Washington Research Council

e-POLICY brief

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Legislature Should be Cautious in Reducing Reserves

BRIEFLY

Lawmakers should not make substantial reductions in budget reserves. Fiscal risks, both economic and political, justify maintaining a sizeable emergency reserve fund. The two House budgets differ markedly in their approach to reserves, with the Republican budget plan providing a more adequate protection against a revenue downturn.

As House budget writers negotiate a supplemental spending plan for 1999-2001, they should avoid the temptation to spend down General Fund – State (GFS) budget reserves. The state may need the money.

In the seven years since voters adopted Initiative 601, the combined effect of expenditure restraint and a strong economy has led to an extraordinary accumulation of budget reserve funds. If no supplemental budget changes were adopted, the three biennia picture would look like Figure 1.

Long Term GFS Balance Sheet
(Dollars in Millions)

	1999-01	2001-03	2003-05
RESOURCES			
Unrestricted Beginning Reserves	462	576	576
February Revenue Forecast	20,843	22,534	24,633
Total Unrestricted Resources	**21,305**	**23,110**	**25,210**
APPROPRIATIONS and SPENDING LIMIT			
Adjusted 601 Spending Limit	**20,687**	**21,671**	**23,261**
GFS Appropriations[1]	**20,573**	**21,671**	**23,261**
RESERVES			
Unrestricted Ending Balance	576	576	576
Emergency Reserve Ending Balance	760	1,098	1,185
Total Ending Reserves	**1,336**	**1,674**	**1,761**
Transfer to School Construction Account	**-**	**661**	**2,122**

[1] Spending at the limit assumed for 2001-03 and 2003-05
Source: Senate Ways & Means Committee

FIGURE 1

Reserves climb steadily under these projections, with more than $1 billion in the Emergency Reserve Fund (ERF) by the end of the 2001-2003 biennium, and unrestricted balances remaining stable at $576 million. Given recent history, lawmakers understandably want to use these funds to mitigate I-695 impacts, provide additional tax relief and increase school funding – an ambitious agenda for a supplemental budget. As is common and appropriate, the budgets use the baseline revenue forecast. But the forecast also includes a pessimistic scenario, which reduces expected revenues by $713 million from the levels shown for 1999-2001.

With an adequately funded emergency reserve, the legislature can be relatively unconcerned with the downside risk of a mild economic slowdown, the scenario captured in the pessimistic forecast. But given the fiscal risks on the horizon, both economic and political, reducing reserves substantially is imprudent.

Initiative 601 called for the ERF not to exceed five percent of biennial general fund – state (GFS) revenues. That's consistent with the rule-of-thumb cited by the National Conference of State Legislatures and others. (Generally, however, it's five percent of annual revenues.) Yet, as Katherine Barrett and Richard Green wrote in *Governing* magazine last September, conditions vary and

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"one-size-fits-all doesn't make a whole lot of sense." States with fragile revenue streams, such as those with an extraordinary reliance on sales taxes, may need somewhat more, others somewhat less.

Recall that Initiative 601 was passed as the state came out of the expansion of the late 1980s into the slowdown of 1992-93. Washington fared relatively well during that national recession, but reserves were inadequate and spending commitments that had ballooned during the good times were unsustainable. The 1993 legislature cut spending and raised taxes. The voters responded by adopting the spending limit.

With that in mind, consider how the two House budgets would position the state for 2001-2003 and beyond. (For more information on the two plans see ePB 00-12 February 25, 2000 *House Democrats Present Budget: Spending Up, 601 Challenged* and e-PB 00:9 February 22, 2000 *House Republicans' Supplemental Budget Provides Transportation Funding, Relief to Local Government.*)

One of the challenges in this puzzling post-I-695 budget session is establishing comparability between two budgets that lack a common philosophy. As we've noted before, the Democrats' assumptions regarding ERF transfers and Initiative 601 are quite different from those made by the GOP budget writers. In particular, the Democrats' budget plan assumes an amendment to I-601 dropping the emergency reserve requirement to five percent of annual GFS revenues. As well, the Democrats make a number of direct transfers (essentially, appropriations) from the ERF. (See Figure 2.)

FIGURE 2

House Budget Comparisons
(Dollars in Millions)

	Republican 1999-01	Republican 2001-03	Democratic 1999-01	Democratic 2001-03
RESOURCES				
Unrestricted Beginning Balance	462	399	462	393
H 3043 Correct Deposit to ERF			67	
February Revenue Forecast	20,843	22,534	20,843	22,554
Less: Transfers, Credits, Tax Cuts	(241)	(640)	(163)	(545)
Net Revenue	20,602	21,894	20,680	22,009
Total Resources	**21,064**	**22,293**	**21,209**	**22,402**
APPROPRIATIONS AND SPENDING LIMIT				
Adjusted 601 Spending Limit	20,653	21,657	20,842	21,828
GFS Appropriations[1]	20,601	21,657	20,778	21,828
UNRESTRICTED GENERAL FUND RESERVES				
Beginning Balance	462	399	462	393
Change in Reserves	(63)	-	(69)	(14)
Unrestricted Ending Balance	**399**	**399**	**393**	**379**
EMERGENCY RESERVE ACCOUNT				
Beginning Balance	536	668	536	355
New Deposit (Revenue > Limit)	64	237	38	195
Interest Earnings	68	80	68	36
H 3043 Correct Deposit to ERF	-	-	(67)	-
Transfers		-	(220)	(200)
Emergency Ending Balance	**668**	**985**	**355**	**386**
TOTAL RESERVES (UNRESTRICTED + EMERGENCY)	**1,067**	**1,384**	**748**	**765**

[1] Spending at the limit assumed for 2001-03
Source: House Appropriations Committee

The Republican supplemental budget leaves a total of $1.1 billion in reserves at the end of the 1999-2001 biennium (June 30, 2001), or 5.1 percent of biennial revenues. The Democrats leave $748 million, or 3.6 percent of biennial revenues. Should the pessimistic forecast hold and revenues fall $713 million below projections, the reserves anticipated in the Democrats' budget virtually disappear, leaving no cushion for 2001-2003. Further, should there be a slowdown in the current biennium, revenues in 2001-2003 would also be negatively affected.

Washington's economy remains strong, and the worst-case scenario is unlikely to be experienced here (the Forecast Council pegs it as a 10% probability) in the next eighteen months. But there are valid reasons for concern. First, Washington has become

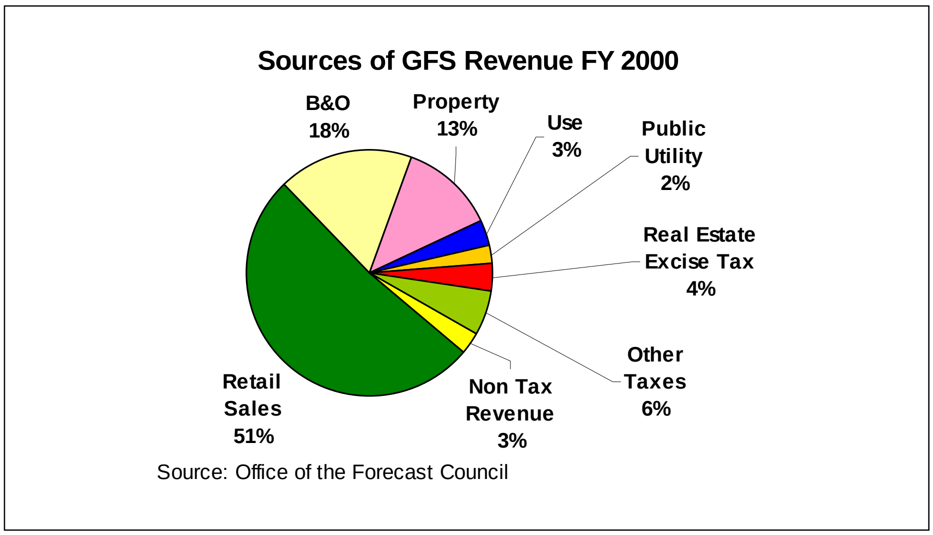

FIGURE 3

extraordinarily dependent on the sales tax to finance the general fund, as Figure 3 shows. More than half of the GFS now comes from sales and use taxes, which traditionally are more sensitive to economic downturns than more stable revenue sources. The potential erosion of the sales tax base as e-commerce escalates, while overstated, presents a further element of risk. Second, the economy appears to be softening. Washington's heavy reliance on business taxes, its high housing prices, transportation problems and regulatory regime - all combine to weaken our competitive position within the US. Third, a number of initiatives have been filed that threaten to further diminish our competitive position, reduce revenues and increase state expenditures.

Given the current uncertainty, the state legislature would be well-advised to protect the emergency reserve account and avoid further eroding the revenue base through local option tax credits.

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