Cash Reserve Fund Decision Memo

Planning Committee, Nebraska Legislature

<u>Current Law</u>

Current law (see Section 77-4602) as amended by LB 638, makes deposits into the Cash Reserve Fund when revenues are a specified level above the revenue estimate. An alternative rule is used when the annual increase for the current fiscal year is greater than the 20-year average annual increase.

LB 713 (approved by the Governor April 24, 2019) declared that,

> "The restoration of cash reserves over the next two biennial budgets is essential if the state is to meet its obligations and adapt to the challenges projected by data accumulated by the Legislature's Planning Committee."

LB 713 also mandated that the Legislative Fiscal Analyst shall provide a joint revenue volatility report in even numbered years, and a budget stress test in odd-numbered years. These reports, and other sources, can be used to identify the volatility of different state revenue sources.

<u>Policy Alternatives</u>

The National Association of State Budget Officers (2019) has reported that the median for state rainy day funds has increased from 1.6% in FY 2010 to 7.5% in 2019. Nebraska's Cash Reserve Fund averaged 15.2% from 2007 to 2017, but fell to 8% in 2018 and 7% in 2019 (Barrett and Greene, pp. 24-25). The Planning Committee has expressed concern about the current level of the Fund. Two studies provide recommendations that suggest using volatile revenue sources to fund the Cash Reserve Fund.

1. A report by The Tax Policy Center recommends that, "states consider investing volatile revenue sources, such as capital gains revenues, into budget stabilization funds (BSFs). Policymakers can tie BSF deposit rules to the level of state revenue volatility… BSFs with strict deposit and withdrawal rules mitigate business cycle volatility more effectively than funds with weak rules" (Rueben and Randall, 2017).
2. The Volcker Alliance (Barrett and Greene, 2019) identifies nine states that link their reserve funds to volatile revenue streams: Alaska, California, Louisiana, Massachusetts, North Dakota, Oklahoma, Texas, Utah and Washington. Seven states use economic formulas to determine the funding level of reserve funds: Arizona, Idaho, Indiana, Michigan, Minnesota, North Carolina, and Tennessee. For instance, "Indiana contributes to the state fund when personal income grows more than 2 percent from the previous year (p. 17).

Evidence

Two studies provide evidence on the volatility of Nebraska state tax sources:

1. A report from the Federal Reserve Bank of Kansas City found that the most volatile tax in Nebraska during the period 1967 to 2007 is the corporate income tax, followed by the personal income tax. The general sales tax is least volatile (Felix, 2008). The personal income tax is volatile in part because of its progressive tax brackets and the volatility of capital gains income and S Corporations.
2. A more recent report by the Pew Charitable Trusts that examined the period 1998 to 2017 also found the corporate income tax the most volatile, followed by the personal income tax, general sales tax and the motor fuels tax (Murphy, Iyengar and Zhang, 2018).

Options

1. Current policy (see Section 77-4602) as amended by LB 638, which makes deposits into the Cash Reserve Fund when revenues are a specified level above the revenue estimate.
2. Dedicate a portion of the unencumbered general fund balance at the end of the fiscal year for the Cash Reserve Fund.
3. Identify a volatile tax (such as the corporate income tax) or a volatile component of a tax (such as capital gains) and dedicate some portion of those revenues to the Cash Reserve Fund.
4. Use an economic formula to determine the amount of deposits in the Cash Reserve Fund.

References

Barrett Katherine and Richard Greene, "Rainy Day Fund Strategies: A Call To Action," (2019). Volcker Alliance, New York. https://www.volckeralliance.org/publications/rainy-day-fund-strategies-call-action.

Felix, R. Alison, (2008). "The Growth and Volatility of State Tax Revenue Sources in the Tenth District," *Economic Review* (Third Quarter) Federal Reserve Bank of Kansas City

Murphy Mary, Akshay Iyengar and Alexandria Zhang, (2018) "Tax Revenue Volatility Varies Across States, Revenue Streams," Pew Charitable Trusts, https://www.pewtrusts.org/en/research-and-analysis/articles/2018/08/29/tax-revenue-volatility-varies-across-states-revenue-streams.

National Association of State Budget Officers (2019), The Fiscal Survey of States. Washington DC. https://www.nasbo.org/reports-data/fiscal-survey-of-states.

Rueben Kim S. and Megan Randall, (2017) *Revenue Volatility: How States Manage Uncertainty*. Tax Policy Center: Urban Institute and Brookings Institution, https://www.taxpolicycenter.org/sites/default/files/publication/149171/revenue-volatility_1.pdf.