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The Budget Stabilization Fund

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Executive Summary

Michigan's Budget Stabilization Fund (BSF) was created in 1977 in order to help alleviate the need for major budget-balancing actions during an economic downturn. Statutory provisions governing the fund provide for calculated fund pay-ins or pay-outs based on annual personal income growth, although actual transfers into or out of the fund have been implemented through specific legislative actions.

The fund's peak balance was $1.2 billion in FY 1999-2000; that balance was quickly depleted following the 2001 recession. More recently, a fund balance of about $500 million has been re-established, equal to about 2.5% of total General Fund and School Aid Fund expenditures. National-level budget observers recommend building a Rainy Day Fund balance of anywhere between 5% and 15% during times of economic expansion. The current statutory limit in Michigan is 10%.

While the statutory calculations do not currently call for a BSF pay-in or pay-out for FY 2013-14, the FY 2013-14 Executive Budget recommendation includes a deposit of $75 million into the Budget Stabilization Fund, with an additional deposit of $150 million planned for FY 2014-15 under the recommendation.

Background and Statutory Provisions

The Counter-Cyclical Budget and Economic Stabilization Fund, commonly referred to as the Budget Stabilization Fund (BSF) or Rainy Day Fund, was established by Public Act 76 of 1977. The national economic recession of the mid-1970's and corresponding drop in automobile sales had led to major state budget difficulties, which had been addressed at least in part through one-time budget maneuvers such as accrual accounting and a 15-month state fiscal year. The creation of the BSF was intended to supplement state revenue and stimulate employment during periods of economic recession, helping to avoid the need for those sorts of one-time maneuvers.[1]

Subsequently, Public Act 431 of 1984, the Management and Budget Act, compiled a number of budget-related statutory provisions into a single act, including the provisions governing the BSF. Those provisions are incorporated as sections 351 through 359 of that act (MCL 18.1351 to 18.1359). Major BSF-related provisions are summarized as follows:

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[1] Analysis of Senate Bill 42, House Legislative Analysis Unit, July 5, 1977.

Section 351: Creation of BSF

Creates the fund "to assist in stabilizing revenue and employment during periods of economic recession and high unemployment."

Section 352: Transfers Into and Out of BSF

Establishes the formula by which transfers into or out of the BSF are calculated:

- When annual growth in state personal income, adjusted for inflation and to exclude transfer payments, is greater than 2% for a calendar year, that percentage above 2% is to be multiplied by state General Fund/General Purpose (GF/GP) revenue for the fiscal year *ending* in that calendar year to determine the transfer from the state General Fund into the BSF for the fiscal year *beginning* in that calendar year.

- When annual growth in adjusted state personal income is below 0% for a calendar year (that is, when real personal income is declining), the percentage below 0% is to be multiplied by state GF/GP revenue for the fiscal year ending in that calendar year to determine the transfer from the BSF into the General Fund for that same fiscal year. If the formula calls for a larger transfer than is necessary to balance the current GF/GP budget, the excess is to remain in the BSF.[2]

Hypothetical BSF Transfer Calculation Examples

For calendar year 2013, using a simplified hypothetical example of $9.0 billion in FY 2012-13 GF/GP revenue:

If the growth rate in adjusted personal income were 3.0%:

$90 million (3.0% minus 2.0%, multiplied by $9.0 billion) would be transferred from the General Fund *into the BSF* for *FY 2013-14*.

If the growth rate in adjusted personal income were 1.0%:

The formula would call for no transfer into or out of the BSF (since growth was between 0.0% and 2.0%).

If the growth rate in adjusted personal income were negative 1.0%:

$90 million (1.0% below 0.0%, multiplied by $9.0 billion) would be transferred *out of the BSF* into the General Fund for *FY 2012-13*.

Section 353: Allowable Appropriations Based on Unemployment Rate

Allows appropriations out of the BSF in the subsequent calendar quarter if the seasonally adjusted state unemployment rate in a calendar quarter is 8% or more. Appropriations are limited to either 2.5% of the fund's balance (if the unemployment rate is between 8.0% and 11.9%) or 5.0% of the fund's balance (if the unemployment rate is 12.0% or higher). Allowable purposes for these appropriations include capital outlay, public works and public service jobs, refundable business tax credits to incentivize new outlays and hiring, or any other purpose to provide employment opportunities counter to the state's economic cycle.

[2] The terms "adjusted personal income," "annual growth rate," and "transfer payments" are defined in sections 302 and 305 of the Management and Budget Act (MCL 18.1302 and 18.305). As defined by the federal Bureau of Economic Analysis, transfer payments consist of "Payments consisting of government social benefits and other current transfer payments to the rest of the world." Source: http://www.bea.gov/glossary/glossary_c.htm.

Section 354: Estimates of Transfer Amounts

Requires that estimates of any transfer into or out of the BSF be contained in both the Executive Budget and the final version of the budget enacted by the Legislature. (This requirement is implemented each year in the General Government budget.)

Provides that a transfer into the fund be made in equal monthly installments through the fiscal year, while a transfer out of the fund may be made as needed during the fiscal year.

Provides that, for FY 1997-98 and subsequent fiscal years, any unreserved GF/GP balance at the close of a fiscal year be transferred into the BSF. Any such transfer is to be considered part of the transfer required under section 352 if a transfer into the BSF is determined under that section.

Section 355: Adjustment of Transfer Into or Out of BSF

Allows transfer amounts to be adjusted if a personal income growth rate is revised by the federal Bureau of Economic Analysis. Such an adjustment must be implemented through an appropriations bill (to be effective June 1 of the relevant fiscal year), shall be proportional to the increase or decrease in the growth rate, and cannot exceed 1% of GF/GP revenue for that fiscal year.

Section 356: Limit on BSF Balance

Limits the balance in the BSF to 10% of combined GF/GP and School Aid Fund (SAF) revenues. If the balance exceeds that amount, the excess is to be rebated to taxpayers on individual income tax returns.

Section 357: Shortfall in State General Fund

Provides that in a fiscal year in which funds are transferred into the BSF, if GF/GP revenue falls short of the level upon which a balanced state budget was adopted (for reasons other than changes in tax policy), an amount not to exceed the amount of the original transfer may be appropriated back from the BSF to supplement GF/GP revenue to the originally anticipated level.

Section 358: Emergency Appropriation from BSF

Allows the Legislature to make an emergency appropriation from the BSF, beyond the amount determined under the section 352 formula, through a 2/3 majority vote of each house of the Legislature. Such a transfer can only be made for the current fiscal year. (As a practical matter, however, the act can be amended through a simple majority vote in each house to make a larger appropriation from the fund.)

Section 359: Investment Earnings

Allows the state treasurer to combine funds in the BSF with other amounts in the state treasury for purposes of cash management, provides that the fund's investment earnings shall accrue to the fund, requires that the BSF be accounted for separately from other state funds, and specifies that transfers into the BSF be credited toward the fund balance at the start of the fiscal year.

Other BSF-Related Provisions

Several other sections within the Management and Budget Act deal with the BSF tangentially:

- Section 350c includes withdrawals from the BSF in the limit on annual state government expenditures.
- Section 350d provides that, if state revenues exceed the constitutional revenue limit by less than 1%, the excess revenues be deposited in the BSF, rather than being refunded to taxpayers.
- Section 367b includes required BSF pay-ins or pay-outs in the official forecast established at the revenue estimating conferences held in January and May each year.
- Section 386 includes the year-to-date balance of the BSF as an item included in the monthly financial report prepared by the State Budget Director.

In addition to the provisions summarized above, the sections of the Management and Budget Act pertaining to the BSF have been amended at various times to provide for specific transfers out of the BSF into the General Fund or other state funds in order to address budget shortfalls or other spending issues. Transfers into the BSF, on the other hand, have generally been implemented through budget act boilerplate language, sometimes in a higher amount than that calculated under section 352.

As a practical matter, the formulas for transfers into and out of the BSF contained in the Management and Budget Act (generally based on the estimate from the May Revenue Estimating Conference) have served as a guideline for the Legislature, which has then implemented the transfers through specific legislative action: budget bill boilerplate language for deposits and amendments to the Management and Budget Act for withdrawals.

BSF History

Figure 1 shows a history of year-end BSF balances since the fund was created in 1977, including a projected balance for FY 2012-13.[3] Over the first two years the fund existed (FYs 1977-78 and 1978-79), a balance of $241.1 million was accumulated, but the fund's balance was then depleted almost entirely in the subsequent year (FY 1979-80) when the 1980 national recession occurred.

A balance of $385.1 million was then re-established following transfers into the fund in FYs 1984-85 and 1985-86. That balance was eventually depleted almost entirely at the close of FY 1991-92. A total of $106.0 million was withdrawn from the fund between FY 1984-85 and FY 1988-89 for prison construction as an economic stabilization initiative (roughly corresponding with the fund's investment earnings over that period), followed by larger withdrawals in FYs 1990-91 and 1991-92 as a result of the national recession of 1990-91.

In both cases, modest balances were established during periods of economic growth but then quickly depleted during economic recessions.

Table 1 provides a more detailed accounting of the BSF for the past two decades, beginning with FY 1992-93. A large BSF balance was accumulated during the 1990's:

- Over the three-year period of FY 1992-93 to FY 1994-95, three substantial deposits were made as the national and state economies expanded, taking the BSF balance from near zero to just over $1.0 billion.
- The balance remained at about $1.0 billion through FY 1997-98, as withdrawals for several court settlements (FY 1994-95), transportation purposes (FY 1996-97), and special education-related costs required under the *Durant* lawsuit (FYs 1997-98) precluded growth in the fund's balance.
- The BSF balance peaked at the close of FY 1999-2000 at $1.3 billion, as two additional deposits were made due to strong economic growth. Additional withdrawals for *Durant* costs (FYs 1998-99 and 1999-2000) and transportation purposes (FY 1999-2000) prevented the balance from rising higher.

Investment earnings were substantial over the period of FY 1994-95 to FY 2000-01—exceeding $50 million per year—as substantial balances were available to be invested.

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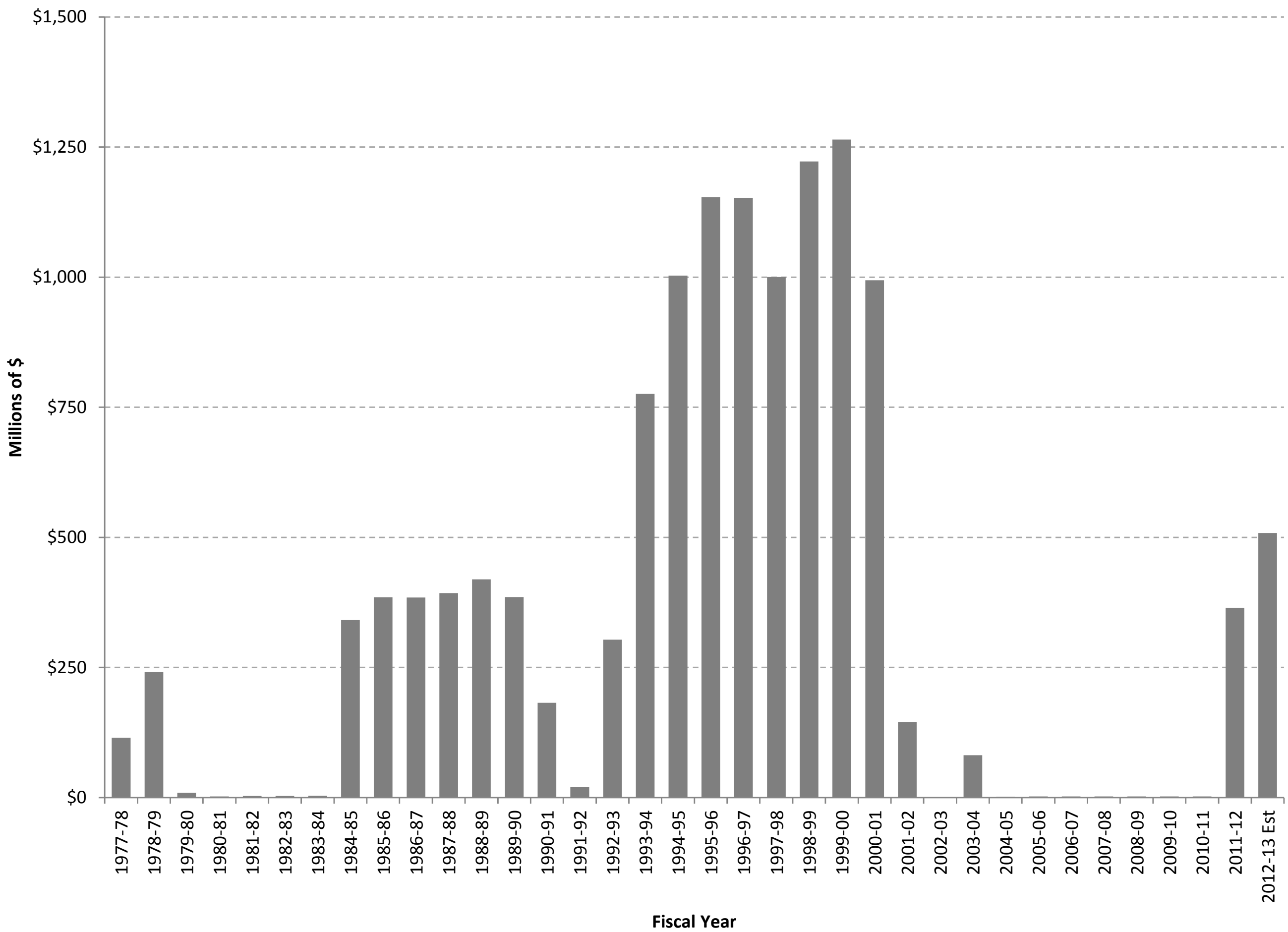
[3] The Senate Fiscal Agency report, "Economic and Budget Stabilization Fund Transfers, Earnings and Fund Balance: FY 1977-78 to FY 2007-08" was utilized to build the historical information in this report. That report is available at http://www.senate.michigan.gov/sfa/Revenue/BudgetStabilizationFund.PDF.

Figure 1
Budget Stabilization Fund Year-End Balance



The FY 1999-2000 BSF balance of $1.3 billion was rapidly depleted as the state dealt with budget difficulties caused by the national economic recession of 2001. During the three-year period of FY 2000-01 to FY 2002-03, $846.8 million was transferred from the BSF to the General Fund, $446.0 million was transferred to the School Aid Fund (a portion of which was for continuing *Durant*-related costs), and $70.0 million was transferred for transportation purposes. These transfers were part of a larger series of budget-balancing adjustments, many of them one-time in nature, undertaken by the Legislature as Michigan's economy failed to rebound from the 2001 recession at the same rate the nation as a whole did and the state's budget difficulties, therefore, persisted throughout the decade.[4]

At the close of FY 2002-03, the fund's balance had been entirely eliminated. The balance remained near zero for the next eight years, with the exception of an $81.3 million deposit made in FY 2003-04 that was immediately withdrawn in FY 2004-05.

[4] See the January 2011 House Fiscal Agency Report "Michigan's General Fund/General Purpose Budget" for more information on budget-balancing actions taken during the decade. Available at: http://www.house.mi.gov/hfa/PDFs/FiscalForum_MIGFGPBudgetJan11.pdf.

Table 1
Budget Stabilization Fund History
Millions of Dollars

			Transfers Out To					
Fiscal Year	**Deposits**	**Investment Earnings**	**General Fund**	**School Aid Fund**	**Trans-portation**	**Other**	**Total**	**Ending Balance**
					FY 1991-92 Ending Balance:			$20.1
1992-93	$282.6	$0.7					$0.0	$303.40
1993-94	460.2	11.9					0.0	775.5
1994-95	260.1	57.7				90.4	90.4	1,003.0
1995-96	91.3	59.2					0.0	1,153.6
1996-97		67.8			69.0		69.0	1,152.4
1997-98		60.1		212.0			212.0	1,000.5
1998-99	244.4	51.3		73.6			73.6	1,222.5
1999-00	100.0	73.9		32.0	100.0		132.0	1,264.4
2000-01		66.7	270.0	32.0	35.0		337.0	994.2
2001-02		20.8	452.8	382.0	35.0		869.8	145.2
2002-03	9.1	1.8	124.0	32.0			156.1	0.0
2003-04	81.3	0.0					0.0	81.3
2004-05		2.0	81.3				81.3	2.0
2005-06		0.0					0.0	2.0
2006-07		0.1					0.0	2.1
2007-08		0.1					0.0	2.2
2008-09		0.0					0.0	2.2
2009-10		0.0					0.0	2.2
2010-11		0.0					0.0	2.2
2011-12	362.7	0.1					0.0	365.0
2012-13 Est.	140.0	3.6					0.0	508.6

Notes:
(1) Transfers to School Aid Fund include withdrawals for costs related to the *Durant* lawsuit.
(2) Numbers may not add to due to rounding.

Over the last two budget years, FYs 2011-12 and 2012-13, a significant balance has been reestablished in the BSF:

- A deposit of $255.8 million GF/GP was made as part of the initial FY 2011-12 budget. This amount was based on the statutory BSF formula. Adjusted personal income growth for calendar year 2011 was estimated to be 5.4% at the May 2011 Revenue Estimated Conference.
- An additional $106.9 million was subsequently transferred from the Medicaid Benefits Trust Fund (MBTF) to the BSF in FY 2011-12, equal to half of the $213.8 million that been set aside in the MBTF in the initial FY 2011-12 budget to be used in the event of a federal disallowance related to the state's Medicaid program.
- A deposit of $140.0 million GF/GP was included in the initial FY 2012-13 budget, despite the statutory BSF formula not calling for a pay-in. (Adjusted personal income growth for calendar year 2012 was estimated to be 0.1% at the May 2012 Revenue Estimating Conference.)

At the close of FY 2012-13, the BSF will have an estimated balance of $508.6 million.

The January 2013 Revenue Estimating Conference provided the following statutory BSF calculations:

- No pay-in or pay-out based on estimated calendar year 2012 adjusted personal income growth of 0.8%.
- No pay-in or pay-out based on estimated calendar year 2013 adjusted personal income growth of 0.7%.
- A pay-in of $9.3 million for FY 2014-15 based on estimated calendar year 2014 adjusted personal income growth of 2.1% (preliminary long-term estimate).[5]

These amounts will be re-estimated in May 2013 based on the economic forecast reached at the next Revenue Estimating Conference.

The FY 2013-14 Executive Budget recommendation, released earlier this month, allocates a portion of available GF/GP revenue for a deposit of $75.0 million into the BSF for FY 2013-14, with an additional deposit of $150.0 million planned for FY 2014-15. If deposits were made in those amounts, and no withdrawals were made over the same time period, the BSF would have a balance of nearly $750 million at the close of FY 2014-15.[6]

Rainy Day Funds in Other States

Most states have a Rainy Day Fund of some sort. According to the National Association of State Budget Officers, 40 of the 50 states are expected to have at least a small Rainy Day Fund balance for FY 2012-13.[7] As shown in Figure 2, those balances vary widely as a percentage of annual state expenditures. Ten states have fund balances that are near to or above 10% of their total General Fund expenditures, including several states with very large balances tied to oil and mineral revenues (Alaska, Wyoming, Texas, etc.).

Michigan's percentage in Figure 2 has been adjusted to divide its projected BSF balance by the total of both General Fund and state School Aid Fund appropriations. Most states do not have a separate operating fund for school-related expenditures. When divided by only General Fund appropriations, Michigan's BSF balance is equal to 5.6%, but that figure overstates the balance since resources would also be needed to maintain School Aid spending during an economic downturn. Including both General Fund and School Aid Fund appropriations, the balance is equal to 2.5% of estimated expenditures. That places Michigan 24th among the 50 states, among a group of 27 states with a balance in the range of 1.0% to 6.0% of annual expenditures.

The legal provisions governing Rainy Day Funds also vary widely across the states, including the requirements and mechanisms for when revenues are deposited or withdrawn from the funds. Most states have a cap on the amount of funds that can be held in a Rainy Day Fund. Based on information compiled by the National Conference of State Legislatures, Michigan's cap of 10% of combined General Fund and School Aid Fund revenues is on the higher side.[8] Twelve other states have a cap equal to 10% of state appropriations or revenues, three states have a cap higher than 10%, and seven states do not have a cap. On the lower end, 28 states have a cap somewhere between 2% and 7.5% of appropriations or revenues.

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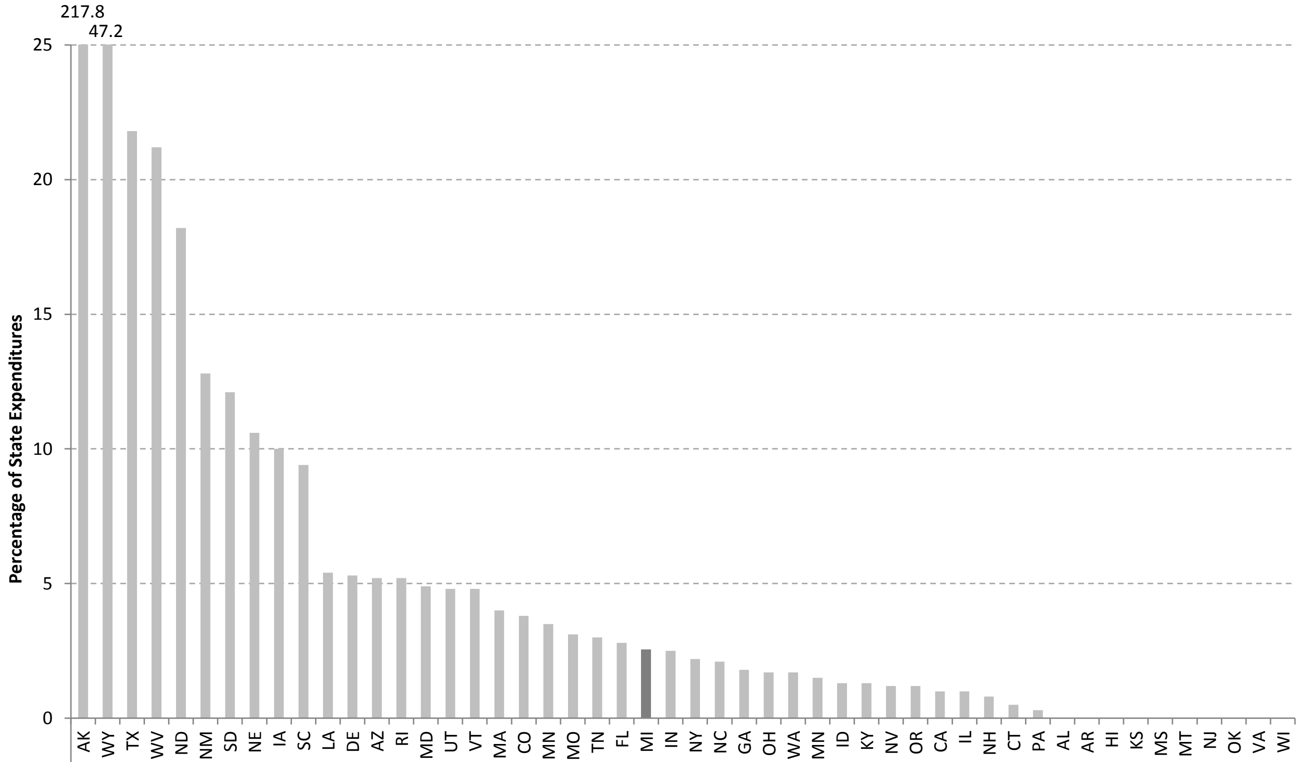
[5] For a detailed description of these calculations, see Table 4 of the following HFA memo: http://www.house.mi.gov/hfa/PDFs/CREC%20memo%20Jan13.pdf.

[6] In addition to the proposed standard deposits to the BSF, the Executive Recommendation also proposes to deposit $103.0 million for FY 2013-14 and $137.8 million for FY 2014-15 into a new Michigan Health Savings Fund, which would be established as a subaccount of the BSF. These funds represent half of the indirect savings from the proposed Medicaid expansion under the federal Affordable Care Act, which would be held in reserve to be utilized for direct expansion costs in future years as the state match rate increases from 0% to 5% and then 10%.

[7] "The Fiscal Survey of States," National Association of State Budget Officers, Fall 2012. Available at: http://www.nasbo.org/sites/default/files/Fall%202012%20Fiscal%20Survey%20of%20States.pdf.

[8] "State Budget Stabilization Funds," National Conference of State Legislatures, Spring 2008. Available at: http://www.ncsl.org/issues-research/budget/state-budget-stabilization-funds-spring-2008.aspx.

Figure 2
Rainy Day Fund Balances as Percentage of State Expenditures
FY 2012-13 Estimates



Source: National Association of State Budget Officers, *Fall 2012 Fiscal Survey*
Note: Michigan's percentage is adjusted to account for both General Fund and School Aid Fund expenditures; most states do not have a separate operating fund for school-related expenditures.

Conclusion

The two key BSF-related considerations for policymakers are as follows:

- During a period of economic expansion, how much current spending (which may also have long-term benefits) should be foregone, in order to increase the balance of the BSF?
- During an economic downturn, how quickly should the BSF balance be drawn down in order to maintain current spending, as opposed to permanently reducing expenditures or increasing revenues?

In addition to serving as a buffer during times of economic recession, maintaining a substantial BSF balance can have benefits in terms of improving the state's credit rating (as one of many factors credit agencies examine) and lessening or eliminating the need for the state to engage in short-term borrowing to deal with cash flow issues.

Over the past two years, policymakers in Michigan have chosen to make significant deposits into the BSF as the state has begun to recover from the effects of the 2008 recession, building the balance to a level equal to 2.5% of total General Fund and School Aid Fund appropriations.

The NCSL report referenced above offers the following survey of guidelines regarding fund balance levels:

> *Budget experts and observers debate the amount states should accumulate in their budget stabilization funds. The National Conference of State Legislatures' Fiscal Affairs and Oversight Committee (and informally used by municipal bond rating agencies) suggests that the combination of general fund surpluses and budget stabilization funds should equal at least 5 percent of total state expenditures. Other organizations, such as the Center on Budget and Policy Priorities, suggest a target fund level of at least 15 percent of expenditures. (CBPP, 2007). Suggested levels can vary according to individual state circumstances, specific economic conditions or access to atypical revenue sources, such as vast mineral resources. Professors Cornia and Nelson caution against "a one-size-fits-all [budget stabilization fund]," because of the "heterogeneity among state economic conditions and tax codes." (Cornia and Nelson, 2003). For example, states with highly elastic revenue sources, such as a progressive income tax system, might opt for larger balances because revenues from these sources tend to experience greater fluctuations during economic swings.*[9]

Based on projected FY 2013-14 revenue levels, a BSF balance of 5% of total General Fund and School Aid Fund revenue ($20.7 billion) would be just over $1.0 billion, while a balance of 10% (the statutory limit) would be just over $2.0 billion.

In FY 1999-2000, Michigan had a peak BSF balance equal to about 6% of combined General Fund and School Aid Fund revenues, as shown in Figure 3. This was still well below the statutory cap of 10%, but at the time, the state was considered to be a model in terms of the amount of funds it had set aside. One hypothetical scenario showed Michigan's BSF balance to be further above the amount that would be needed during a three-year recession than any other state's.[10] As it turned out, the BSF balance would prove to be fleeting during the recession that followed, as it took over five years for revenues to return to their peak level in even nominal terms.

Michigan did not have a BSF balance to rely on when the 2008 recession occurred. That recession caused a severe reduction in state revenues, requiring a series of both temporary and permanent budget-balancing actions. Other states were able to rely on Rainy Day Fund balances that had been rebuilt in the middle portion of the decade to at least temporarily reduce the need for such actions.[11]

While Michigan policymakers have been able to identify resources to shift to the BSF over the last two years, total state revenues still remain below the peak level in FY 2007-08 and are essentially flat from the FY 1999-2000 level, before adjusting for inflation. This results from a combination of growth in state tax expenditures (for example, the exemption of most services from the sales and use taxes), economic trends within the state (most prominently, the large decline in manufacturing output), and tax policy changes adopted (most recently, the net cut in business and individual income taxes adopted in 2011) over the last decade. The past decade, then, has not followed a traditional model in which revenue losses caused by a recession are temporary in nature and can simply be offset with reserves from the BSF before revenue growth then returns to at least inflationary levels. It is possible that the state could return to that sort of path over the next decade, depending on economic trends and state policy decisions.

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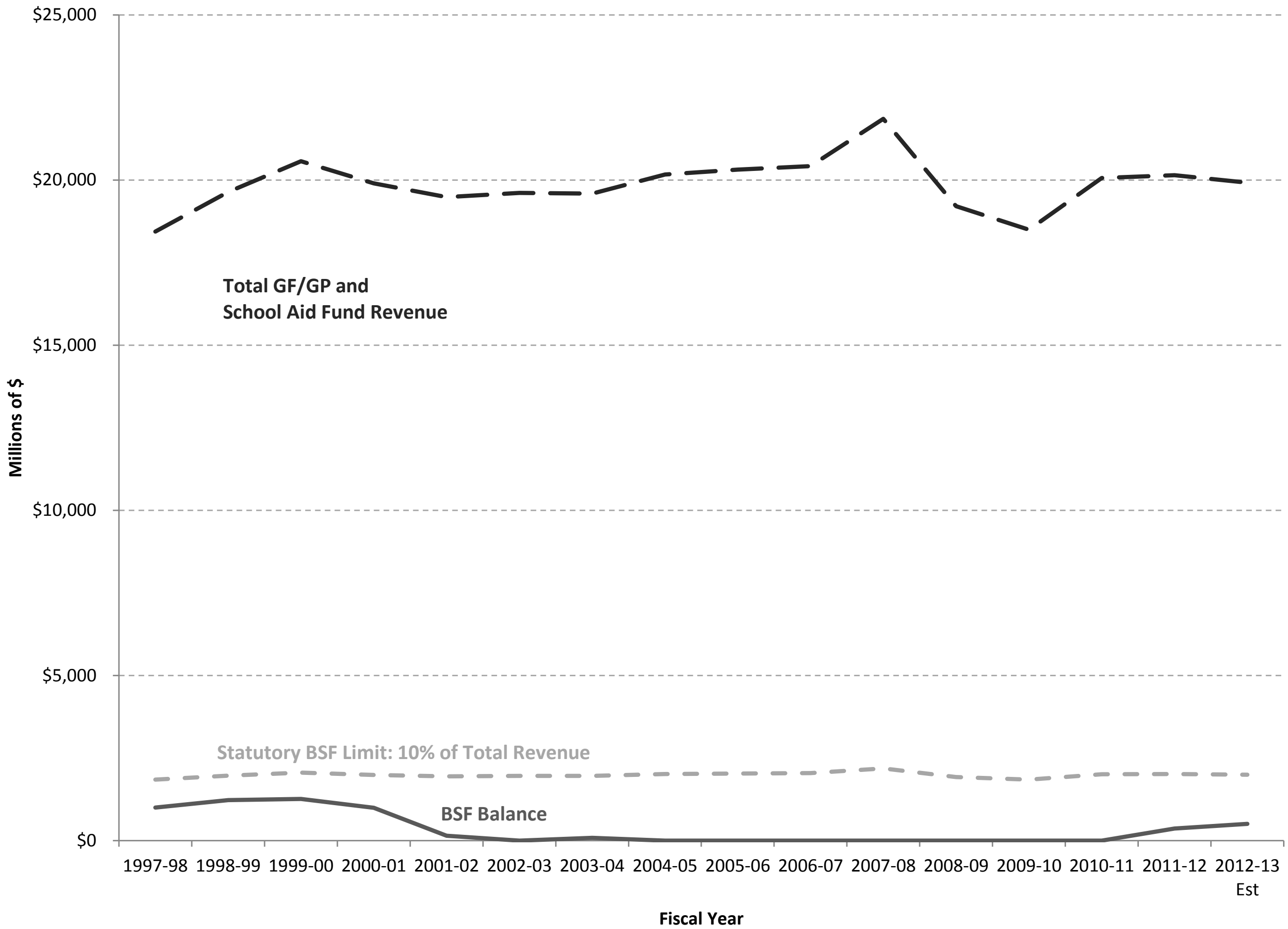
[9] See previous NCSL citation. A more recent report from the Center on Budget and Policy Priorities, "Why and How States Should Strengthen Their Rainy Day Funds" (February 2011), also makes the case for the 15% benchmark, based on estimates of the state budget shortfalls during past recessions, while also asserting that fund balances should be used aggressively when a downturn does occur. That report is available at: http://www.cbpp.org/files/2-3-11sfp.pdf.
[10] "Michigan's Rainy Day Fund: Is It Adequate?," Public Sector Consultants, July 1999. Available at: http://www.pscinc.com/Portals/0/Publications/PSR/Adv/1999/070299.html.
[11] See page 7 of the CBPP report cited above.

Figure 3
State Revenue and Budget Stablization Fund Balance



While the timing and severity of future economic downturns cannot be forecast precisely, the ability to rely on a BSF balance to help shield the state budget, and those entities that rely on state funding to provide public services, from the full effects of such a downturn can be of real benefit to the state. The BSF balance that has been re-established as of FY 2012-13 will provide at least some measure of security in such an event.

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NOTE: This report was written by Kyle I. Jen, Deputy Director. Kathryn Bateson, Administrative Assistant, prepared the report for publication.