Massachusetts Taxpayers Foundation
The Independent Resource for the Commonwealth's Decision Makers

Stabilization Fund Briefing

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Stabilization Fund Dip During Recovery Puts State At Risk

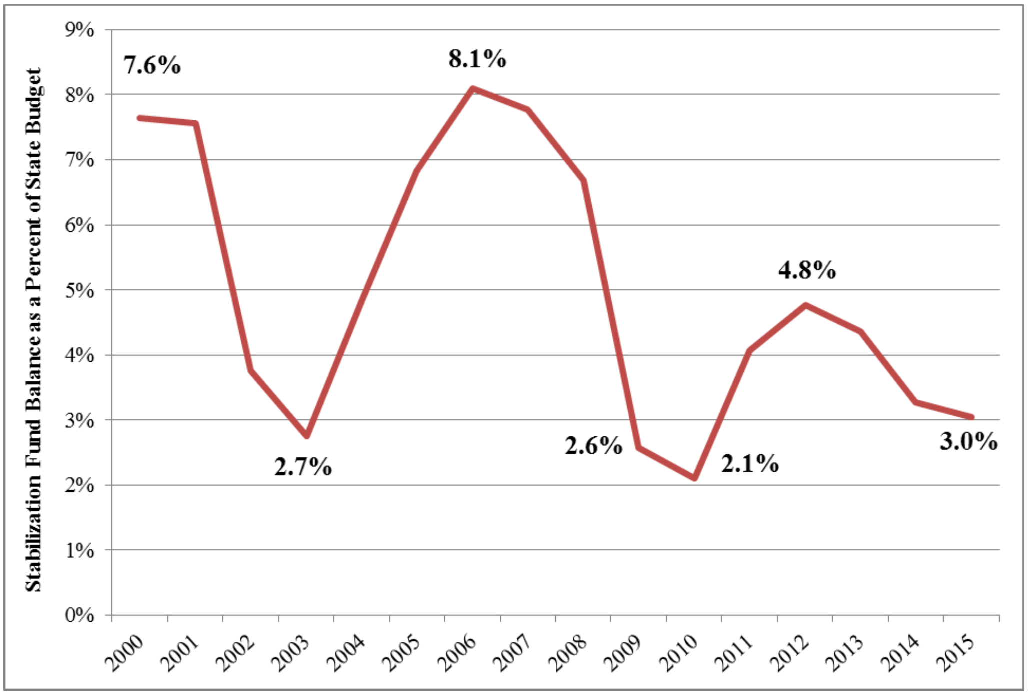
Summary

The Commonwealth has engaged in a problematic budgetary practice in recent years in which it has become increasingly reliant on one-time funds in the middle of an economic recovery to pay for operating expenses. Perhaps the most troubling of these one-time sources is the state's reserves, or stabilization fund. Using the stabilization fund to balance the operating budget, whether by withdrawing or diverting money, runs counter to the fund's sole purpose as a reserve to help the state weather difficult – and often unexpected – fiscal and economic periods.

This practice is a particular cause for concern for several reasons. First, the state is spending stabilization fund reserves during an economic recovery, the very time in which the fund should be replenished. Without strong reserves, the state is more exposed to risk: there may be inadequate funds to fill in weak revenue performance during the next, inevitable economic downturn. At the same time, relying on the stabilization fund – a non-recurring, or one-time, revenue source – to pay for recurring operational costs only expands the state's structural deficit by increasing the budget base. A structural deficit occurs when recurring revenues are inadequate to support recurring spending. In a period of fiscal stress, which is often when the state's residents have a heightened need for its services, the combination of an inadequate stabilization fund balance and a structural deficit will place enormous pressure on the budget.

The current $1.25 billion balance falls far short of the approximately $2.5 billion to $3 billion the state is likely to need to help mitigate the impact of the next downturn. In fact, the 2015 stabilization fund balance is equal to just three percent of state spending – among the lowest proportions since 2000 (Figure 1). The current level of funding is significantly less than the five percent of spending that creditors prefer and best practices suggest maintaining given Massachusetts' dependence on volatile sources of revenues. The state has not achieved that level of reserves since before the 2008 fiscal crisis.

Figure 1 – State Stabilization Fund Balance as a Percent of State Spending, FY 2000 – FY 2015[1]



This brief examines the Commonwealth's stabilization fund, including its purpose, history, and the critical importance of replenishing it to weather challenging fiscal and economic periods. Given the need for healthy reserves and the growing difficulty in replenishing and maintaining the stabilization fund balance, the Foundation also makes the following recommendations.

1. Increase the stabilization fund balance to ten percent of annual state tax revenues within five years and then maintain the fund balance at that level thereafter. To meet this standard for FY 2016 would require attaining a balance of approximately $2.5 billion.

2. Dedicate a minimum of one percent of annual budgeted tax revenues each year to the stabilization fund as a pre-budget transfer. This transfer may be backed by capital gains tax revenues above the threshold, settlement revenues in excess of $10 million, and if those sources are insufficient, by general fund revenues.

[1] Includes pre-budget transfers for pensions, the MBTA, and the Massachusetts School Building Authority.

Determining the Right Balance

Stabilization funds, sometimes referred to as "rainy day" funds, are a longstanding best practice in public budgeting. The purpose of a stabilization fund, as its name suggests, is to provide a source of funding during periods of expected or unexpected budget hardship. For example, governments may draw on stabilization funds to respond to weather or infrastructure emergencies or to mitigate drastic service cuts when tax and other revenue sources are impacted by larger economic forces.

Under state finance law, there are no requirements regarding the minimum size of the fund balance or the types of revenue that are deposited and only loose restrictions on how it can be spent; however, several entities provide guidelines on best practice. The stabilization fund balance must be large enough to help offset significant declines in budgeted revenues; on the other hand, accumulating an especially large balance would indicate that a government is either collecting more revenue than it needs to fund the budget or spending less than it should to provide quality services.

The National Conference of State Legislators (NCSL) suggests that reserves of five percent of state expenditures indicate a healthy stabilization fund balance while acknowledging that what constitutes a high level of reserves depends on a state's individual circumstances.[2] A recent report from the Pew Charitable Trust finds that the "5 percent rule is not universally applicable."[3] According to Pew, a more accurate determinant of the optimal size of a stabilization fund balance is the volatility of the state's revenues – the more volatile the revenue source, the larger the balance in the stabilization fund. For Massachusetts, which is ranked as the 11th most volatile state in the country due to its dependence on income and capital gains taxes[4], the reserves should be greater than five percent if it were to adhere to the Pew standard.

Credit rating agencies track stabilization fund balances carefully as a measure of a state's fiscal discipline. The ability of lawmakers to build and maintain a high level of reserves does in fact require discipline because there are always competing interests for the funds. For example, Standard and Poor's and Moody's both give top scores to states with balances in excess of eight percent of annual spending. For Massachusetts to obtain a top score, it would need a balance of $3.4 billion in FY 2016.[5]

The Government Finance Officers Association (GFOA) recommends a more stringent standard, suggesting a state should maintain a minimum of two months operating expenditures, or 17 percent of state expenditures, in its stabilization fund. To meet the GFOA standard, Massachusetts would need a balance of nearly $7 billion.[6]

Regardless of the metric used to measure adequacy, it is clear that the Commonwealth's current balance is lower than it should be and concrete steps must be taken to grow the fund balance.

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[2] National Conference of State Legislators: *NCSL Fiscal Brief, State Balanced Budget Provisions,* October 2010.
[3] The Pew Charitable Trusts, *Building State Rainy Day Funds,* July 2014.
[4] The Pew Charitable Trusts, *Building State Rainy Day Funds,* July 2014, p. 32. Volatility is measured by year-over-year changes in total tax revenues after accounting for legislative changes.
[5] Includes state spending on pre-budget transfers for pensions, the MBTA, and the Massachusetts School Building Authority
[6] Government Finance Officers Association Board, *Appropriate Level of Unrestricted Fund Balance in the General Fund,* September 2015.

History of the Massachusetts' Stabilization Fund

The Commonwealth stabilization fund was established in 1986, as part of a broader fiscal reform act.[7] The fund was designed so the state would set aside surplus revenues during times of economic expansion in order to provide vital reserves during economic downturns when the state typically confronts unexpected revenue shortfalls or budget deficits.

More specifically, the statutory language for the stabilization fund grants legislators the authority to withdraw funds for budget appropriations under certain circumstances:

- to replace the state and local loss of federal funds; and
- for any event which threatens the health, safety or welfare of the people or the fiscal stability of the commonwealth or any of its political subdivisions. Such event or events, as determined by the general court, shall include, but are not limited to, a substantial decline in economic indicators which result in severe reductions in state revenues or state financial assistance to local governmental units, or court ordered or otherwise mandated assumptions by the commonwealth of programs or costs of programs previously borne by local governmental units.

To build up the fund's reserves, lawmakers initially proposed deposits from a portion of the consolidated net surplus (unspent balances at the end of the fiscal year from budgeted funds such as the General Fund, the Commonwealth Transportation Fund, and the Massachusetts Tourism Fund) and retained interest earnings. In recent years, the Legislature provided two additional sources of funding: 1) all capital gains tax revenues above a statutory threshold and 2) tax and other settlements in excess of $10 million that are not included in revenue forecasts and vary substantially from year to year.[8] These two sources, described in greater detail in a later section, have generated more than $2 billion since they were enacted into law.

Although the Legislature has wide discretion to appropriate stabilization funds, historically lawmakers have been careful to use it judicially during economic downturns and to increase the fund's balance during periods of economic growth and recovery. As shown in Figure 2, the stabilization fund balance declined on just three occasions since its inception, and in each case it was due to a severe economic downturn.

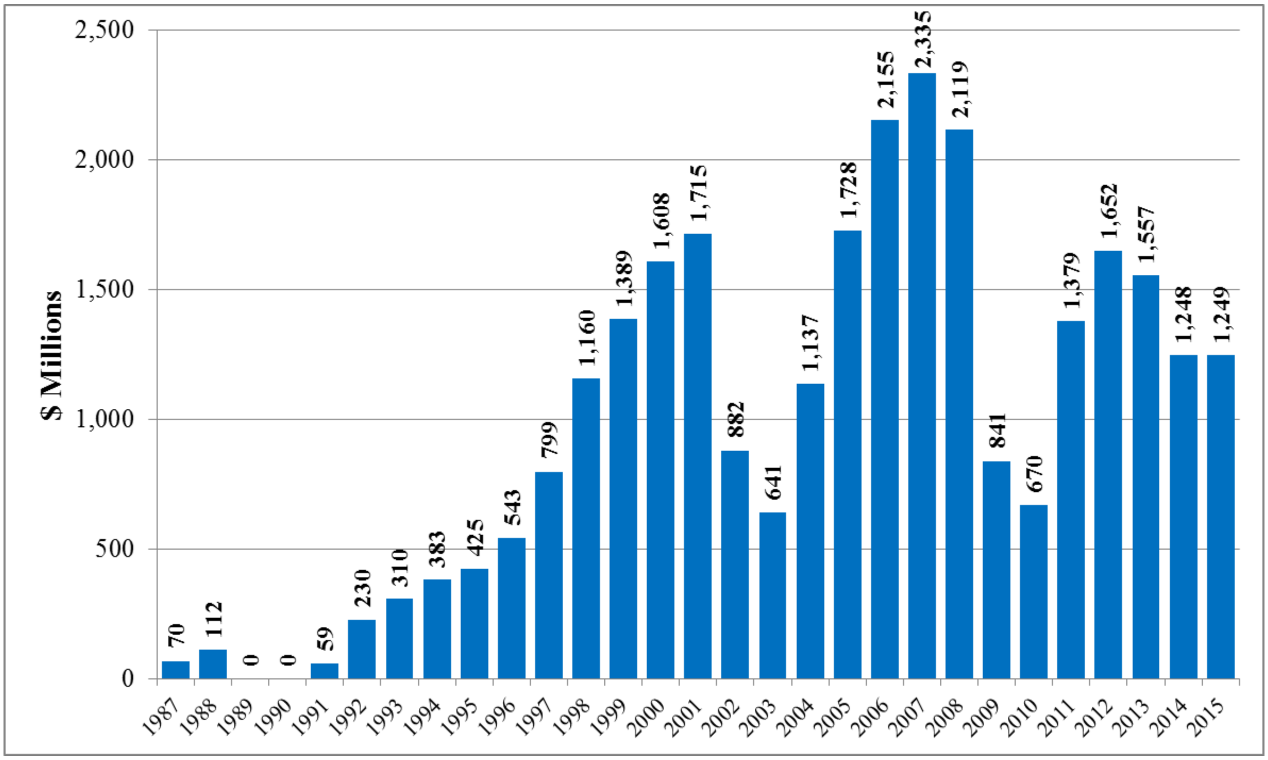
Two years after the creation of the stabilization fund, the state confronted a growing economic crisis that forced lawmakers to withdraw all reserves to help balance the 1989 budget.[9] As the economy expanded in the 1990s, reserves increased from a zero balance in FY 1990 to $1.7 billion in FY 2001.

[7] Section 6 of Chapter 488 of the Acts of 1986 was a comprehensive fiscal reform that included, among other things, restoration of certain personal tax exemptions, repeal of an income tax surcharge, an exemption from sales taxes for snacks and candy purchased from vending machines, and extension of the carry forward on capital losses from five years to indefinite.

[8] Approximately 90 percent of tax settlement revenues derive from corporations and business.

[9] Lawmakers transferred $112 million to the General Fund in FY 1989 to help cover $377 million in fund deficits per Section 8 of Chapter 287 of the Acts of 1989.

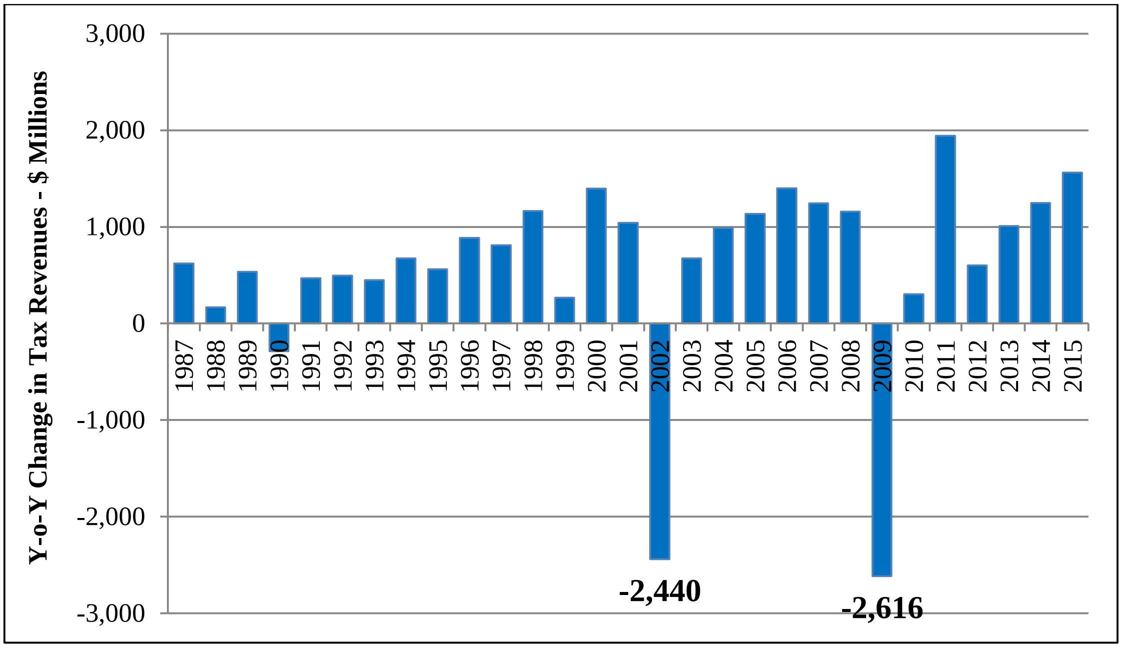
Figure 2 – Year-End Stabilization Fund Balances for Fiscal Years 1987 - 2015



The first substantial reduction in stabilization fund reserves occurred during the recession of 2002 which had an enormous and immediate impact on the state's budget. In FY 2002, revenues plummeted by $2.4 billion representing a 14.5 percent decline over collections from the previous year. The unemployment rate doubled from a low of 2.9 percent in January 2001 to 5.9 percent in July 2003 during which time the state lost over 180,000 jobs.

The impact of the 2008 fiscal crisis was equally severe for the state. In FY 2009, revenues plunged by $2.6 billion – a 12.5 percent decline from FY 2008 tax collections (Figure 3). The unemployment rate climbed four points from 4.7 percent in January 2008 to 8.8 percent in December 2009 as state employment fell by 125,000 jobs.

Figure 3 – Year-over-Year Change in State Tax Collections



In all instances, lawmakers relied on substantial withdrawals from the Stabilization Fund to help the state survive these fiscal calamities. Lawmakers withdrew a total of $1.07 billion in FY 2003 and FY 2004 to partially offset the $2.44 billion drop in tax revenues. Similarly, to help balance the FY 2009 and FY 2010 budgets, the state withdrew $1.45 billion in total rainy day reserves which covered 55 percent of the $2.62 billion loss in state tax revenues. These withdrawals greatly alleviated the budget crises and demonstrated the importance of maintaining healthy reserves.

Economic Recoveries and Replenishing the Stabilization Fund

The 2002 and 2008 recessions underscored that the stabilization fund is a vital fiscal resource during times of hardship. The fact that the state had built a substantial balance at the start of each recession – 7.6 percent of state spending in 2002 and 8.1 percent in 2009 – placed Massachusetts in a strong position compared to other states and helped it to maintain its credit rating during a time when many other states saw their ratings decline.

The state clearly took advantage of a rebounding economy driving robust tax revenue growth to replenish the fund in the aftermath of the 2002 recession. Actual tax revenues exceeded budgeted tax revenues by an average of approximately $1 billion per year for FY 2004 through FY 2007 (Table 1) and this allowed lawmakers to add an average of $400 million per year to the stabilization fund. As a result, the stabilization fund balance more than tripled from a low of $640 million at the close of FY 2003 to $2.3 billion in FY 2007, an increase of approximately $1.7 billion (Figure 2 and Table 1).

Table 1 – Change in State Tax Revenues and Stabilization Fund Balance, FY 2004 – FY 2007[10]

Fiscal Year	Budgeted Tax Revenues	Actual Tax Revenues	Difference	Change in Stab. Fund Balance
2004	15,269	15,953	684	496
2005	15,987	17,088	1,101	591
2006	17,286	18,488	1,201	426
2007	18,445	19,736	1,291	200
Average			**1,069**	**428**
Total			**4,278**	**1,714**

Similarly, actual tax revenues in FY 2011 and FY 2012 exceeded budgeted tax revenues by $2 billion. The increase in revenues allowed lawmakers to deposit nearly $1 billion into the stabilization fund, increasing the balance to $1.65 billion in FY 2012 from $670 million at the close of FY 2010 (Figure 2 and Table 2).

Table 2 – Change in State Tax Revenues and Stabilization Fund Balance, FY 2011– FY 2012[11]

Fiscal Year	Budgeted Tax Revenues	Actual Tax Revenues	Difference	Change in Stab. Fund Balance
2011	16,562	18,028	1,466	709
2012	20,615	21,115	500	273
Average			**983**	**491**
Total			**1,966**	**982**

During these two fiscal years, the state also made two important statutory changes designed in part to ensure that the stabilization fund would be replenished quickly. Effective in FY 2011, capital gains tax revenues in excess of $1 billion were statutorily required to be deposited into the fund.[12] This change was important because capital gains tax revenues are an extremely volatile revenue source that tracks the economic cycle, increasing during economic growth and plunging during periods of economic contraction. In fact, the 2002 and 2009 budget crises were greatly exacerbated by staggering year-over-year declines in capital gains tax revenues of $560 million in FY 2003 (50 percent of the FY 2002 total capital gains tax revenues) and $1.6 billion in FY 2009 (75 percent of the FY 2008 total).

[10] Commonwealth of Massachusetts, *Information Statements*, August 8, 2007 p. A-6.
[11] Commonwealth of Massachusetts, *Information Statements*, September 2015, p. A-19.
[12] The $1 billion threshold was subsequently adjusted each year "to reflect the average annual rate of growth in United States gross domestic product over the preceding 5 years based on the most recently available data published by the Bureau of Economic Analysis in the United States Department of Commerce." M.G.L. Chapter 29, Section 5G.

The following year, lawmakers passed legislation effective in FY 2012 that required all settlements received by the state in excess of $10 million be deposited into the stabilization fund. Most of these settlements are tied to corporate tax audits, though occasionally they are from other sources, such as estate settlements. Revenues from these two sources, capital gains in excess of the threshold and settlements over $10 million, totaled nearly $2.2 billion during fiscal years 2012 through 2015 (Table 3).

Table 3 – Capital Gains Tax Revenues Above Threshold and Tax Settlements in Excess of $10 Million, FY 2012 – FY 2015

	FY 2012	FY 2013	FY 2014	FY 2015	Total
Cap. Gains Above Threshold	0	468	45	620	1,133
Tax Settlements > $10 Million	375	32	414	215	1,037
Total	**375**	**500**	**460**	**835**	**2,169**

The Fund Balance Since 2012: A Changed Approach

Despite the concerted effort in FY 2011 and FY 2012 both to restore the fund and to adopt policies that would ensure continued contributions to the fund, the stabilization fund balance has declined by approximately $400 million over the last fiscal three years.

Slow growth in state tax revenues combined with growing costs for non-discretionary obligations, particularly MassHealth, have resulted in budgets that continue to rely on the rainy day funds. As shown in Table 4, stabilization fund withdrawals of nearly $1.1 billion were used to support the 2013 through 2015 budgets.

Table 4 – Revenues Withdrawn and Diverted from the Stabilization Fund, FY 2013 – FY 2015

	FY 2013	FY 2014	FY 2015	Total
Stab. fund withdrawals	595	354	140	1,089
Diverted from Stab. fund				
Cap. gains tax revenues	0		500	500
Settlements in excess of $10 million	0	414	215	629
Total	**595**	**768**	**855**	**2,218**

Additionally, the state used the bulk of settlement funds and capital gains tax revenues that should have been deposited into the stabilization fund to address mid-year budget shortfalls. In FY 2014, the state elected to divert more than $400 million in tax settlement revenue to the general fund to close out the fiscal year as tax revenue growth was insufficient to meet supplemental spending needs (Table 4). In FY 2015, a permanent change was made to the statutory provision pertaining to settlement revenue that allowed more than $200 million of these revenues to be used in that year's budget.

In FY 2014 and FY 2015, more than $1.1 billion of capital gains and settlement revenue was diverted from the stabilization fund to the general fund to balance the budget and address budget gaps. To close the burgeoning budget gap of more than $1 billion halfway through FY 2015, $500 million in excess capital gains tax revenue – which otherwise would have gone to the stabilization fund – was used for operational purposes.[13]

In fact, but for the surge in capital gains tax revenues in the final quarter of FY 2015, tax revenues would have fallen short of the estimate used to create the original budget for that fiscal year. If lawmakers had not suspended the deposit of capital gains tax revenues into the stabilization fund, the state would have faced a $400 million shortfall and been forced to take far more drastic action to balance the budget. However, such a move comes at a price because the state does not have that money available for the next economic downturn.

Despite these large withdrawals and diversions, some money from capital gains tax revenues ($633 million), tax settlements ($32 million), and a repayment of Gaming Commission startup costs from licensing fees ($20 million) were deposited into the stabilization fund. But, most importantly, the result remains a $400 million reduction in reserves over the past three years (Table 5).

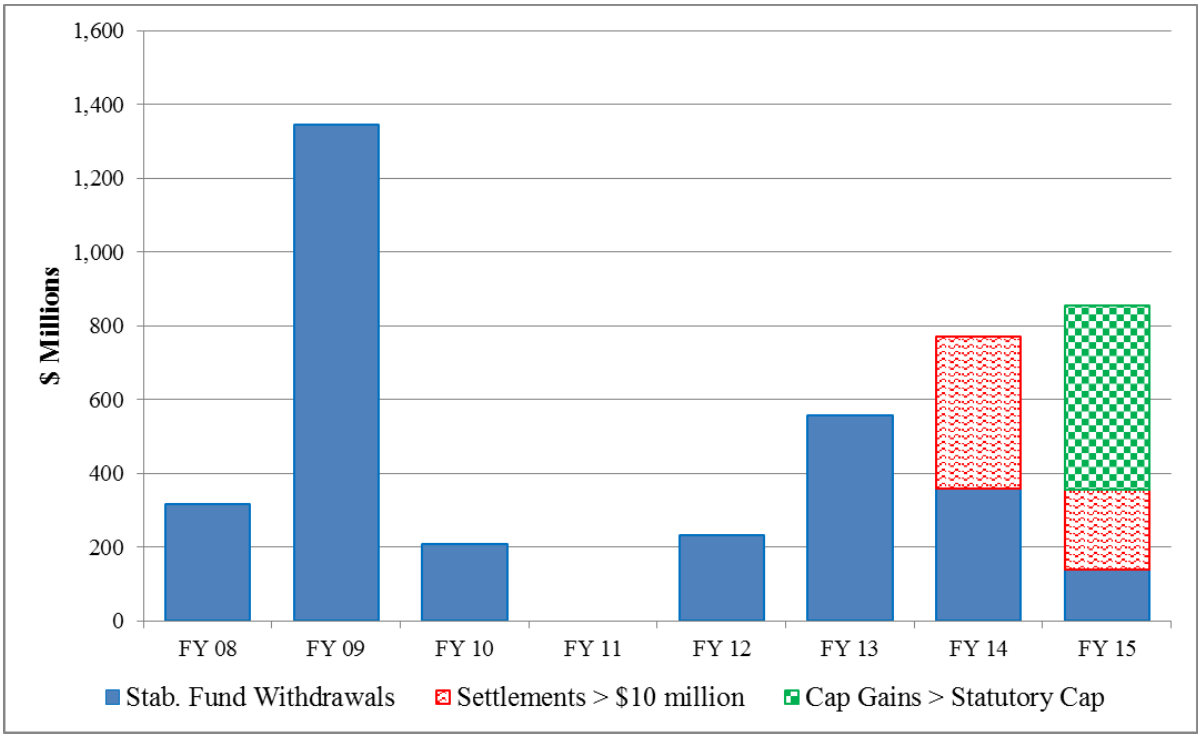
Table 5 – Stabilization Fund Withdrawals and Deposits, FY 2013 – FY 2015

	FY 2013	FY 2014	FY 2015	Total
Stab. fund withdrawals	-595	-354	-140	-1,089
Stab. fund deposits	500	45	140	685
Capital gains tax revenues	468	45	120	633
Settlements in excess of $10 million	32			32
Reimbursement from Casino License Fees			20	20
Net Change in Stab. fund balance	**-95**	**-308**	**0**	**-403**

In all, the FY 2013 through FY 2015 operating budgets were supported by $2.2 billion in transfers or diversions from the stabilization fund – a staggering amount during an economic recovery (Figure 4). The troubling result of these decisions is a 25 percent drop in the fund balance over the past three years during a time when the Commonwealth has had economic growth marked by a gain of 265,000 jobs and a drop in the unemployment rate from 7.2 percent to 4.6 percent – its lowest level in a decade.

[13] The Massachusetts Taxpayers Foundation discovered a $1.2 billion shortfall mid-way through the FY 2015 fiscal year. To help close the gap, lawmakers suspended the required deposit of excess capital gains tax revenues to the Stabilization Fund. Fortuitously, late in the fiscal year, capital gains tax revenues soared to $1.67 billion or $620 million above the statutory threshold allowing the state to deploy $500 million to close the budget shortfall and deposit the remaining $120 million to the Stabilization Fund.

Figure 4 – Withdrawals or Diverted Revenues from the Stabilization Fund to the Operating Budget, FY 2008 – FY 2015



One markedly different trend of the last three years is the fact that actual tax revenues have more closely matched budgeted tax revenues. Tax revenues for FY 2013 and FY 2015 averaged $410 million in excess of budget revenues, substantially lower than the $1 billion in excess tax revenues experienced in FY 2004 through FY 2007 and FY 2011 through FY 2012 (see Tables 6, 1 and 2). This change means that there were inadequate revenues to address supplemental funding needs and non-tax revenue shortfalls thus requiring lawmakers to dip into reserves to cover state spending.

Table 6 – Change in State Tax Revenues and Stabilization Fund Balance, FY 2013 – FY 2015[14]

Fiscal Year	Budgeted Tax Revenues	Actual Tax Revenues	Difference	Change in Stab. Fund Balance
2013	22,011	22,123	112	-95
2014	22,797	23,370	573	-308
2015	24,387	24,932	545	1
Average			**410**	**-134**
Total			**1,230**	**-403**

[14] Commonwealth of Massachusetts, *Information Statement*, September 2015, p. A-19.

While the Legislature and administration agree to a revenue forecast before constructing the budget each year, in practice, lawmakers anticipate actual tax revenue collections will be higher than projections and routinely rely on that money for operational needs that were either unanticipated or unfunded at the time of the original budget's adoption. For example, the state typically funds snow and ice removal at a level lower than necessary during the initial budget process because it does not want to tie up funds if there is limited snow removal needed during the winter. Once the season is over and costs are accumulated, lawmakers pay for these additional costs in supplemental budgets. Other line-items, such as emergency shelters or private counsel services, must be adjusted during the year to account for higher-than-anticipated caseloads. Since FY 2013 there has been very little money, if any, available for deposit in the stabilization fund after accounting for these expenses.

Recommendations

The state's stabilization fund balance inadequacy comes at a particularly difficult time. State tax revenue growth is slowing and global economic risks are rising. Should another recession occur, it is likely that the state will have to rely on its own reserves to manage the impacts unlike the last fiscal crisis where the federal government provided the state with $4.7 billion in aid to mitigate the fiscal calamity.

As described in this paper, it is vital that the Commonwealth prioritize rebuilding the stabilization fund to protect the state budget against the next economic downturn and the volatility of major sources of tax revenue. Without the implementation of standard practices for minimizing the use of one-time revenue sources and rebuilding reserves during periods of economic expansion, the next recession will find the Commonwealth incapable of plugging budgetary holes without resorting to catastrophic cuts.

The Foundation recommends that lawmakers take the following actions:

- Transfer a minimum of one percent of budgeted tax revenues each year to the Stabilization Fund.
    - To be included as a pre-budget transfer in the annual budget
    - To the extent that capital gains tax revenues and settlement revenues are insufficient, General Fund revenues should be used to fund the balance
- Return the excess settlement revenue statutory provision to its original language so that all settlement revenues in excess of $10 million are dedicated to the Stabilization Fund.
- Increase and then maintain the stabilization fund balance to an amount equal to 10 percent of annual state tax revenues within five years.

- Until the 10 percent balance is reached, transferring funds to support the operating budget, including interest earnings, should occur only when there has been a year-over-year decline in state revenues.

These recommendations would establish a clear medium-term goal for the state's stabilization fund balance. Perhaps most importantly, the establishment of a minimum transfer to the stabilization fund in the annual budget would strengthen and coordinate existing policies for dedicating excess capital gains and settlement revenues to the fund. MTF believes that these recommendations provide a vital step towards rebuilding a stabilization fund capable of meeting future challenges.

About MTF

Founded in 1932, the Massachusetts Taxpayers Foundation is widely recognized as the state's premier public policy organization dealing with state and local fiscal, tax and economic policies. The Foundation's record of high quality research and non-partisan analysis has earned the organization broad credibility on Beacon Hill and across the Commonwealth. Our mission is to provide accurate, unbiased research with balanced, thoughtful recommendations that strengthen the state's finances and economy in order to foster the long-term well being of the Commonwealth. Over the course of eight decades the Foundation has played an instrumental role in achieving major reforms and promoting sound public policy in state government. In the past ten years, the Foundation has won seven prestigious national awards from the Governmental Research Association for our work on a wide array of topics. Our unique credibility has allowed the Foundation to have a significant impact on a wide range of issues - from health care, business costs and transportation funding to tax competitiveness, capital investments and state and local finances.