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## MTF Session Preview: Rainy Day Fund & Reserves

The state has enjoyed two and a half years of unprecedented revenue growth, but economic warning signs and recent history make clear the importance of preparing state finances for economic challenges to come. The state's primary bulwark against declining revenues is its Rainy Day Fund (also called the Stabilization Fund). This preview summarizes the current state of the Rainy Day Fund and other budget reserves, and poses some key policy questions for the upcoming session.

### Background

The Rainy Day Fund (RDF) was created in the mid-1980's as a way to set aside funds during good times to help ease budget pressures during bad times. Over time, the balance of the fund has generally tracked the state's larger economic picture. Growing during good times and being depleted during downturns.

The experience of the Great Recession resulted in an important change to the state's RDF policy. In the years leading up to the downturn, large increases in non-withholding income tax collections (including capital gains) were built into the operating budget. When the recession began, these revenues fell by almost 70 percent and made up the majority of tax revenue loss between Fiscal Year (FY) 2008 and FY 2010. At the same time, the state was forced to use 70 percent of its $2.3 billion RDF balance to plug budget holes caused by lost tax revenue. In light of this, policymakers required that, going forward, 90 percent of capital gains revenues over a certain threshold be automatically deposited into the RDF.[1] While it took several years for this requirement to be adhered to, since FY 2018 it has resulted in $4.7 billion in RDF deposits.

Largely due to capital gains tax deposits, the state's RDF has grown exponentially over the last five years. At the start of FY 2018, the fund's balance stood at $1.3 billion, less than 3 percent of budgeted revenues and more than $1 billion short of the pre-Great Recession balance. At the end of FY 2022, the fund balance stood at more than $6.9 billion, almost 12 percent of budgeted revenues.

In addition to capital gains, the RDF receives funds in several ways:

- Interest earned on the fund balance ($13.9 million in FY 2022);

[1] The remaining 10 percent of above benchmark capital gains is evenly divided between the State Retiree Benefits Trust Fund and the state's Pension Liability Fund

- 10 percent of gaming revenue received from the state's two casinos ($24.3 million in FY 2022)
- 75 percent of year over year growth in abandoned property tax revenue (no deposit in FY 2022);
- Tax settlement revenues that exceed average settlement collections over the prior five years (no deposit under this provision in FY 2022); and
- Any end of year surplus revenues as certified by the Comptroller (no deposit in FY 2022).

The RDF was consistently used to balance the budget during the Great Recession and the fiscal years that followed, between FY 2008 and FY 2015, the state withdrew at least $140 million from the RDF in each year except FY 2011. Since FY 2015, RDF trends have changed. The balance of the fund has grown every year and in four of the last five years, net deposits exceeded $700 million.

Under state law, the end of year balance of the RDF is capped at 15 percent of "budgeted revenues and other financial resources pertaining to budgeted bunds" as determined by the Comptroller. Any amount above the cap is automatically transferred to the Tax Reduction Fund. Under state law, the legislature can only use resources in the Tax Reduction Fund to increase the personal income tax exemption. In FY 2021, the Stabilization Fund balance fell more than $3 billion short of the cap at which additional deposits would go into the Tax Reduction Fund.

**Key Policy Actions, 2021-22**

**Creation of Student Opportunity Act reserve** – Throughout the first six months of 2021, state tax collections blew past projections by billions of dollars. As a result of this, the FY 2022 budget conference committee upgraded revenue estimates for the coming year by $4.2 billion and decided to use $350 million of the upgrade to capitalize a new Student Opportunity Act Investment Fund. The purpose of the new fund is to set aside resources for future Student Opportunity Act implementation costs. The FY 2023 budget deposited a further $150 million into the fund, for a current balance of $500 million. These funds will remain available until appropriated by the Legislature.

**Early Education & Care reserve – T**he FY 2023 budget Conference Committee also had the luxury of upgrading expected tax collections by billions compared to the original House and Senate budgets and once again, this resulted in the creation of a new, policy-specific, reserve fund. The FY 2023 budget created a new High-Quality Early Education & Care Affordability Fund and made a deposit of $150 million. That balance was ultimately increased to $490 million when other resources, initially tabbed to pay for tax relief, were repurposed into the EEC fund. As with the SOA Investment Fund, these resources will remain in the new reserve until appropriated.

**Expected FY 2023 Stabilization Fund deposit** – In the FY 2023 budget the Governor included a section that lays out assumed RDF deposits for the coming year, a practice that improves the financial transparency of the budget. In FY 2023, budget-makers assume the following RDF deposits:

- $1.4 billion from capital gains revenues in excess of the statutory threshold;

- $21.7 million from dedicated gaming revenues;
- $34.7 million from the increase in abandoned property revenues; and
- $12 million from other sources.

Combined this results in a projected deposit of $1.47 billion and an end of FY 2023 balance of $8.4 billion.

## Policy Context

The biggest contextual factors that will affect the RDF and other state reserves in the next session are the health of the Massachusetts economy, the implementation of the income surtax ballot question, and future spending plans in early and K-12 education.

*The Larger Economic Picture*

In the last twenty years, the state has suffered two recessions and both times resulted in a depleted Stabilization Fund that took years to rebuild. Between FY 2001 and 2003, budget-makers withdrew $1.07 billion (63 percent) from the fund to lessen budget cuts and it took until FY 2005 to restore the pre-recession balance. It took more than 10 years (from FY 2008 to FY 2019) for the RDF balance to return to its pre-Great Recession level.

The state has had an extended period of economic growth and recent boom years have enabled the RDF to grow to record levels. The growth will stop eventually and declining revenues or increased cost pressures could require the use of reserves. The FY 2023 budget is based on the assumption that tax collection will decline compared to FY 2022, and this appropriate caution buttresses the current year's budget against an immediate downturn.

It is possible that the statutory 15 percent cap could affect the Stabilization Fund over the next two years, but it is unlikely unless revenues decline sharply. In FY 2022, the cap is likely to be $9.4 billion, or $2.4 billion higher than the current balance. If the RDF balance does hit the cap, funds are automatically deposited into a Tax Reduction Fund for use to reduce income taxes.

*Income Surtax*

The new income surtax constitutional amendment could affect and complicate automatic deposits into the RDF. As noted above, currently 90 percent of capital gains tax collections above a certain level go directly to the RDF. Capital gains are likely to comprise a large share of income subject to the new surtax, which is constitutionally dedicated to education and transportation spending. It appears that, without a legislative change, surtax collections from capital gains would need to be deposited into the RDF and then withdrawn for spending on education or transportation.

*Status of Early & K-12 Spending Reserves*

The $990 million set aside by the legislature for reserves dedicated to K-12 and early childhood education have no specific plan or process for their use. Implementation costs for the SOA will continue to increase over the next five years and lawmakers could call upon the $500 million reserve to augment other resources. The early education reserve funds could be used to extend existing childcare stabilization grants, first funded by federal aid during the pandemic or they could

be used in support of omnibus early education legislation. In addition to these dedicated reserves, revenues from the new income surtax are constitutionally dedicated to either education or transportation uses which could affect the need for dedicated reserves in these areas.

## Key Questions for the Upcoming Session

### *What is the right amount for the Rainy Day Fund?*

There is no magic number for a state's reserves, but between 10 and 15 percent of budgeted revenues is a good target. The current balance equates to just over 11 percent of revenues, which is a strong position in the midst of heightened economic uncertainty.

A recent Pew survey of each state's RDF found that on average, state balances could support 42.5 days of services. Massachusetts ranked above the national average, at 55.8 days, but still well short of states like Connecticut (100 days), California (82.3 days) and Vermont (71.7 days).

Massachusetts requires a more robust RDF fund than most other states because our revenue structure is more reliant on volatile revenue sources, like non-withheld income taxes, and because our state government provides a broader array of services than many other states. Since the income surtax will largely apply to non-withheld income, our volatility will grow, and therefore require a continued commitment to maintaining strong reserves.

### *Is it time to redirect a share of windfall resources to other uses?*

When Massachusetts instituted the direct deposit of capital gains taxes to the RDF, state reserves were dangerously low and so the decision to retain 90 percent of deposits in the RDF and transfer 10 percent to pension and OPEB liabilities made sense. Now state reserves are stronger and warrant reassessing the share of windfall resources that go to other needs and liabilities.

The state has significant capital needs as well as unfunded long-term liabilities for pension and retiree health insurance costs. As long as the RDF balance is within the target range identified above, the state should increase the share of windfall revenues that go to ongoing liabilities and pay-as-you-go capital resources. The Senate put forward a proposal in their version of last session's Economic Development Bill to do just that: they proposed doubling the share of above benchmark capital gains revenue dedicated to OPEB and pension funds. The Healey administration and legislature should consider a similar approach.

### *How will the income surtax work with dedicated revenue?*

Both the income surtax and existing state law will lay claim to a portion of capital gains tax collections, with the surtax requiring the funds be used for education and transportation and existing statute requiring the funds be directed to the RDF. Policymakers need to clarify where these funds will go. However, they should remember that the purpose of the RDF set aside is to avoid the problems created when unstable capital gains revenues are baked into the operating budget. One approach could be to segregate a portion of the capital gains revenues dedicated to the RDF to protect against future cuts in education and transportation. This sub-fund would mitigate the danger of making education and transportation investments on unreliable revenue and create a reserve to maintain investments in those areas when times get tough.

***Do policy specific reserve funds make sense?***

The creation of the SOA and early education reserve funds in the FY 2022 and FY 2023 budgets follow a predictable pattern: when revenue times are good, new funds proliferate which set aside resources for future use in specific policy areas. When times get bad, those resources are typically swept back in to the General Fund to balance the budget. Given the known future costs of the SOA, creating a reserve fund to guard against revenue shortfalls makes sense. In early education, there is no current plan for the $490 million reserve.