Y01A
State Reserve Fund

Operating Budget Data

($ in Thousands)

	FY 15 Actual	FY 16 Working	FY 17 Allowance	FY 16-17 Change	% Change Prior Year
General Fund	$14,786	$81,435	$235,336	$153,901	189.0%
Deficiencies and Reductions	0	-8,935	0	8,935	
Adjusted General Fund	**$14,786**	**$72,500**	**$235,336**	**$162,836**	**224.6%**
Adjusted Grand Total	**$14,786**	**$72,500**	**$235,336**	**$162,836**	**224.6%**

- The fiscal 2017 appropriation into the State Reserve Fund totals $235.3 million.

- Although the Revenue Stabilization Account balance is less than the 7.5% target, it increases from 5.0% to 6.3%. As required by law, the Administration's budget appropriates $235.3 million. This is equal to the amount required by the general fund sweeper.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Major Trends

Rainy Day Fund Balance Increases to 6.3% of Revenues: If the fund balance is below 7.5%, the Governor is required to appropriate at least $50.0 million into the fund. In addition, the Governor is required to appropriate an amount equal to the general fund sweeper, which is $235.3 million in fiscal 2017. No transfers are planned out of the fund in fiscal 2017, which increases the fund balance from 5.0% to 6.3%.

Issues

Review of Rainy Day Fund Laws and Practices: The issue examines the adequacy of the 7.5% fund balance target, how to replenish the fund after it is used, recent uses of the Rainy Day Fund, withdrawal guidelines, and over-use of other fund balances during recessions. **The Department of Legislative Services (DLS) recommends that the committees adopt committee narrative that a study group be formed to examine how to improve Rainy Day Fund statutes and practices.**

Dedicating Unanticipated Revenues to Replenish the Rainy Day Fund or Reduce Unfunded Liabilities: The issue discusses two sources of unanticipated revenues. One is limiting nonwithholding income tax revenues and another is limiting capital gains revenues. **DLS recommends that the committees adopt narrative that requires that the Department of Budget and Management, Comptroller's Office, and DLS examine approaches for calculating unanticipated revenues and dedicating these revenues for the Rainy Day Fund or an unfunded liability. The report should recommend a specific approach that the General Assembly could use to enact legislation.**

Use of Unassigned General Fund Surplus: Prior to the 2015 session, State law required that an amount equal to the unassigned general fund surplus in excess of $10 million be appropriated into the Rainy Day Fund. The equation was changed last session to dedicate a portion of surplus funds to the Pension Fund in fiscal 2017 through 2020. The Attorney General's Office advises that the Program Open Space transfer takes precedence over the pension sweeper. **DLS recommends that legislation be considered if the legislature wishes to establish a different order of priorities relating to the application of surplus funds at closeout.**

Recommended Actions

1. Adopt narrative to request a report to examine general fund revenue volatility.

Operating Budget Analysis

Program Description

The State Reserve Fund provides a means to designate monies for future use. It comprises four individual accounts:

- Revenue Stabilization Account (Rainy Day Fund);
- Dedicated Purpose Account (DPA);
- Catastrophic Event Account; and
- Economic Development Opportunities Account (Sunny Day Fund).

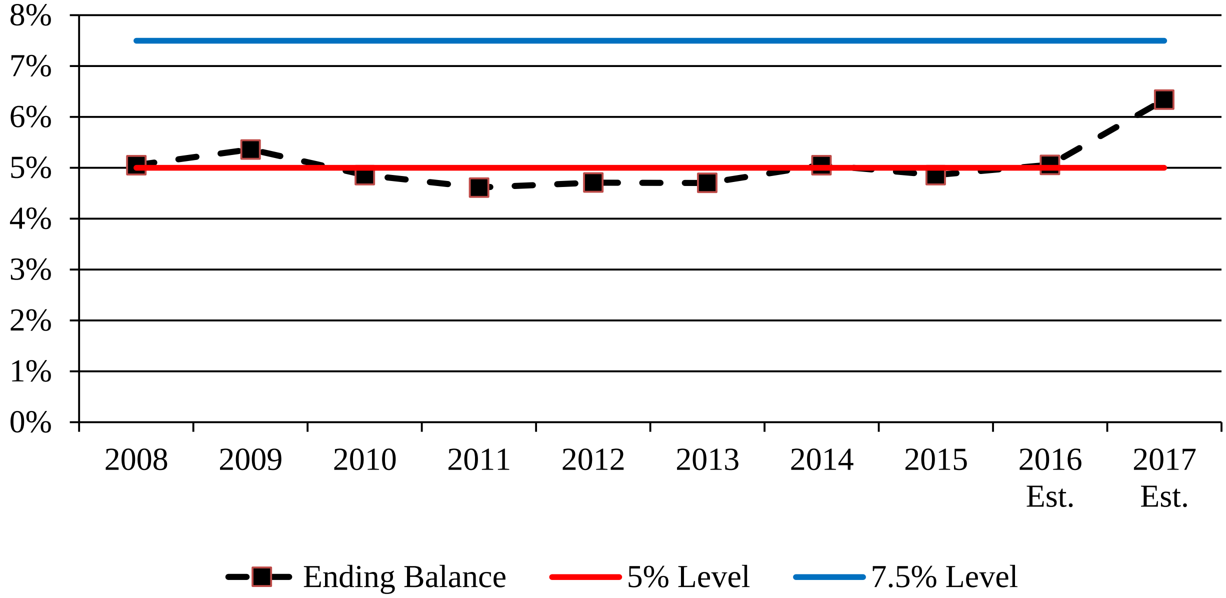
The purpose and status of three of these accounts is discussed in more detail in this analysis. Discussion of the Sunny Day Fund can be found in the analysis of the Department of Commerce.

Performance Analysis: Managing for Results

1. Rainy Day Fund Balance Increases to 6.3% of Revenues

Section 7-311 of the State Finance and Procurement Article establishes a target reserve balance of 7.5% of estimated general fund revenues. Except for fiscal 2017 and 2018, the Governor is authorized to expend balances down to 5.0% in the annual budget bill, which was the case from fiscal 2008 to 2016, as the State grappled with structural deficits. **Exhibit 1** provides the actual and estimated closing balances in the Rainy Day Fund since fiscal 2008. The fiscal 2017 budget does not rely on Rainy Day Fund transfers to the General Fund, so the Rainy Day Fund balance is expected to increase to $1,083 million. This is 6.3% of fiscal 2017 ongoing general fund revenues.

Exhibit 1
Rainy Day Fund End-of-year Balances
Fiscal 2008-2017 Est.



Source: Department of Budget and Management, January 2016

Fiscal 2016 Actions

Proposed Deficiency

The budget bill includes two deficiencies, $10.0 million for the Catastrophic Event Account and $2.5 million for the DPA. The Catastrophic Event Account fund balance is $0.2 million, which is insufficient to provide much help. Over the last 15 years, the account has provided relief from hurricanes, tornadoes, snowstorms, and droughts. The deficiency should provide a balance that is sufficient to support these typical events. **The Department of Legislative Services (DLS) recommends approving this deficiency appropriation.**

The budget also includes a $2.5 million deficiency appropriation for information technology upgrades. This replaces hardware, mostly personal computers and servers, in approximately 20 agencies. Most of the equipment is six to nine years old. These funds will be matched by agency funds. The Department of Information Technology expects that agencies will provide almost $12.0 million in additional appropriations to support these upgrades. The budget anticipates that all of the $2.5 million will be spent in fiscal 2017. **It is recommended that this deficiency appropriation be approved.**

Proposed Budget

Exhibit 2 shows that the fiscal 2017 allowance is $235.3 million. This is the amount required by law. State law requires that the Administration appropriate an amount equal to any unassigned general fund balance at closeout in excess of $10.0 million into the Rainy Day Fund. This appropriation is made to the budget two years after the unassigned general fund surplus is realized. This appropriation to the Rainy Day Fund is referred to as the "sweeper." The Budget Reconciliation and Financing Act (BRFA) of 2015 (Chapter 489) amended the sweeper requirement so that the Rainy Day Fund receives only 50% of any unassigned general fund surplus for fiscal 2017 to 2020. The other 50% is appropriated to reduce the State's unfunded pension liability. The pension appropriation is limited to $50.0 million.

Exhibit 2
Proposed Budget
State Reserve Fund
($ in Thousands)

How Much It Grows:	General Fund	Total
Fiscal 2015 Actual	$14,786	$14,786
Fiscal 2016 Working Appropriation	72,500	72,500
Fiscal 2017 Allowance	235,336	235,336
Fiscal 2016-2017 Amount Change	$162,836	$162,836
Fiscal 2016-2017 Percent Change	224.6%	224.6%

Where It Goes:	
Personnel Expenses	
Rainy Day Fund	
Remove fiscal 2016 appropriation	-$50,000
Sweeper appropriation	235,336
Dedicated Purpose Account	
Remove Local Income Tax Reserve Account transfer	-10,000
Remove deficiency appropriation for information technology upgrades	-2,500
Catastrophic Event Account	
Remove fiscal 2016 deficiency appropriation	-10,000
Total	**$162,836**

Note: Numbers may not sum to total due to rounding.

Fiscal 2015 closed with an unassigned surplus totaling $295.3 million. By law, the Administration was required to:

- keep $10.0 million in the General Fund;
- appropriate $235.3 million for the Rainy Day Fund; and
- appropriate $50.0 million for the pension fund.

The allowance includes the required sweeper amount. The Administration also adjusted the pension contribution rates so that an additional $75 million ($65 million in general funds) was appropriated into the pension fund. This action technically satisfies the pension sweeper requirement.

The State maintains a Local Income Tax Reserve Account. According to generally accepted accounting principles (GAAP), the State is supposed to maintain a sufficient fund balance to pay future refunds in case the income tax is no longer collected. Recently, the State has transferred funds from this account to balance the State budget. The fiscal 2016 appropriation included $10 million to reduce the unfunded liability in the Local Income Tax Reserve Account. There is no appropriation in fiscal 2017. The plan is to increase credits into the account when revenues are collected to reduce the liability.

Exhibit 3 provides an overview of State Reserve Fund activity between fiscal 2016 and 2017. Detail for each account may be found in **Appendix 3** (Rainy Day Fund), **Appendix 4** (DPA), and **Appendix 5** (Catastrophic Event Account).

Exhibit 3
State Reserve Fund Activity
Fiscal 2016-2017
($ in Millions)

	Rainy Day Fund	Dedicated Purpose Account	Catastrophic Event Account
Balances 6/30/15	**$773.5**	**$0.0**	**$0.2**
Fiscal 2016 Appropriations	50.0	152.5	10.0
Transfer to Local Income Tax Reserve Account	0.0	-10.0	0.0
Section 48 Initiatives Restored by Administration	0.0	-118.6	0.0
General Fund Reversion	0.0	-21.4	0.0
Interest	8.1	0.0	0.0
Estimated Balances 6/30/16	**$831.5**	**$2.5**	**$10.2**
Fiscal 2017 Appropriations	235.3	0.0	0.0
Information Technology Upgrades	0.0	-2.5	0.0
Interest	16.1	0.0	0.0
Estimated Balances 6/30/17	**$1,083.0**	**$0.0**	**$10.2**
Percent of Revenues in Reserve	**6.3%**		

Source: Department of Budget and Management, January 2016

In fiscal 2016, the General Assembly restricted $140.0 million of the appropriations into the DPA so that the funds could only be used to restore reductions that the Administration made to specific programs and purposes. In addition to the DPA, appropriations totaling $26.6 million in Medicaid (M00QA01.03), $10.2 million in the Public School Capital Appropriation (D06E02.02), $13.0 million in the Department of Human Resources' (DHR) Assistance Payments (N00G00.08), and $11.9 million in the Maryland State Department of Education's (MSDE) Foundation Program (R00A02.10) were also restricted. If the Administration chose not to fund these programs or purposes, the funds would revert to the General Fund.

The Administration restored all funds except those supporting the Geographic Cost of Education Index and Prince George's County Hospital. All of the restricted funds in Medicaid, public school capital, DHR, and MSDE will revert to the General Fund. In addition, $21.4 million from the DPA will also revert. **Exhibit 4** details how fiscal 2016 DPA appropriations were spent in accordance with legislative intent as expressed in Section 48 of the FY 2016 budget bill.

Exhibit 4
Fiscal 2016 Dedicated Purpose Account Section 48 Allocations
($ in Millions)

Agency	Description	Amount
Restoration		
Personnel		
Statewide	General Salary Increase	$68.7
Medicaid and Entitlements		
Medicaid	Community Mental Health Provider Rates	$6.5
BHA	Substance Abuse Heroin Addiction Treatment	2.0
Medicaid	Adult Day Care	2.1
Medicaid	Pregnant Women and Family Planning	4.8
Medicaid	Home and Community Based Services	4.8
Medicaid	Primary Care and Physician Specialty Rates	15.5
Medicaid	Nursing Home Rates	4.0
Medicaid	Psychiatrists Reimbursement Rates	1.1
Subtotal		***$40.8***
State Agencies		
MSB	Additional Support	$1.8
DDA	Purchase of Care for Individual and Family Support	2.2
PHPA	Children's Medical Day Care	0.1
MSDE	Charter School Funding Report	0.3
DDA	Crisis Intervention	3.0
Subtotal		***$7.4***
Local Aid		
MSDE	Nonpublic Placement Rates	$1.7
Total Restorations		**$118.6**
Reverted to the General Fund		**$21.4**
Transferred to Local Income Tax Reserve Account		**$10.0**
Total Appropriation		**$150.0**

BHA: Behavioral Health Administration
DDA: Developmental Disabilities Administration
MSB: Maryland School for the Blind
MSDE: Maryland State Department of Education
PHPA: Prevention and Health Promotion Administration

Source: Department of Budget and Management, January 2016

Issues

1. Review of Rainy Day Fund Laws and Practices

Since 1986, the State has had a Rainy Day Fund. The purpose of the fund is to retain revenues that can be transferred to the General Fund to provide short-term liquidity when revenues underperform. Originally, the fund was required to maintain a balance of 2.0% of estimated general fund revenues. This was increased to 5.0% at the 1993 session, then 7.5% at the 2006 session.

State law requires the Governor to appropriate funds into the account if the balance is below 7.5%. Specifically, repayment to the fund requires annual appropriations of $100 million if the balance falls below 3.0% and $50 million if the balance is below 7.5%. An amount equal to unappropriated general funds above $10 million at closeout are also required to be appropriated into the fund. Maryland has no requirement for a minimum general fund balance.

For fiscal 2017 and 2018, the Administration can only transfer funds out of the Rainy Day Fund through legislation other than the State budget. Beginning in fiscal 2019, the Administration can withdraw funds above 5.0% from the Rainy Day Fund and transfer them to the General Fund in the annual budget bill. However, if the Rainy Day Fund balance falls below 5% of general fund revenues, the Administration must submit separate legislation (such as a BRFA) to transfer funds to the General Fund.

This issue examines Rainy Day Fund statutes and practices. Specifically, the issue examines:

- general fund revenue volatility;
- purpose of a Rainy Day Fund;
- how recessions put pressure on spending;
- replenishing the fund if the balance is less than the 7.5% target;
- recent uses of the Rainy Day Fund;
- withdrawal guidelines; and
- overuse of other fund balances during recessions.

General Fund Revenue Volatility and the 7.5% Rainy Day Fund Target

DLS has examined actual general fund revenues collected from fiscal 1980 to 2015. To measure the underlying changes in base revenues, revenues are adjusted to remove revenue changes attributable to changes in tax laws. Also, inflation rates varied over the period. During the 1980s, inflation averaged about 5%. From calendar 2006 to 2015, inflation averaged less than 2%. Without adjusting for inflation, swings in the 1980s tended to be more pronounced due to inflation. To minimize this, the data has also been adjusted for inflation.

Exhibit 5 shows that the average percent change over the period was a 2.5% increase. The standard deviation was 3.9%. Over the 35 years, 23 years had annual revenue changes that were within one standard deviation. The data are slightly skewed; there were 7 years in which revenues increased by more than one standard deviation above the average and 5 years in which revenue decreases were more than one standard deviation below the average.

Exhibit 5

Inflation Adjusted General Fund Revenue Volatility

Fiscal 1980-2015

Statistic	Result	Exceptional Years
Number of Years in Sample	35	n/a
Average Percent Change	2.5%	n/a
Median Percent Change	3.0%	n/a
Standard Deviation	3.9%	n/a
Number of Years Below Average	17	n/a
Number of Years with Changes That Were within One Standard Deviation	23	n/a
Increases More Than One Standard Deviation Greater Than Average	7	1984, 1985, 1987, 1988, 1999, 2000, 2005
Decreases More Than One Standard Deviation Below Average	5	1981, 1992, 2002, 2003, 2009
Year-on-year Revenue Decreases More Than 5.0%	3	1992, 2002, 2009
Year-on-year Revenue Decreases More Than 7.5%	1	2009
Largest Increase	8.9%	1987
Largest Decrease	-8.4%	2009

Note: To measure the underlying revenue changes, revenues are adjusted to remove the effect of changes to tax law. Revenues are adjusted for inflation.

Source: Comptroller's Office; Department of Legislative Services

The change in growth rates (or year-on-year revenues) declined by more than 5% in three years, when compared to the previous year. Specifically:

- revenues declined from 4.3% growth in fiscal 1991 to -2.3% growth in fiscal 1992, a 6.6% swing;

- revenues declined from 4.3% growth in fiscal 2001 to -3.2% growth in fiscal 2002, a 7.5% swing; and

- revenues declined from 0.3% growth in fiscal 2008 to -8.4% growth in fiscal 2009, an 8.7% swing.

Of these changes in revenue growth, the only year in which year-on-year revenues declined more than 7.5% was fiscal 2009. That was during the Great Recession, which was the most severe recession since the Great Depression.

The data measures the full impact of three recessions; the first recession was from July 1990 to March 1991, the second from March 2001 to November 2001, and the third from December 2007 to June 2009 (the Great Recession). All three recessions have a different impact on revenues. Not surprisingly, the Great Recession was the deepest and the longest. But the other two recessions had markedly different effects on revenues. The revenue decline from fiscal 1992 was initially milder, but the recovery was slower. The revenue decline in fiscal 2002 was more severe, but revenues bounced back more quickly. **Exhibit 6** compares the initial decline and number of years until revenues bounced back in real and nominal terms. Higher inflation masked the severity of the fiscal 1992 decline, since actual revenues increased that year. Inflation also masked the slow recovery. The table also shows how deep the Great Recession was and how weak the recovery has been.

Exhibit 6

Revenue Decline and Recovery in Real and Nominal Terms for Last Three Recessions

	Real Revenues		**Nominal Revenues**	
Fiscal Year of Initial Revenue Loss	**Initial Decline**	**Number of Years to Recover**	**Initial Decline**	**Number of Years to Recover**
1992	-2.32%	4	0.35%	1
2002	-3.16%	2	-1.42%	2
2009	-8.42%	7+	-6.91%	4

Note: To measure the underlying revenue changes, revenues are adjusted to remove the effect of changes to tax law.

Source: Comptroller's Office; Department of Legislative Services

Except for the Great Recession, 7.5% seems to be enough to maintain revenues for the first year of a recession. But 7.5% of general fund revenues does not appear to be enough to maintain revenue growth until a recovery is fully underway. The year after revenues declined in fiscal 1992, 2002, and 2009, inflation-adjusted revenues continued to shrink (fiscal 2003 and 2010) or revenues barely increased (in fiscal 1993 revenues increased by 0.84%). The conclusion is that having a 7.5% fund balance is sufficient to support one year of revenue declines in all but the worst recessions, but also that this will require some restructuring of revenues or spending in the second year.

Purpose of the Rainy Day Fund

There is a debate about the purpose of a Rainy Day Fund. One position is that a Rainy Day Fund should have sufficient revenues to insulate a State from the effects of a recession. Another perspective is that a Rainy Day Fund provides short-term relief while a State restructures its revenues and spending. Maryland has adopted this second approach. The State's Rainy Day Fund provides relief, but as the revenue volatility analysis will show, the fund does not have a fund balance sufficient to insulate the State from the adverse effects of a recession.

As previously discussed, inflation-adjusted general fund revenues in fiscal 2015 were still below fiscal 2008 levels, seven years after they peaked. To maintain services at the level that they were in fiscal 2007 would have required a Rainy Day Fund that is nearly as large as the entire General Fund budget. **Exhibit 7** compares actual inflation-adjusted revenues with inflation-adjusted revenues increasing at a rate of 2.46%, which is the average growth rate since fiscal 1981. Replacing these revenues requires providing at least $1.5 billion each year. Over the seven years, it requires $15.5 billion, which is more than fiscal 2008 revenues. Maintaining a Rainy Day Fund that is sufficient to replace all revenues is not practical.

Exhibit 7
Comparing Actual Revenues to Revenues Increasing at the Average Growth Rate
Fiscal 2008-2015
($ in Millions)

Fiscal Year	Actual Revenues	Revenues Increasing 2.46%	Difference
2008	$14,052	$14,052	$0
2009	12,870	14,398	1,529
2010	12,808	14,753	1,945
2011	13,206	15,117	1,911
2012	13,385	15,489	2,104
2013	13,390	15,871	2,481
2014	13,461	16,262	2,800
2015	13,959	16,662	2,703
Total	**$107,130**	**$122,603**	**$15,473**

Source: Comptroller's Office; Department of Legislative Services

While fully replacing lost revenues during a recession is impractical, it does appear that one lesson from the Great Recession is that more reserves are needed. In response to the last recession, a number of states have increased their Rainy Day Fund limits. **Exhibit 8** shows that the number of states with limits above 6% increased from 22 in fiscal 2008 to 31 in fiscal 2016.

Exhibit 8
Changes in Other States' Rainy Day Fund Limits

Limit	Number in Fiscal 2008	Number in Fiscal 2016	States' Limits in Fiscal 2016
No Fund/Unreported	7	4	Colorado, Illinois, Kansas, Montana
Dollar Limit	1	2	Arkansas ($125 million), Minnesota ($811 million)
1%-4%	3	2	**Iowa** (2.5%), Louisiana (4%)
5.0%	11	8	**Delaware**, Kentucky, New Jersey, New York, Rhode Island, South Carolina, Vermont, Wisconsin
6%-9%	7	12	Pennsylvania (6%), Arizona (7%), Indiana (7%), **Maryland** (7.5%), Mississippi (7.5%), Oregon (7.5%), New Mexico (8%), **North Carolina** (8%), Tennessee (8%), Ohio (8.5%), **Utah** (9%), North Dakota (9.5%)
10%	12	11	Alabama, California, Florida, Hawaii, Idaho, Michigan, **Missouri**, New Hampshire, South Dakota, **Texas**, Washington
11%-20%	3	8	West Virginia (13%), Connecticut (15%), **Georgia** (15%), Massachusetts (15%), Oklahoma (15%), **Virginia** (15%), Maine (18%), Nevada (20%)
No Limit	6	3	Alaska, Nebraska, Wyoming
Total	**50**	**50**	

Note: Bold indicates states with "AAA" bond rating from all three rating agencies.

Source: National Conference of State Legislatures; Pew Charitable Trusts

Recessions Also Put Pressure on State Spending

Another concern is that the cost of programs that support the indigent tend to increase during recessions. For example, Medicaid expenditures increased from $4.7 billion to $5.5 billion from fiscal 2007 to 2009. This is a total increase of 17.4% and an annual increase of 8.3%. The changes were even more pronounced as caseloads (excluding Maryland Children's Health Program and Primary Adult Care) increased at an annual rate of 15.4% (33.2% total growth) over the same period. While this period did include a health care expansion, much of this increase was likely due to the economic downturn. This means that even if revenues are fully replaced, they are insufficient since costs are higher. Similar trends were also experienced in the Temporary Cash Assistance program, another component of the State's social safety net. Caseloads increased from approximately 51,400 in fiscal 2008 to 72,200 in fiscal 2011.

Replenishing the Rainy Day Fund

If the Rainy Day Fund balance is less than 7.5% of general funds, the Administration is required to appropriate $50 million (when the balance is less than 3.0%, the minimum appropriation is $100 million). The State also has a sweeper, which requires that the Administration make an appropriation equal to an unassigned general fund end-of-year balance in excess of $10 million. This appropriation is made two years after the unassigned balance is realized.

In fiscal 2017, 7.5% of general fund revenues is $1,281.1 million and 5.0% of revenues is $854.1 million. The $50.0 million minimum appropriation is quite low; $50.0 million is only 3.9% of $1.3 billion. The minimum requirement was set at $50.0 million in 1993. Since it was introduced, the economy and State budget have increased. Inflation has also eroded the value of $50.0 million. The State should consider increasing the minimum Rainy Day Fund appropriation required when the fund balance falls below the 7.5% target.

Recent Rainy Day Fund Uses

Another aspect to examine is the State laws and practices regarding withdrawing funds from the Rainy Day Fund. To transfer funds from the Rainy Day Fund requires specific authorization by an Act of the General Assembly or specific authorization in the budget bill if the transfer results in a Rainy Day Fund balance that is at least 5% of projected general fund revenue. To transfer an amount that would reduce the Rainy Day Fund balance below 5% requires the transfer to be authorized in an Act of the General Assembly other than the budget bill. For fiscal 2017 and 2018 only, transferring any funds out of the Rainy Day Fund require an Act of the General Assembly other than the budget bill.

Recent State Practices Suggest That Maryland Is Not Fully Taking Advantage of Its Rainy Day Fund

Rainy Day Funds were transferred to the General Fund during the first recession after the fund was created. In response to the 1991 recession, the fund was depleted. The General Fund received $127 million in fiscal 1991 and $15 million in fiscal 1992. After the recession, funds were appropriated and funds as a share of general fund revenues increased so that they exceeded 5% by fiscal 1996.

Since fiscal 1996, the end-of-year Rainy Day Fund balance has been at least 5% of general fund revenues each year. The fund balance increased over time, and by fiscal 2001, the end-of-year fund balance was 9% of revenues. To manage cash flows during a recession, funds were transferred to the General Fund and by fiscal 2004 the balance had been reduced to 5% of revenues. Similarly, the fund balance reached 11% of revenues in fiscal 2007 before the Great Recession began. In fiscal 2008, funds were transferred to the General Fund, which reduced the balance to 5% of revenues.

Because the State did not reduce the balance below 5%, the State did not take full advantage of the Rainy Day Fund during the Great Recession. Maryland went into the recession with a balance that was equal to 11% of revenues in fiscal 2007. This balance was quickly spent down to 5%. After reaching the 5% threshold, the State no longer used the Rainy Day Fund.

This approach is different than those taken by other AAA-rated states. When the Great Recession began, there were seven states with AAA ratings from all three major rating agencies (Fitch, Moody's, and Standard and Poor's). In addition to Maryland, the states were Delaware, Georgia, Missouri, North Carolina, Utah, and Virginia. All these states have Rainy Day Funds.

Exhibit 9 shows that three of the states, Georgia, North Carolina, and Virginia, aggressively used their balances to mitigate the short-term effects of the Great Recession. Rating agencies have said that this approach is appropriate. Using the balance from the Rainy Day Fund has not resulted in a loss of AAA ratings for states that have transferred fund balances.

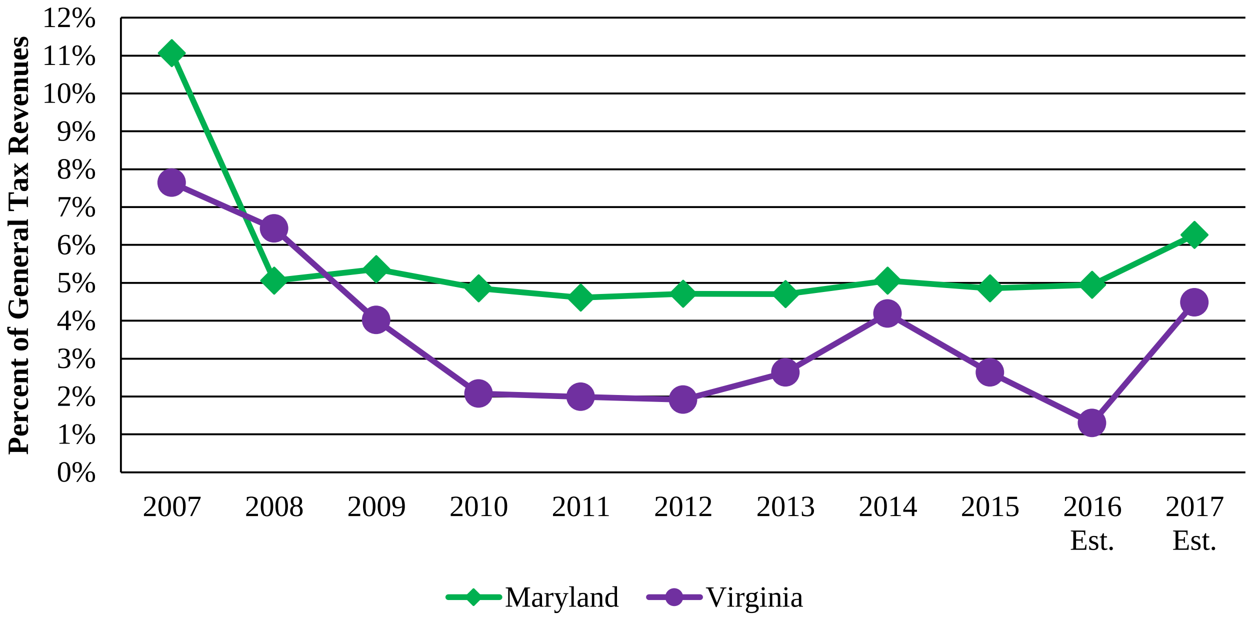
Exhibit 9
AAA-rated States' Rainy Day Fund Responses to Great Recession

State	Pre-recession Balance	Response to Recession	Assessment
Delaware	5.0% of revenues in fiscal 2007 and 2008	Maintained 5.0% of revenues in fiscal 2009 and 2010	No Rainy Day Fund actions taken
Georgia	9.0% of revenues in fiscal 2007	Withdrew funds and reduced balance to 1.0% of revenues by fiscal 2009	Aggressively used funds to manage recession cash flows
Missouri	7.5% of general fund revenue	Small withdrawals but maintained balance near Statutory limit	No substantial Rainy Day Fund actions taken
North Carolina	4.0% of revenues in fiscal 2008	Withdrew funds and reduced balance to 1.0% of revenues by fiscal 2009	Aggressively used fund to manage recession cash flows
Utah	8.0% of revenues in fiscal 2008	Withdrew funds and reduced balance to 5.0% of revenues in fiscal 2009 and 2010	Moderate use of fund to manage recession cash flows
Virginia	8.0% of revenues in fiscal 2007	Withdrew funds and reduced balance to 2.0% of revenues by fiscal 2010	Aggressively used funds to manage recession cash flows

Source: State Budget Offices; State Legislative Fiscal Offices

Even more recently, the State has not fully taken advantage of the fund. Since fiscal 2006, Virginia's approach has been to withdraw Rainy Day Funds during times of fiscal stress and replenish the fund as the economy improves. **Exhibit 10** shows that Virginia's fund balances have fluctuated from approximately 8% of revenues in fiscal 2007 to 2% by fiscal 2010 and were replenished to reach 4% again in fiscal 2014. Withdrawals were made in fiscal 2015 and 2016. By contrast, Maryland's fund balance has hovered near 5% since fiscal 2008, after an initial withdrawal.

Exhibit 10
Maryland and Virginia's Rainy Day Fund Balances
As a Percent of General Tax Revenues
Fiscal 2007-2017 Est.



Note: Excludes transportation-related tax revenues.

Source: Maryland Department of Budget and Management; Virginia Department of Budget and Planning

How Much Should Be Withdrawn and How Soon Should It Be Withdrawn When Revenues Underattain?

One reason that Maryland does not use the Rainy Day Fund more is that it is concerned about losing its AAA rating if fund balances are too low. Another reason may be that there are not any guidelines concerning the use of the funds. As discussed earlier, the Rainy Day Fund provides revenues sufficient to replace revenues in the first year of a downturn in all recent recessions except the Great Recession. The problem is that revenues did not fully recover in the second year, so additional actions are necessary. It can be difficult to decide when to go into savings if it is unclear how long the State will need to rely on savings.

Providing some guidelines regarding appropriate withdrawal levels could be helpful. One approach could be to develop a policy that limits how much can be withdrawn each year so that there are funds available if the economy recovers slowly. For example, the amount withdrawn cannot exceed the lessor of half of the Rainy Day Fund balance or half of the projected shortfall. Though this approach is unlikely to provide funds sufficient to replace the entire revenue loss during most recessions, it provides short-term support without depleting the fund in the first year. This also provides some relief while the State restructures spending and revenues.

Using the Rainy Day Fund Can Result in Reduced Fund Transfers When Revenues Decline

Instead of using the Rainy Day Fund to manage cash flow, the State has transferred revenues from other funds. Approaches taken include transferring funds from GAAP accounts, transferring funds from special funds, and ending general fund appropriations for some programs. Housing programs no longer receive operating budget support; instead general obligation bonds are authorized. As discussed in more detail in the Public Debt analysis, taxable bonds are issued for housing programs at a greater cost than the tax-exempt bonds generally used for the State's capital program. Special funds dedicated for capital programs, like Program Open Space (POS), were transferred to the General Fund, and were partially repaid through the capital program. Doing this crowds out other capital projects (such as education and State facilities) and also adds to the already significant pressure to continuously increase capital spending. **Exhibit 11** lists these transfers.

Exhibit 11
Fund Balance Transfers to the General Fund
Fiscal 2009-2011
($ in Millions)

Source	Amount	Percent of Total
Local Income Tax Reserve Account	$916.8	34%
Rainy Day Fund Over 5%	405.0	15%
Program Open Space	369.4	14%
Highway User Revenues	263.8	10%
Agencies	262.3	10%
Pay-as-you-go Capital	213.7	8%
Higher Education Fund Balances	179.5	7%
Dedicated Purpose Account and Other Sources	85.4	3%
Total	**$2,695.9**	**100%**

Source: Department of Legislative Services

The legislature has responded to this practice by enacting legislation that restricts the transfer of special funds into the General Fund. Examples include creating a lockbox around the Transportation

Trust Fund (TTF) and requiring the repayment of transfer tax revenues diverted from POS. Chapter 422 of 2013 proposed a constitutional amendment, which was approved by voters in fiscal 2014. The amendment prohibits the transfer or diversion of funds from the TTF to the General Fund or a special fund unless the transfer or diversion is approved through legislation passed by a three-fifths majority of specified full standing committees in each of the two houses of the General Assembly and then enacted into law. The bill creates exceptions to the prohibition on TTF transfers but only if the State is invaded or a major catastrophe occurs and the Governor proclaims a state of emergency and declares that TTF funds are necessary for the immediate preservation of public health or safety. Similarly, Section 13-209 of the Tax-Property Article requires that any transfer tax funds diverted from POS should be reimbursed. In recent years, the State circumvented this by exempting POS transfers from repayment. A concern about these measures is that it results in a loss of flexibility during recessions.

By using the Rainy Day Fund more effectively, there would be less pressure to transfer these funds into the General Fund, though the Rainy Day Fund is not large enough to entirely resolve revenue shortfalls following an economic downturn.

Conclusions

In conclusion, DLS recommends changes to the State's Rainy Day Fund laws and practices. Issues to examine include:

- increasing the $50 million minimum appropriation if the fund balance is less than 7.5% of revenues;

- developing guidelines that encourage the use of the Rainy Day Fund during recessions instead of transferring other fund balances to the General Fund when revenues underattain; and

- considering increasing the 7.5% Rainy Day Fund balance requirement.

DLS recommends that the committees examine how to improve Rainy Day Fund statutes and practices during the 2016 interim so that legislation can be introduced at the 2017 legislative session.

2. Dedicating Unanticipated Revenues to Replenish the Rainy Day Fund or Reduce Unfunded Liabilities

Revenue volatility is a concern. Overestimating revenues shortly before the beginning of a recession, particularly at the height of a revenue bubble, can inflate expectations and make it more difficult to make adjustments during a recession. Another issue is that volatility can lead to a reliance on revenues that decline sharply during recessions, which also makes it more difficult to make adjustments during a recession.

Reducing revenue volatility and transferring excess revenues into a Rainy Day Fund may make it easier to manage recessions by reducing the reliance on one-time revenues and increasing available reserves. DLS has identified two options that can be used to reduce revenue volatility and increase reserves. They are:

- ***Limiting the Nonwithholding Income Tax Revenue Estimate and Transferring Fund to the Rainy Day Fund:*** To deal with volatility in income tax collections, Virginia, in its fiscal 2015 budget, capped the estimate for nonwithheld revenue sources. This involved capping projected nonwithholding collections at the average share to total general fund revenues comprised by that revenue source over a 10-year period. In fiscal 2016, for example, the prior 10-year average was 16.1% of total revenue. Nonwithholding income tax collections include quarterly estimated payments, payments from fiduciaries, and final payments with returns. Nonwithholding income tax revenue tends to be volatile and this approach could provide a cushion by restraining the revenue estimate when this source is growing strongly. An advantage of this approach is that the data is available soon after the fiscal year ends and can easily be calculated before the next legislative session. In years that sources from nonwithholding revenues are above the capped estimate, the State can appropriate a share of this into the Rainy Day Fund; and

- ***Transferring Unanticipated Capital Gains to the Rainy Day Fund:*** Capital gains are among the most volatile revenue sources. From fiscal 2007 to 2009, taxable capital gains declined from $15.6 billion to $3.7 billion. The standard deviation of revenue increases is over eight times greater than that of total general funds. Since this is such a volatile revenue source, this is an excellent candidate to be segregated from ongoing revenues. Since tax year 2014, the Comptroller's Office has been receiving capital gains data from State tax forms. Tax year 2015 data becomes available at the end of calendar 2016. This should be enough time to determine an amount to be transferred in time for the 2017 session and fiscal 2018 budget. This does result in a lag, compared to a collar on nonwithholding income. There will also only be two data points in 2017, which complicates estimating how much is unanticipated.

These excess revenues can be substantial in some years. Another option would be to credit these volatile revenue sources into other accounts with unfunded liabilities, such as employee pensions, other postemployment benefits (retiree health insurance), Local Income Tax Reserve Account, and workers' compensation.

DLS recommends that the committees adopt narrative that requires that the Department of Budget and Management, Comptroller's Office, and DLS examine approaches for calculating unanticipated revenues and dedicating these revenues for the Rainy Day Fund or an unfunded liability. The report should recommend a specific approach that the General Assembly could consider as legislation at the 2017 session.

3. Use of Unassigned General Fund Surplus

Section 7-311 of the State Finance and Procurement Article requires that the Administration appropriate an amount equal to any unassigned general fund balance two years after the balance is realized. For example, fiscal 2008 closed with an unassigned surplus totaling $185.7 million, thus the Administration's fiscal 2010 allowance included a $175.7 million appropriation to the Rainy Day Fund. This appropriation to the Rainy Day Fund is referred to as the "sweeper."

In addition to the sweeper, Section 13-209(g) of the Tax-Property Article requires that any Transfer Tax revenues transferred to the General Fund after fiscal 2005 be repaid starting in fiscal 2012. The only transfer to which this applies was made in fiscal 2006, for $90 million. No part of the $90 million has yet to be paid as mandate relief in budget reconciliation legislation led to no appropriation in fiscal 2012 and funds were cut from the fiscal 2013 allowance to ensure a sufficient general fund balance. Chapter 489 (the BRFA of 2015) delayed the earliest repayment until fiscal 2019.

A third claim on unassigned budget surpluses was added last year. Chapter 489 stipulates that for unassigned balances over $10 million, an amount equal to the first $100 million is split 50/50 between the Rainy Day Fund and the State Pension Fund. Any surplus above $110 million is allocated to the Rainy Day Fund. The Attorney General's Office advises that the Program Open Space transfer takes precedence over the pension sweeper. Repayment of the $90 million transfer tax would occur for any unassigned balance over $110 million at closeout for fiscal 2017. **If there is concern about the priority of payments equal to unassigned balances at closeout, legislation would need to be enacted to reorder how funds are appropriated in fiscal 2019.**

Recommended Actions

1. Adopt the following narrative:

 Review of General Fund Revenue Volatility: The Department of Legislative Services, Comptroller's Office, and Department of Budget and Management should examine approaches for calculating unanticipated revenues and dedicating these revenues to either the Rainy Day Fund or an unfunded liability. The review should include nonwithholding income tax revenues and capital gains tax revenues. The agencies should submit a report to the budget committees by November 1, 2016. The report should recommend an approach and offer legislation that can be considered during the 2017 legislative session.

Information Request	**Authors**	**Due Date**
Review of General Fund Revenue Volatility	DLS DBM Comptroller's Office	November 1, 2016

Appendix 1

Current and Prior Year Budgets

Current and Prior Year Budgets
State Reserve Fund
($ in Thousands)

	General Fund	**Special Fund**	**Federal Fund**	**Reimb. Fund**	**Total**
Fiscal 2015					
Legislative Appropriation	$19,714	$0	$0	$0	$19,714
Deficiency Appropriation	0	0	0	0	0
Cost Containment	-4,928	0	0	0	-4,928
Budget Amendments	0	0	0	0	0
Reversions and Cancellations	0	0	0	0	0
Actual Expenditures	**$14,786**	**$0**	**$0**	**$0**	**$14,786**
Fiscal 2016					
Legislative Appropriation	$200,000	$0	$0	$0	$200,000
Budget Amendments	-118,565	0	0	0	-118,565
Working Appropriation	**$81,435**	**$0**	**$0**	**$0**	**$81,435**

Note: The fiscal 2016 working appropriation does not include deficiencies or reversions. Numbers may not sum to total due to rounding.

Fiscal 2015

Reductions to the fiscal 2015 appropriation were taken in January 2015. The Board of Public Works reduced the Rainy Day Fund appropriation by $4.9 million.

Fiscal 2016

The fiscal 2016 appropriation totals $200.0 million, $50.0 million for the Rainy Day Fund and $150.0 million for the Dedicated Purpose Account. Dedicated Purpose Account budget amendments transfer funds to State agencies, specifically:

- budget amendment 001-16 transferring $68.7 million to agency budgets to restore a 2% general salary increase given to State employees in January 2015; and

- budget amendment 002-16 transferring an additional $49.9 million to agency budgets consistent with Section 48 of the Budget Bill.

Fiscal Summary
State Reserve Fund

Program/Unit	FY 15 Actual	FY 16 Wrk Approp	FY 17 Allowance	Change	FY 16 - FY 17 % Change
01 Revenue Stabilization Account	$ 14,785,500	$ 50,000,000	$ 235,335,792	$ 185,335,792	370.7%
02 Dedicated Purpose Account	0	31,435,000	0	-31,435,000	-100.0%
Total Expenditures	**$ 14,785,500**	**$ 81,435,000**	**$ 235,335,792**	**$ 153,900,792**	**189.0%**
General Fund	$ 14,785,500	$ 81,435,000	$ 235,335,792	$ 153,900,792	189.0%
Total Appropriations	**$ 14,785,500**	**$ 81,435,000**	**$ 235,335,792**	**$ 153,900,792**	**189.0%**

Note: The fiscal 2016 working appropriation does not include deficiencies or reversions. The fiscal 2017 allowance does not include contingent reductions.

Appendix 3

Revenue Stabilization Account (Rainy Day Fund)
Section 7-311 State Finance and Procurement Article

Account Characteristics

- ***Purpose:*** The account was established in 1986 to retain State revenues to meet future short-term funding needs and to reduce the need for future tax increases by moderating revenue growth.

- ***Appropriations:*** The account consists of direct appropriations in the budget bill and interest earned from all reserve fund accounts.

- ***Required Appropriations If Account Balance Is Less Than 7.5% of General Fund Revenues:*** Current law requires that if the fund balance is between 3.0% and 7.5% of projected general fund revenues, annual appropriations of at least $50.0 million must be made until the account balance reaches 7.5% of estimated general fund revenues. If the account balance is below 3.0%, State law requires an appropriation of at least $100.0 million.

- ***Sweeper Provision:*** State law requires that the Administration appropriate an amount equal to any unassigned general fund balance at closeout in excess of $10.0 million into the Rainy Day Fund. This appropriation is made to the budget two years after the unassigned general fund surplus is realized. For example, fiscal 2008 closed with an unassigned surplus totaling $185.7 million, thus the Administration's fiscal 2010 allowance included a $175.7 million appropriation to the Rainy Day Fund. This appropriation to the Rainy Day Fund is referred to as the "sweeper." The Budget Reconciliation and Financing Act of 2015 (Chapter 489) amended the sweeper requirement so that the Rainy Day Fund receives 50% of any unassigned general fund surplus over $10 million for fiscal 2017 to 2020 up to $110 million, and any amount above $110 million. One-half of the surplus between $10 million and $110 million is appropriated to reduce the State's unfunded pension liability.

- ***Transfer Tax Repayment:*** Section 13-209(g) of the Tax-Property Article requires that any Transfer Tax revenues transferred to the General Fund after fiscal 2005 be repaid starting in fiscal 2012. The only transfer to which this applies was made in fiscal 2006, for $90 million. No part of the $90 million has yet to be paid as mandate relief in budget reconciliation legislation led to no appropriation in fiscal 2012 and funds were cut from the fiscal 2013 allowance to ensure a sufficient general fund balance. The fiscal 2015 Budget Reconciliation and Financing Act delayed the earliest repayment until fiscal 2019.

Mechanisms for Transferring and Spending Funds

Except for fiscal 2017 and 2018, to transfer funds from the Rainy Day Fund requires specific authorization by an Act of the General Assembly or specific authorization in the budget bill if the transfer results in a Rainy Day Fund balance that is at least 5% of projected general fund revenue. To transfer an amount that would reduce the Rainy Day Fund balance below 5% requires the transfer to be authorized in an Act of the General Assembly other than the budget bill. The use of any balance below 7.5% requires separate legislation for fiscal 2017 and 2018.

Rainy Day Fund Activity

The following table illustrates fiscal 2013 through 2017 activity in the Rainy Day Fund. Appropriations totaling $27.8 million in fiscal 2013 and $55.3 million in fiscal 2014 were made to ensure a minimum 5.0% fund balance. The Budget Reconciliation and Financing Act of 2012 authorized the transfer of $5.0 million to fully fund Teacher Retirement Supplemental grants. In fiscal 2015, the Board of Public Works withdrew $4.9 million of the appropriation to the fund. This amount is withdrawn because the Administration anticipates that this is the amount above the 5.0% fund balance target. The fiscal 2017 allowance includes the required sweeper appropriation, which totals $235.3 million. The end of fiscal 2017 balance is projected to be 6.3% of ongoing general fund revenues.

Revenue Stabilization Account Status
Fiscal 2013-2017 Est.
($ in Millions)

	2013	2014	2015	2016 Est.	2017 Est.
Beginning Balance	**$671.5**	**$700.4**	**$763.6**	**$773.5**	**$831.5**
Appropriation	27.8	55.3	19.7	50.0	235.3
BPW Reduction	0.0	0.0	-4.9	0.0	0.0
Transfer to BPW Contingent Fund	0.0	0.0	-13.1	0.0	0.0
Fund Projects and Programs	-5.0	0.0	0.0	0.0	0.0
Interest Earnings	6.1	7.9	8.1	8.1	16.1
Ending Balance	**$700.4**	**$763.6**	**$773.5**	**$831.5**	**$1,083.0**

BPW: Board of Public Works

Note: Numbers may not sum due to rounding.

Source: Department of Budget and Management, January 2016

Governor's Out-year Forecast

In the out-years, the Administration's Rainy Day Fund forecast projects that the fund balance increase to 7.0% through fiscal 2021. Since the fund balance is projected to be less than 7.5% of general fund revenues, a minimum $50 million appropriation is assumed from fiscal 2018 to 2021. The Adminstration's plan is to keep these appropriations in the fund. Fiscal 2021 ends with an estimated balance of $1,384 million.

Appendix 4

Dedicated Purpose Account
Section 7-310 State Finance and Procurement Article

Account Characteristics

- ***Purpose:*** The account was established in 1986 to retain appropriations for major, multi-year expenditures where the magnitude and timing of cash needs are uncertain and to meet expenditure requirements that may be affected by changes in federal law or fiscal policies, or other contingencies.

- ***Appropriations:*** The account consists of direct appropriations in the budget bill committed to a specific purpose. Interest earnings generated by the account are credited to the Rainy Day Fund.

- ***Other:*** The unspent balance of an appropriation reverts to the Rainy Day Fund four years after the end of the fiscal year for which the appropriation was made.

Mechanisms for Transferring and Spending Funds

To transfer funds from the Dedicated Purpose Account (DPA):

- funds may be reflected in the State budget subject to appropriation;

- after submission to the budget committees and review and approval by the Legislative Policy Committee (LPC) funds may be transferred by budget amendment to the appropriate Executive Branch agency; or

- the Governor may declare appropriations to the DPA surplus and may transfer funds by budget amendment to the Rainy Day Fund following review by the budget committees and LPC.

Dedicated Purpose Account Activity

The following table illustrates the activity in the DPA from fiscal 2013 through 2017. The account ends the period with no fund balance. In fiscal 2013, $10 million was appropriated to offset lost revenues attributable to federal sequestration. Funds were transferred in fiscal 2014 to the following agencies: $4.1 million to Maryland State Department of Education (MSDE) Head Start programs, $1.6 million to Department of Health and Mental Hygiene substance abuse programs, $1.4 million for Department of Aging nutrition and employment support, $1.2 million to support Department of Human Resources social service block grants, $0.8 million to support MSDE vocational rehabilitation services, $0.5 million to support Department of Labor, Licensing, and Regulations (DLLR) training and job placement programs, and $0.4 million to support DLLR adult education programs.

In fiscal 2016, $152.5 million is appropriated. This includes $140.0 million to fund legislative priorities, $10.0 million to reduce an unfunded liability in the Local Income Tax Reserve Account, and $2.5 million for information technology upgrades. In fiscal 2016, $118.6 million was restored and the remaining $21.4 million will revert to the General Fund. Information technology upgrades are expected to be made in fiscal 2017.

Dedicated Purpose Account Status
Fiscal 2013-2017
($ in Millions)

	2013	2014	2015	2016	2017
Beginning Balance	**$0.0**	**$10.0**	**$0.0**	**$0.0**	**$2.5**
Appropriation:	**$10.0**	**$0.0**	**$0.0**	**$152.5**	**$0.0**
Information Technology Upgrades				2.5	
Local Income Tax Reserve Repayment				10.0	
Section 48 Appropriations Restored by Administration				140.0	
Transfers:	**$0.0**	**-$10.0**	**$0.0**	**-$150.0**	**-$2.5**
Local Reserve Account Repayment				-10.0	
Federal Sequestration		-10.0			
Information Technology Upgrades					-2.5
Section 48 Initiatives Funded by Administration				-118.6	
General Fund Reversion				-21.4	
Ending Balance	**$10.0**	**$0.0**	**$0.0**	**$2.5**	**$0.0**

Source: Department of Budget and Management, January 2016

Governor's Out-year Forecast

The Administration does not have any plans to appropriate any funds into the DPA through fiscal 2021.

Appendix 5

Catastrophic Event Account
Section 7-324 State Finance and Procurement Article

Account Characteristics

- ***Purpose:*** The account was established in 1990 to enable the State to respond quickly to a natural disaster or catastrophe that could not be addressed within existing State appropriations.

- ***Appropriations:*** The account consists of direct appropriations in the budget bill. Interest earnings generated by the account are credited to the Rainy Day Fund.

Mechanisms for Transferring and Spending Funds

Prior to transferring funds by budget amendment to the appropriate Executive Branch agency, the Administration must notify the Legislative Policy Committee of the proposed amendment and allow the committee 45 days to review and approve the proposed amendment.

Catastrophic Event Purpose Account Activity

The following table shows that the account's balance was $1,000,000 at the start of fiscal 2013. In fiscal 2013, $432,313 was transferred to provide relief for victims of Hurricane Sandy and the Derecho Storm. In fiscal 2014, $394,750 was provided to support the Military Department's deployment during severe snowstorms in February 2014. In fiscal 2016, the Administration's budget includes a $10,000,000 deficiency appropriation. The account is expected to close fiscal 2017 with a $10,172,937 balance.

Catastrophic Event Account
Fiscal 2013-2017
($ in Thousands)

	2013	2014	2015	2016 Est.	2017 Est.
Beginning Balance	**$1,000**	**$568**	**$173**	**$173**	**$10,173**
Appropriation	0	0	0	10,000	0
Snowstorms	0	-395	0	0	0
Hurricane Sandy and Derecho Storm Relief	-432	0	0	0	0
Ending Balance	**$568**	**$173**	**$173**	**$10,173**	**$10,173**

Source: Department of Budget and Management, January 2016