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Building Georgia's Revenue Shortfall Reserve to a Responsible Level

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Georgia's Revenue Shortfall Reserve Fund (RSR) should be treated as an important component of the state's overall fiscal plan. The report that follows explains the purpose of a reserve, specifics to Georgia's RSR, lessons learned from recent recessions, and recommendations for building Georgia's RSR to a responsible level.

What is a reserve?

A reserve (also called a rainy day fund or a budget stabilization fund) is a designated account for a state to make deposits into when the state's revenues exceed its anticipated needs and to make withdrawals from when revenues fall below need.¹ The concept of reserves is an essential part of fiscal planning since taxes and spending operate on different economic cycles. During periods of economic growth, tax collections can exceed a state's spending needs—creating a short-term budget surplus. During economic downturns, tax collections can decline—resulting in a short-term budget deficit while the need for important public services continues.

Budget surpluses and deficits are regularly occurring features of state tax systems, even if the state makes no changes to its tax system and spending priorities. However, states, unlike the federal government, must balance their budgets.² Thus, during economic downturns, states' must cover the short-term deficit by cutting spending, increasing taxes, tapping into reserves, or finessing some combination of the three. With an adequate reserve, states can balance their budgets without constantly changing their tax system or spending priorities.³

An adequate reserve also makes it easier for states to borrow money for financing long-term capital investments. Bond rating agencies consistently cite healthy reserves as a reason for giving states high bond ratings. Good bond ratings directly reduce the cost of borrowing for a state, which in turn reduces the cost of providing public services in the long run.⁴

In addition, states often have other reserve funds to stabilize parts of the budget outside of the General Fund. In Georgia, there are "several other important reserves, including using lottery funds for the education fund reserve (which requires a deposit of 10 percent of the annual lottery proceeds up to a cap of 50 percent) and debt reserves. These funds however are restricted to specific purposes and cannot be used generally to meet a general revenue shortfall."⁵

Common State Reserve Rules

Deposit Rules:

How money is deposited

Size Limit Rules:

If/how size limits or caps are imposed

Withdrawal Rules:

How money may be withdrawn

Replenishment Rules:

If/How withdrawals must be replenished

Georgia's Revenue Shortfall Reserve (RSR)

History

Georgia's Revenue Shortfall Reserve (RSR) was created during the 1976 session of the General Assembly. From 1976 to 2000, the Georgia state auditor reserved from the state surplus:

- An amount equal to no less than 3 percent of the previous year net revenues for the RSR.
- An amount equal to 1 percent of previous year net revenues for a Midyear Adjustment Reserve, available for appropriation for any purpose in the supplemental budget yet mostly spent on K-12 education due to enrollment growth.

Starting in 2001 and continuing through 2005, an optional 2 percent of previous year net revenues (Discretionary Reserve) was added to the first 3 percent of the previous year net revenues (Regular Reserve). As a result, the RSR increased from 3.3 percent of previous year net revenues in 1999 to 5.3 percent of previous year net revenues in 2001. A separate Midyear Adjustment Reserve was retained.

Current Law

During the 2005 General Assembly session, HB 509 redefined the RSR:

- The state auditor reserves from surplus a minimum of 4 percent of previous year net revenues for the RSR.
 - The General Assembly may appropriate out of the RSR up to 1 percent of prior year net revenues to fund K-12 needs in the supplemental budget. The separate Midyear Adjustment Reserve is eliminated.
 - The first 4 percent of the RSR can only be used to cover state funded deficits and to fund increased K-12 needs.
 - The Governor may release for appropriation funds from the RSR that are in excess of 4 percent of prior year net revenues.
- The RSR cannot exceed a maximum of 10 percent of prior year net revenues.

Georgia's Midyear Adjustment Reserve

In Georgia, state funding for each local district's public schools (K-12) is determined by the Quality Basic Education (QBE) formula (i.e., the weighted FTE student count multiplied by the guaranteed financial support base). The Governor's budget includes estimated FTE student counts for the upcoming school year that historically undercount the number of students. Thus, mid-way through the school-year, a supplemental budget includes an appropriation to the State Board of Education, currently from the RSR, to fund QBE for increased enrollment based on the actual fall quarter counts.⁶

Historically, the Georgia state auditor "sets aside" from surplus an amount equal to no more than one percent of prior year revenues to fund the Midyear Adjustment Reserve. These funds were expended in the supplemental budget. Up until 2005, these funds could be used for any purpose, although they were mostly expended for K-12 fall enrollment growth. HB 509 eliminated the separate Midyear Adjustment Reserve but designated within the RSR that one percent of prior year net revenues from the state surplus is available only to fund K-12 needs in

the supplemental budget. Note, “K-12 needs” is currently interpreted to include funding QBE for increased fall enrollment plus any other K-12 funding needs up to the maximum of one percent of prior year net revenues.

Practice

At the end of each fiscal year (June 30), the RSR is calculated by subtracting expenditures from revenues. The State Auditor then “sets aside” any positive balance, which “represents a surplus which is not reported as being available for appropriation during the coming fiscal year.”⁷ This “set aside” is an accounting mechanism. That is, RSR funds are not moved to a separate account but are earmarked within the general fund.

Relationship between RSR, Midyear Adjustment Reserve (K-12 enrollment growth) and Annual Revenue Estimate

It is also important to understand how the RSR and funding for K-12 enrollment growth within the supplemental budget interacts with the annual revenue estimate. Each year, the Governor determines the total revenues that can be appropriated for the upcoming fiscal year.⁸ Georgia is one of 17 states in which the executive branch has primary responsibility for developing the official state revenue forecast.⁹

Planning for the RSR and funding for K-12 enrollment growth within the supplemental budget is part of the overall fiscal plan of the state. The size of the RSR and funding available for K-12 enrollment growth within the supplemental budget is dependent in part on the Governor’s revenue estimate. Governors traditionally choose a conservative (or low) revenue estimate to force a year-end surplus that can build the RSR and fund K-12 enrollment growth within the supplemental budget. A revenue estimate that does not drive a surplus would not only make it difficult to increase the RSR, but would result in a lack of funds within the supplemental budget for K-12 enrollment growth.

Recent RSR and Surplus Funds

Due to conservative revenue estimates, revenue collections between FY 1995 and FY 2002 exceeded the revenue estimate enough to generate an additional surplus above the fully funded RSR. Looking at the RSR plus the additional surplus provides the true picture of the “potential reserve funds” Georgia had on hand during this period. Table 1 on the following page shows that from FY 1995 thru FY 2001 Georgia’s “potential reserve funds” increased from 4.0 percent to 11.2 percent of previous year net revenues. The additional surplus was available each year to act as a second reserve in case of an economic downturn.

The FY 2006 RSR is \$792.5 million, or 4.6 percent of previous year net revenues. In that there is no surplus above the funds available for the RSR, the true funding available for use in case of budget shortfalls is lower than at any time between FY 1996 and FY 2002. An RSR equivalent to 10 percent of previous year net revenues would total over \$1.8 billion.

Table 1
Revenue Shortfall Reserves (RSR) and Surplus as Percent of Net Revenues

Fiscal Year	RSR	Surplus	Total Potential Reserve Funds (RSR + Surplus)	Net Revenue	Total as % of Net Revenues
1995	\$288,769,754	\$ 94,742,679	\$ 383,512,433	\$ 9,625,658,475	4.0%
1996	\$313,385,534	\$363,354,921	\$ 676,740,455	\$10,446,184,459	6.5%
1997	\$333,941,806	\$588,907,843	\$ 922,849,649	\$11,131,393,549	8.3%
1998	\$351,545,470	\$601,483,714	\$ 953,029,184	\$11,718,182,319	8.1%
1999	\$380,883,294	\$750,527,063	\$1,131,410,357	\$12,696,109,796	8.9%
2000	\$551,277,500	\$973,442,868	\$1,524,720,368	\$13,781,937,492	11.1%
2001	\$734,449,390	\$917,836,322	\$1,652,285,712	\$14,688,987,803	11.2%
2002	\$700,273,960	\$239,732,975	\$ 940,006,935	\$14,005,479,208	6.7%
2003	\$260,600,570	--	\$ 260,600,570	\$13,624,846,657	1.9%
2004	\$ 51,577,479	--	\$ 51,577,479	\$14,584,644,742	0.4%
2005	\$256,664,658	--	\$ 256,664,658	\$15,813,996,667	1.6%
2006	\$792,490,296	--	\$ 792,490,296	\$17,338,759,588	4.6%

Sources: RSR from Governor's Budget Report FY 2008. RSR excludes Midyear Adjustment Reserve.

Surplus from Bourdeaux (2006) <http://frc.gsu.edu/frpreports/report135/Rpt135FIN.pdf>.

Net Revenues from Governor's Budget Reports and Bourdeaux (2006).

Reserves in Recent Recessions

Reserves are maintained to help ease funding across multiple fiscal years during an economic downturn. The Government Finance Officer's Association (GFOA) recommends that states set aside between 5 to 15 percent of general fund operating revenues (or at least one to two months of general fund operating expenditures) as reserves.¹⁰ Georgia state government expends approximately \$50 million per day. A fully funded RSR (10 percent of previous year net revenues or \$1.8 billion) would run Georgia state government for approximately 36 days.

Due to low revenue estimates and higher revenue collections during the economic boom of the 1990's, at the end of FY 2001 Georgia had "potential reserve funds" of 11.2 percent of previous year net revenues (\$1.7 billion). These funds were used to minimize the impact of the 2002-2004 economic downturn. A five percent reserve would have been depleted immediately in 2002 and likely require mid-year cuts. The severity of cuts in 2003 would have also been much greater.¹¹

In the 2002-2004 economic downturn, Georgia State University's Willoughby and Guo found that most states used and depleted their reserve funds during the first year. With reserves depleted, states turned to other methods to balance their budgets, such as:

- 31 states made "non-routine" transfers from other funds to finance operating expenses – such as drawing down on funds used for self-insurance or federal relief funds;
- 36 made targeted spending cuts; and
- 32 made across the board spending cuts.¹²

Recent economic downturns have demonstrated that a 5 percent reserve is not sufficient to smooth expenditures over multiple years.

Recommendations

Georgia policymakers should adopt the following Revenue Shortfall Reserve (RSR) policy changes in order to better prepare for the next economic downturn.

1. Remove the Education Midyear Adjustment Reserve from the RSR.

The Governor should determine an accurate revenue estimate that fully funds state government for the entire fiscal year and that responsibly builds the RSR. The objective of the RSR should be to minimize the impact of economic downturns and not to regularly fund basic government services, like K-12 education. Therefore, funding for K-12 education enrollment growth should be pulled out of the RSR. The Governor and General Assembly should accurately estimate QBE fall enrollment growth and associated costs and include those funds in a separate line item within the original annual budget. This appropriation would not be released until the final QBE fall enrollment counts are calculated. That is, OPB could not allocate to the Department of Education (DOE) and DOE could not allocate to local school districts until after the QBE fall enrollment counts are calculated.

2. Increase the size of the RSR.

Georgia should approve legislation that would require the RSR to be an amount equal to a minimum of 10 percent of the previous year net revenues (total general funds) with a maximum RSR equal to 15 percent of previous year net revenues. The Governor would only be able to release for appropriation RSR funds that are in excess of 10 percent of previous year net revenues.

Building a reserve of between 10 and 15 percent requires both strong reserve policies and sufficient time. If Georgia set aside between 1.5 and 2.5 percent of revenue a year into its RSR, it would take between 6 and 10 years to build a reserve that equals 15 percent of spending. At a minimum, the Governor should set a goal of increasing the RSR by one percent of revenue a year to prepare us for the next recession.

3. Create a RSR account.

Georgia should create a separate account, "RSR Fund", to receive (1) a direct appropriation from the annual budget and (2) any surplus revenues and unspent state agency funds at the end of the fiscal year, up to a maximum of 15 percent of previous year net revenues. For example, the RSR could receive a direct appropriation of \$200 million from the annual budget plus \$50 million of surplus revenues and lapsed state agency funds at the end of the fiscal year for a total RSR increase of \$250 million.

As a separate line item, the RSR Fund would be debated during the annual budget process. The Governor and General Assembly would consider the RSR appropriation alongside all other appropriations (e.g., education, health care and corrections). Ideally, an accurate revenue estimate would cover state government services and the RSR. However, periods of slow revenue growth may require the Governor and General Assembly to favor maintaining critical government services over the RSR appropriation.

Establishing the RSR Fund as a separate account may require legislative and constitutional changes, an effort worth pursuing to help Georgia minimize the impact of the next economic downturn.

The GBPI is an independent, nonprofit, non-partisan organization engaged in research and education on the fiscal and economic health of the state of Georgia. The GBPI provides reliable, accessible and timely analyses to promote greater state government fiscal accountability as a way to improve services to Georgians in need and to promote quality of life for all Georgians.

¹ Elaine Maag and David Merriman. *Get Well Soon: Understanding States' Fiscal Health during and after the 2001 Recession*. March 2007. The Urban Institute, Washington, D.C.

² Except Vermont.

³ Institute on Taxation and Economic Policy. *A Primer on State Rainy Day Funds*, Policy Brief 25, 2005
<http://www.itepnet.org/pb25rdf.pdf>

⁴ Ibid

⁵ Carolyn Bourdeaux. *An Assessment of the State of Georgia's Budget Reserves*. FRC Report No. 135. October 2006. <http://frc.gsu.edu/frpreports/report135/Rpt135FIN.pdf>

⁶ http://www.legis.state.ga.us/legis/2007_08/house/budget/knowWhatTalkingAbout.html,
<http://www.nces.ed.gov/edfin/pdf/StFinance/Georgia.pdf>, and
http://www.gsba.com/downloads/FundingGaPublicSchools_talking_points.pdf

FTE "full-time equivalents" are defined as the number of students who are enrolled in each segment (or class) during the school day.

⁷ Bourdeaux 2006.

⁸ Annual general fund revenue estimate is a projection of tax receipts, fees, and other revenue collections by the state's general treasury during a twelve-month fiscal year period. This official estimate becomes a part of the fund availability to be appropriated.

⁹ National Conference of State Legislatures. *Legislative Budget Procedures: A Guide to Appropriations and Budget Processes in the States, Commonwealths and Territories*. <http://www.ncsl.org/programs/fiscal/lbptabs/lbpc2t4.htm>

¹⁰ Government Finance Officers Association. *Recommended Best Practices: Appropriate Level of Unreserved Fund Balance in the General Fund*. <http://www.gfoa.org/services/rp/budget/budget-appropriate.pdf>

¹¹ Bourdeaux. 2006

¹² Katherine Willoughby and David Guo 2006 *Government Performance Project: State Responses to Budget Gaps, 2003 and 2004*. 2004. Georgia State University.