Legislative Fiscal Office

Ken Rocco
Legislative Fiscal Officer

Daron Hill
Deputy Legislative Fiscal Officer

900 Court Street NE
H-178 State Capitol
Salem, Oregon 97301
503-986-1828

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Oregon's Budget Stabilization Funds – Update

States have always left some type of "ending balance" as they balance their budgets. However, dedicated stabilization or reserve accounts, commonly referred to as "rainy day funds" became common during the 1990s and now exist in some form in almost every state. There is a difference between an ending balance and a rainy day fund. Ending balances are dollars that are projected to be received by the state, but are not approved to be spent. Rainy day funds are dollars that are specifically set aside in a separate "savings" account for future use in times of need. A number of states have provisions to ultimately deposit the ending balance into a rainy day fund at the end of the fiscal period.

The existence of a budget stabilization fund is appealing for several reasons. During economic downturns, savings can be used to avoid modifying existing programs or raising taxes, and reduce uncertainty for citizens concerning program or service availability and quality. By using savings, a state can help "smooth out" revenue or expenditure fluctuations during economic downturns and assist the economy in weathering a recession. The fiscal benefits to states with properly structured reserve funds include:

- Promotion of economic stability by allowing state officials to avoid budget cuts to deal with a budget shortfall.
- Allowance for better informed decisions and longer term solutions since decisions do not need to be made in a crisis atmosphere.
- Reduction in the need to use other one-time revenues to fund ongoing expenditures.
- More favorable experience with bond-rating agencies when evaluating the state's fiscal practices.
- Promotion of savings instead of a "spend it all" mentality by the creation of a repository for excess funds.

One potential budget issue with using reserve funds during economic downturns is when the savings are used to continue an unsustainable level of programs and services instead of making expenditure reductions in those programs. Such a practice can lead to a continuation of expenditure difficulties extending into future budget periods.

Oregon's ability to save has been challenged by the existence of the "kicker" law. In several instances, instead of being able to deposit excess revenues into a reserve account, the kicker law has required a return of the moneys to taxpayers when the kicker threshold is met.[i] Despite the challenges of having an extremely volatile revenue system based primarily on income taxes and the existence of the kicker process, Oregon has established two funds that can be considered as budget stabilization, or reserve funds. These two funds are the Education Stability Fund and the Oregon Rainy Day Fund.

<u>Education Stability Fund (ESF)</u>[ii]

The ESF was established in September 2002 when voters amended the state's constitution to reformulate an existing education endowment fund into a reserve fund. The ESF is funded with 18% of the net proceeds from the state's lottery and is capped at 5% of the amount accrued in General Fund revenues during the prior biennium; once the cap is reached, 15% of the net lottery proceeds are deposited into the ESF's school capital matching subaccount. The Legislature is allowed to spend the principal of the fund

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[i] The kicker law requires the return of excess income tax surpluses to taxpayers in biennia where the actual collections exceed forecasted revenues by two percent or more. During the 1990s many states were reserving their rapidly growing revenues, while Oregon returned a portion of the growth to taxpayers through the kicker mechanism. Since the creation of the kicker, over $2.5 billion in personal income taxes and $0.5 billion in corporate taxes have been returned to taxpayers.

[ii] See Oregon Constitution, Article XV, Section 4 (4)(d) – Section 4 (8) and ORS 348.696 – 348.716.

for public education if there is an economic downturn and the expenditure is approved by three-fifths of the members in each chamber of the Legislature.

In order to access the ESF principal, the Legislature must make a finding that either:
1. the last quarterly economic and revenue forecast for a biennium indicates that moneys available to the state's General Fund for the next biennium will be at least 3% less than appropriations from the state's General Fund for the current biennium;
2. there has been a decline for two or more consecutive quarters in the last 12 months in seasonally adjusted nonfarm payroll employment; or
3. a quarterly economic and revenue forecast projects that revenues in the state's General Fund in the current biennium will be at least 2% below what the revenues were projected to be in the revenue forecast on which the legislatively adopted budget for the current biennium was based.

If none of these conditions are able to be met, the ESF can also be used by the Legislature for public education if the Governor declares an emergency and the expenditure is approved by a three-fifths majority of each chamber.

Interest earnings from the ESF are retained in the fund and used for two purposes:
- 75% of the earnings are transferred to the Oregon Education Fund to pay education lottery bond debt service.[iii]
- 25% of the earnings are dedicated to the Oregon Student Assistance Commission for college scholarships.

While the retention of earnings in the fund is a constitutional requirement, the actual distribution of these earnings is a statutory construction. However, the earnings must be used to finance public education.

At the May 2010 primary election, the voters approved a constitutional amendment to the Education Stability Fund referred by the Legislature during the 2009 session (HJR 13). One part of this amendment included the repeal of the original school capital matching subaccount that had been established within the ESF and the creation of a new separate school capital matching fund. The new fund receives any ending balance from the current subaccount and is the future recipient of the 15% of lottery proceeds once the ESF cap is reached. The new fund will be used to provide matching grants to school districts for capital costs and to repay state bonds issued for capital matching grants for these capital costs. Capital costs are defined as the costs of land and other assets with a useful life of more than one year including acquisition, construction, improvement, remodeling, furnishing, equipping, maintenance, or repair. Since the ESF cap has never been reached, neither the subaccount nor the new fund has ever been used and there still remains the need to create clarifying and implementing legislation.

The Oregon Growth Account (OGA) is also an account established by statute within the ESF (ORS 348.702). Funds in the OGA are invested by the State Treasurer under the direction of the OGA Board. From the creation of the ESF through June 2009, 10% of the funds transferred from the state lottery to the ESF were deposited in the OGA (or the equivalent of 1.8% of overall lottery proceeds). During the 2009 session, the Legislature reduced the dedication of lottery proceeds to the OGA from 10% of the ESF deposits to 5% between July 2009 and June 2013. The reduced diversion reverts back to 10% after June 2013, under the language in the bill (SB 496). The bill also specified that declared earnings from the OGA are to be deposited into the ESF instead of the Commercialized Research Fund, another subaccount of the ESF. The OGA is used primarily to provide seed capital to venture and emerging growth businesses within Oregon.

The ESF has been used several times to balance or rebalance a biennial budget. Although the ESF must be used for expenditures on public education, since education comprises a significant portion of the state's budget (K-12 through higher education), expenditure of ESF resources for public education allows the General Fund dollars designated for education to be redirected to other sectors of the budget.
- The constitutional amendment renaming the endowment fund as the Education Stability Fund (HJR 80) authorized a transfer of $150 million from the ESF to the State School Fund (SSF) on May 1, 2003; this occurred during the third special session of 2002 and offset an equivalent General Fund disappropriation to the SSF as part of the 2001-03 budget rebalance plan.

[iii] These earnings are currently used to pay the debt service on bonds for schools that were approved during the 1997 and 1999 legislative sessions.

- During the 2003 session, the Legislature transferred an additional $112 million from the ESF to the SSF in May 2003 as part of the final rebalance for the 2001-03 biennium.
- Also during the 2003 session, the Legislature prospectively transferred 90% of the lottery deposits to be made to the ESF between July 2003 and May 2005 to the SSF on May 1, 2005 as part of the balanced budget plan for the 2003-05 biennium.
- During the 2009 session, the Legislature transferred the balance of the ESF to the SSF, projected at $394 million, as part of the rebalance of the 2007-09 budget.
- To guarantee a commitment made to provide a $6 billion State School Fund for the 2009-11 biennium, the Legislative Assembly made a prospective transfer during the February 2010 special session from the ESF to the SSF to occur in May 2011; the amount transferred was $84.274 million.[iv]
- In order to balance the 2009-11 biennium budget and to address federal post-secondary education maintenance of effort requirements, HB 5055 was passed during the 2011 session; $96.425 million was transferred from the ESF to the State School Fund.
- As part of the 2011-13 biennium budget, $100 million was transferred from the ESF to the SSF in SB 5553 during the 2011 session; the timing of this transfer was subsequently changed from October 2011 to June 2012 in HB 5055.
- During the 2011 session, the Legislature also provided for a transfer of $82.239 million from the ESF to the SSF to occur in May 2013 to be used for several education related programs in the 2011-13 legislatively adopted budget, including an enhancement to the SSF initial funding level.

After actions by the Legislature during the 2011 session, the projected balance in the ESF at the end of the 2011-13 biennium is currently estimated at $15.6 million.

Oregon Rainy Day Fund (ORDF)[v]

The ORDF was established by the 2007 Legislative Assembly in HB 2707 as a general purpose reserve fund. The ORDF was originally capitalized with a deposit of approximately $319 million from the retention of the majority of the corporate income tax "kicker" that was due to be restored to corporate taxpayers in the fall of 2007. Future deposits into the ORDF are to be from the state's General Fund ending balance in an amount of up to 1% of the General Fund appropriations for the biennium. If the biennium's ending balance is greater than 1% of the General Fund appropriations for that biennium, then an amount equal to 1% is transferred to the ORDF and the remaining amounts are retained by the General Fund. If the biennium's ending balance is less than 1% of the General Fund appropriations for that biennium, then the full amount of the ending balance is to be transferred to the ORDF. Due to the amount of time necessary to make final determinations on biennial expenditures, this transfer from the ending balance would normally occur at the time of the March economic and revenue forecast in the year following the conclusion of the biennial budget period.

In addition to the ending balance transfer, HB 2073 passed by the Legislature during the 2009 session provides for the deposit of all revenue collected from corporate income and excise taxes above the 6.6% tax rate into the ORDF. These deposits will begin with the 2013 corporate tax year with revenues collected during the 2013-15 biennium. When HB 2073 was passed in 2009, the Legislative Revenue Office's initial estimate was that $69 million would be collected under the law for deposit in 2013-15. These transfers are to occur on or before June 30th of each odd-numbered year.

If the balance in the ORDF at the time of the ending balance transfer is greater than 7.5% of the General Fund revenues collected during the prior biennium, then the ending balance transfer is made to the General Fund instead of the ORDF. The full amount of the transfer is made to the ORDF if the fund balance does not equal at least 7.5% of the General Fund revenues collected during the prior biennium even if the transfer increases the amount in the ORDF over the cap.

Like the Education Stability Fund, the ORDF also requires a three-fifths majority of both chambers of the Legislature to authorize an expenditure of funds from the reserve fund. The ORDF uses the same trigger mechanisms that are used for the ESF, with two exceptions. First, there is no allowance for a declaration

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[iv] The amount of the transfer was determined by the June 2010 economic and revenue forecast and was equal to the difference between $200 million and the combination of the balance in the Rainy Day Fund plus the projected General Fund ending balance for the 2009-11 biennium.

[v] See ORS 293.144 - 293.148.

of an emergency by the Governor. Second, unlike the ESF, the ORDF is a statutory, not constitutional, creation so the Legislature can change the existing triggers by passing a new law.

The Legislative Assembly is also limited to appropriating for any one biennium only up to two-thirds of the amount in the ORDF at the beginning of that biennium; if the appropriation is for a biennium that has not yet started, the Legislative Assembly can use the most recent official projection of the beginning balance of the ORDF for the biennium for which the appropriation is to be made. The ORDF retains all interest, which is calculated and transferred to the ORDF once a month by the Department of Administrative Services.

The ORDF has been used three times to balance or rebalance a biennial budget.

- During the 2009 session, the Legislative Assembly transferred two-thirds of the balance of the ORDF on July 1, 2009, estimated at $225 million, to the General Fund for general governmental purposes as part of the final 2009-11 biennial balanced budget plan.
- In order to provide a $6 billion State School Fund for the 2009-11 biennium, the Legislative Assembly provided a $200 million trigger in the budget bill for the SSF during the 2009 session; the trigger amount was to come from a combination of the state's projected General Fund ending balance and the ORDF with amounts to be determined at the time of the June 2010 economic and revenue forecast; the amount eventually transferred was $115.726 million.[vi]
- As part of the 2009-11 budget rebalance plan crafted during the February 2010 special session, the Legislative Assembly transferred $10 million from the ORDF to the General Fund for general governmental purposes.

After actions by the Legislature during the 2011 session, the projected balance in the ORDF at the end of the 2011-13 biennium is currently estimated at $10.7 million, plus whatever amount remains from approximately $18 million that was set aside as a 2009-11 reserve for the final forecasts that will determine the actual ending balance for the 2009-11 biennium.

In summary, Oregon's two budget stabilization funds have been successfully used to continue programs and services during times of economic downturn, to improve and stabilize the state's bond rating in the credit markets, and to serve as a hedge against cash flow deficits at the state level. The continuing challenge the state will face will be its ability to save cash surpluses when the economy is strong and the capacity to generate revenue is high so that adequate reserves will be available when that capacity is low.

For additional information, contact: Ken Rocco, Legislative Fiscal Officer, 503-986-1844

[vi] The language creating the transfer mechanism was included in SB 5520 (2009) and then subsequently modified during the February 2010 special session in SB 5565 (2010).