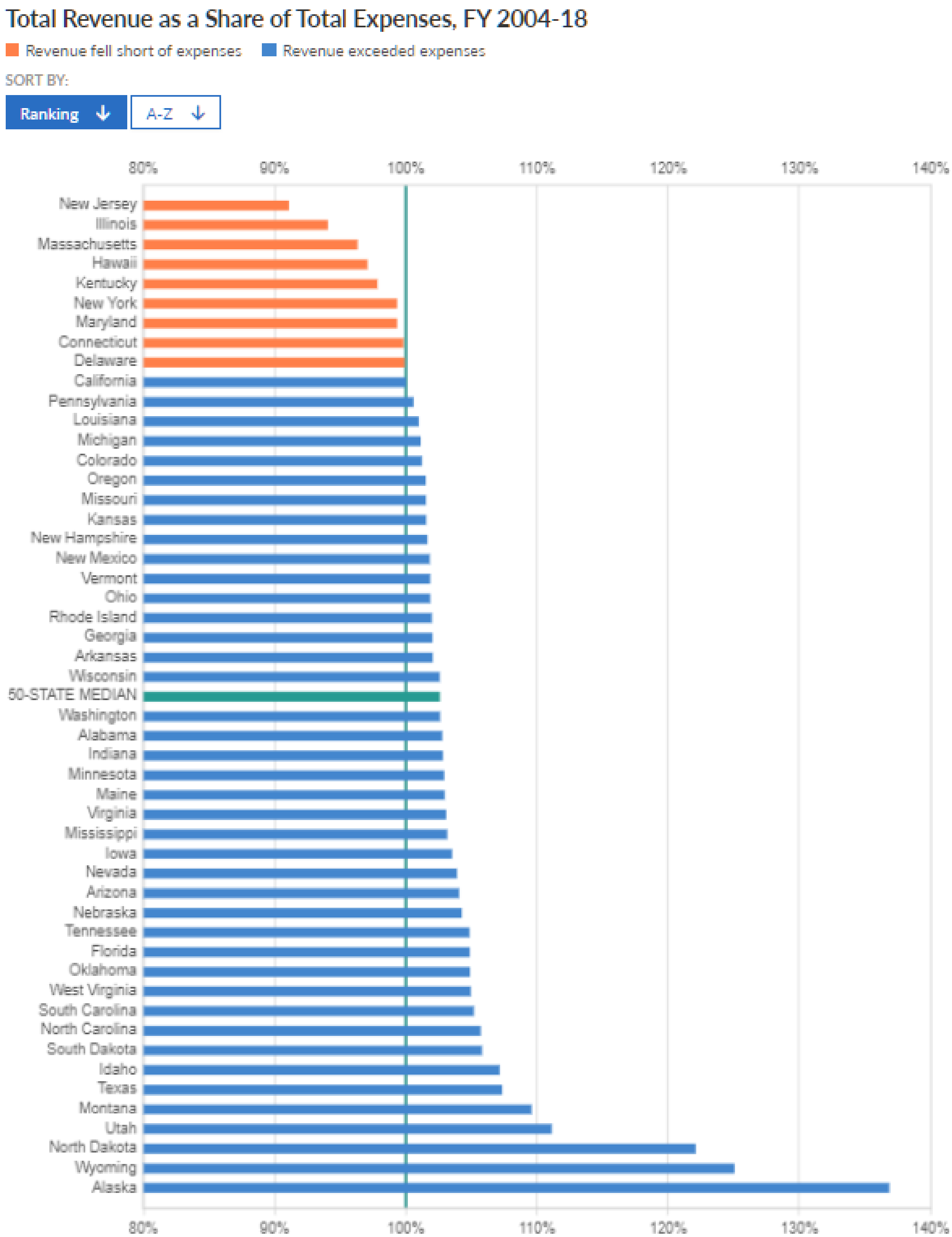
States' annual Audited Comprehensive Annual Financial Reports (CAFRs) attribute:

- revenue to the year it is earned (regardless of when it is received); and
- expenses to the year incurred (even if some bills are deferred or left partially unpaid).

This system of accrual accounting offers a different perspective of state finances than budgets, which generally track cash as it is received and paid out. **"Accrual accounting captures deficits that can be papered over in the state budget process, even when balance requirements are met, such as by accelerating certain tax collections or postponing payments to balance the books."[2]**

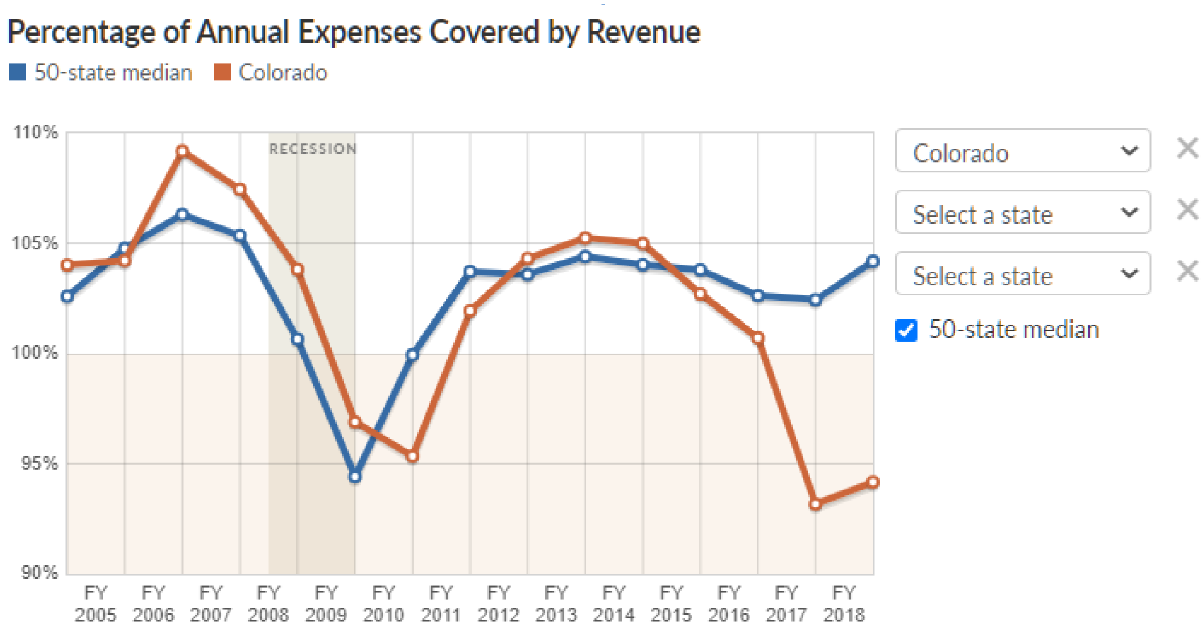
Pew provided the graphic on the following page based on a 15 year analysis of states' revenue and expenses to offer a long-term view to inform present-day decision making. This graphic illustrates that the 50 state median had revenue equal to 102.6 percent of expenses, with deficits in two of 15 years. **Colorado falls short of this median. For this 15-year period, Colorado's revenue equaled to 101.2 percent of expenses, with deficits in four of 15 years.**

[2] Source: https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind9 – see "Analysis" tab



Source: https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind9

The next graphic compares Colorado's experience to that of the 50-state median over this 15 year period.



Source: https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind9

Staff Recommendations in Light of Recommended Reserve Practices

Staff's State reserve recommendations are intended to take advantage of the current unprecedented level of General Fund reserves to restructure State reserves in the short-term to:

- establish a statutory General Fund reserve at a level that provides a more appropriate buffer against revenue volatility, economic forecasts that are subject to historically high risks, and near-term unexpected changes in enrollment- and caseload-driven operating expenses;
- provide the Governor access to liquid assets to respond to disaster emergencies without requiring funds borrowed from dedicated cash funds and without relying on capital assets.

Staff also recommends establishing a mechanism that sets aside a portion of unspent funds each year to provide funding to smooth out expenditures during the next multi-year recession. As this longer-term reserve is established and the balance grows, the General Assembly can reassess reserve policies related to the fund balances, replenishment mechanisms, and limitations on accessing each reserve to ensure that each reserve is serving the intended purpose.