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Leaky Umbrella: The Need to Reform Texas' Rainy Day Fund

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Key Points

- Texas' Economic Stabilization Fund (ESF) acts as a rainy day fund to cover state government budget shortfalls during economic downturns or emergencies and is often used for other purposes.
- The ESF's short-comings include it being rather easily raided for purposes other than covering budget shortfalls and stockpiling of taxpayer dollars in the fund.
- Legislators should raise the threshold vote to use the ESF for non-emergency purposes to four-fifths of each chamber, and consider lowering the cap and allocating funds above the cap to return to taxpayers or pay state liabilities.

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Introduction

In November 1988, Texas voters approved a constitutional amendment creating the Economic Stabilization Fund (ESF), otherwise known as the state's rainy day fund, with the following ballot language:

> *The constitutional amendment establishing an economic stabilization fund in the state treasury to be used to offset unforeseen shortfalls in revenue (HJR 2).*

The fund went into effect at the beginning of the next fiscal year in September 1989. As noted in the ballot language, the Legislature sold the ESF to voters for the purpose of covering "unforeseen shortfalls in revenue" due to economic downturns or emergencies, such as natural disasters. And while the amendment allowed legislators to use the ESF to cover budget shortfalls for the current or subsequent biennium with a three-fifths vote of members present (and voting) in each chamber, it also allows legislators to use it "at any time and for any purpose" with a two-thirds vote of members present in each chamber. This latter language in the amendment differs from the ballot language that voters approved and is not specific, leading to a lack of clarity of the purpose and potentially improper usage of the fund.

Given the issues with the existing structure of the ESF and the need for a rainy day fund outlined in this paper, we recommend correcting these problems by:

- First and foremost, passing a constitutional amendment that constrains its use for non-emergency purposes by increasing the number of votes required in each chamber to use the fund "at any time and for any purpose" from the current two-thirds of members present to four-fifths of all members;
- Considering passage of a constitutional amendment that replaces the inefficient situation today of a constitutional maximum limit and legislatively stated floor in favor of a single maximum limit of 7 percent of certain biennial general revenue (GR)-related funds;[*] and
- Considering passage of a constitutional amendment that requires funds above the cap to be either returned to taxpayers through the Sales Tax Reduction (STaR) Fund or used to make payments on state liabilities.

After chronicling the history of the ESF, the departure of the fund from the ballot language approved by voters, and the problems with the fund's current structure, we explain how our recommendations will promote budget transparency and budgetary certainty.

History of the Economic Stabilization Fund

During the 1980s, the Texas economy suffered two economic downturns prompted by hydrocarbon supply shocks. The inflation-adjusted oil price declined by almost 18 percent from 1982 to 1983 and by almost 39 percent from 1985 to 1987 (Ginn and Roach, 27). These declines contributed to slower economic growth and job creation, which led to state tax collections decreasing by 1.8 percent in 1983 and 4.6 percent in 1986 (Texas Comptroller 2015, 191). Legislators chose to close these revenue gaps by

* We use the term "GR-related funds" throughout this paper to represent "certain GR-related funds" as the revenue base that the Comptroller currently uses to calculate the constitutional ESF cap. GR-related funds include total net deposits to the general revenue fund, federal funds deposited to GR, and deposits in the Tobacco Settlement Account, and exclude interest and investment income in each fiscal year during the prior biennium (LBB 2016, 1).

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raising taxes and cutting government spending. In recognition of the state's exposure to the volatile global oil market and budget uncertainty, the Legislature passed a resolution in 1987 and 61.6 percent of voters approved the constitutional amendment in 1988 that established the ESF as an emergency reserve to cover budget shortfalls (Ballotpedia).

The ESF receives funds through the following mechanisms (Texas Comptroller 2016, 1):

- Oil and natural gas production taxes, collectively known as "severance" taxes, based on the rationale that the state would save production revenues in boom times to spend during busts. Half of the 75 percent of severance taxes over the amounts received in 1987 ($531.9 million for oil and $599.8 million for natural gas) are transferred from GR to the ESF and the other half goes to the State Highway Fund;
- Direct appropriations from GR to the ESF;
- One-half of any GR unencumbered balance; and
- Interest earned on the ESF balance.

Withdrawals from the fund can be made for the following reasons (Parks 2016, 6):

- If the Texas Comptroller certifies that GR appropriations exceed the GR available for the current biennium, the Legislature can tap the fund to cover the budget gap with a three-fifths vote of members present in each chamber;
- If the Comptroller certifies that anticipated revenues for the succeeding biennium will be less than revenues available in the current biennium, the Legislature can use the ESF to make up the difference with a three-fifths vote of members present in each chamber; and
- The Legislature can appropriate ESF funds at any time and for any purpose with a two-thirds vote of members present in each chamber.

Justification

Any discussion of the ESF should begin with the justification for its existence. After all, the private sector could allocate the $10.4 billion expected in the fund at the end of fiscal year (FY) 2017 for many other purposes (Texas Comptroller 2015a, 18). Removing those dollars from the private sector means that $10.4 billion are not going toward investing in businesses, creating jobs, increasing incomes, and assisting in Texans reaching their full potential. Therefore, it is essential that legislators appropriately evaluate how those dollars are allocated.

During economic downturns, such as the Great Recession, tax revenues decline while spending needs may remain mostly constant, creating budget shortfalls. Since Texas (correctly) cannot deficit spend because of a balanced budget amendment, legislatures have chosen on multiple occasions to close fiscal gaps with large tax increases, spending cuts, or some combination of both. The first choice hurts economic productivity, while the second can damage core government services. The ESF provides an alternative to these fiscal options.

Although Texas' real private economy is more resilient to oil price fluctuations with mining's share of the economy declining from 21 percent in the 1980s to 15 percent more recently, it is not immune (Ginn and Roach, 19). Reliance on hydrocarbon production and geographically vulnerable areas, like the $265 billion Port of Houston (Martin Associates), support the need for a rainy day fund. Put simply, the state needs an emergency fund that saves in good times and covers some portion of budget shortfalls in bad times, similar to how a family would set aside income in the event of unforeseen circumstances. For this reason, all three major credit rating agencies (Moody's, Fitch, and S&P) consider the existence and strength of a rainy day fund among their criteria to determine a state's credit ratings (Texas Comptroller, 3).

Purpose

Given that the state needs a rainy day fund, addressing its purpose could seem superfluous; a rainy day fund is created for budget shortfalls and emergencies. However, the ESF has rarely operated as only an emergency fund. Presently, the ESF exists as a source for emergency and non-emergency funds. Consider in turn the following non-emergency purposes that are often advocated by lawmakers for the ESF: automatic budget stabilization, state debt retirement, and large expenditures for non-emergency programs (Garrett, 1-2).

First, automatic budget stabilization is unnecessary and misguided. The state revenue curve, while prone to some volatility, does not portray the high level of instability that would necessitate an automatic stabilizer mechanism. Automatic stabilizers would also incentivize overspending by covering entire revenue gaps instead of allowing legislators to use a combination of spending cuts and emergency funds. Moreover, an automatic stabilizer may require a structural change in the funding mechanism for the ESF, shifting from severance taxes to an annual capture from the state's GR—an unlikely and unnecessary reform.

Second, Texas should not make retiring state debt early a higher priority than budget shortfalls. Debt is not necessarily a bad thing; rather, excessive debt that is issued for needless reasons or for assets that have less utility than the maturity of the debt is bad (Ginn et al.). In 2014, Texas had the lowest state debt per capita among the top 10 most populous states (Texas Bond Review Board, 39). Moreover, the recent economic climate has allowed the state to issue debt at lower interest rates, reducing the amount required for debt service, which is already well below the constitutional cap (Texas Transparency 2016, 2). However, this does not mean that the state should rack up more debt or not have a plan of how to prioritize payments on state liabilities if given the opportunity (Ginn et al.).

Finally, large one-time, non-emergency expenditures should be funded with GR instead of the ESF. These large expenditures, such as the $2 billion for the State Water Implementation Fund for Texas (SWIFT) that helped fund water projects and the 2003 transfer to the Texas Enterprise Fund (LBB 2015, 103), do not qualify as emergency needs. Nevertheless, legislators often find it in their best interest to constitutionally dedicate those funds from the ESF because it increases spending room under the constitutional spending limit (Parks 2016a, 6), which decreases accountability and hurts overall fiscal responsibility. Ultimately, we recommend reforming the spending limit by capping the entire budget to no more than the lowest growth rate of population plus inflation, personal income, or gross state product during the previous two fiscal years immediately preceding a regular legislative session (Heflin and Ginn 2015, 2). This conservative spending limit would account for spending no matter if it was from GR, ESF, or any other funding source.

It should be reiterated that Texans originally approved the ballot language for the ESF in 1988 under the condition that the fund would be used for "unforeseen shortfalls in revenue." This language identifies the ESF as a savings account in case of economic downturns, not a slush fund for legislative abuses. It is clear that the ESF should be reserved for budget shortfalls that qualify as emergency needs; however, the current structure of the fund impedes its ability to serve as an effective rainy day fund.

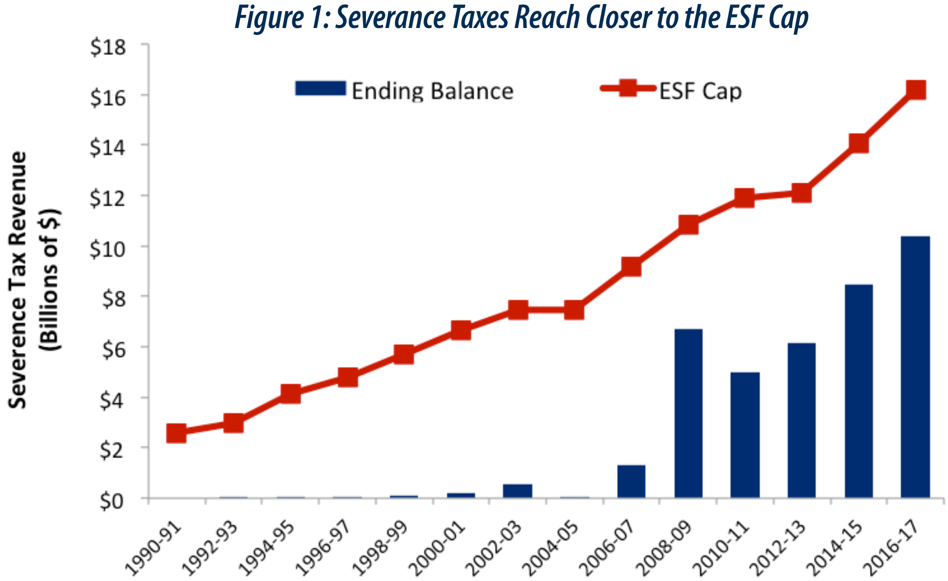
Progression

Following the creation of the ESF, Texas oil and gas production stagnated as oil prices stayed low and conventional drilling flat-lined. Severance taxes did not climb much over the 1987 levels and the ESF received few fund transfers. Legislators also chose not to make any specific appropriations or leave any extra money in the form of unencumbered GR balances. Accordingly, the first four legislatures after the ESF was in place dipped into it and essentially depleted the fund each time (Parks 2016, 7).

In the 2000s, the Texas oil and gas sector took off, as new technologies like hydraulic fracturing and horizontal drilling enabled access to previously unreachable hydrocarbon deposits. Production dramatically increased first in natural gas plays (i.e., Barnett Shale) and then shale oil fields (i.e., Eagle Ford, Permian Basin). With the increase in oil and natural gas production, the cumulative flow of severance taxes in the ESF was $16.3 billion from 2001 to 2015 (Parks 2016, 4-5).

Figure 1 shows that there has been a relatively low balance left at the end of each biennium until the mid-2000s.

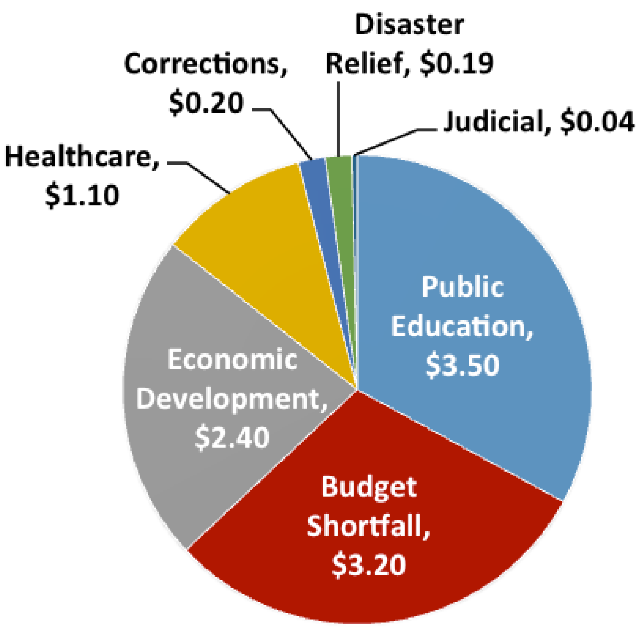
Figure 1: Severance Taxes Reach Closer to the ESF Cap



Source: Texas Comptroller of Public Accounts

Since 1990, legislators have appropriated funds from the ESF seven times for a total of $10.7 billion. **Figure 2** indicates that the largest share went to public education (Parks 2016, 7). Granted, some of these appropriations went to cover budget shortfalls, such as closing the 2003 and 2011 budget gaps; however, billions in ESF dollars also went to non-emergency purposes.

Figure 2: Public Education Receives Largest Share of $10.7 Billion in ESF Appropriations since Inception (Billions of $)



Source: Legislative Budget Board

In 2013, the 83rd Legislature appropriated $2 billion from the ESF to the SWIFT (HB 1025), which is a government-directed fund, approved by voters (SJR 1(R)), to support water projects intended to help local communities develop and optimize their water supplies. The same Legislature also took about $1.8 billion from the ESF to pay the Texas Education Agency (TEA) for a delayed installment in the previous session to the Foundation School Program (HB 1025). Neither of these uses necessarily constituted an emergency shortfall or unforeseen budget gap, yet legislators deemed it necessary to tap the ESF. Lastly, the Legislature, with the approval of Texas voters in 2014, altered the ESF's funding mechanism to divert up to half of the previous revenue streams away from the fund and into the State Highway Fund (SJR 1(3)). This action reduced the balance of the ESF relative to the larger state budget.

In 2014, the oil and gas market began to level off, which, combined with the diversion of funds to the State Highway Fund, substantially decreased the funds flowing into the ESF. For example, in 2015 the ESF received about $600 million less in oil production taxes than in 2014, although overall production severance taxes increased from the previous year (Parks 2016, 5). At the end of FY 2015, the ESF had $8.5 billion and is expected to increase to $10.4 billion by the end of the current 2016-17 biennium (Comptroller 2015a, 18), assuming that oil and natural gas prices remain stable and another petroleum price crash does not occur. Although Texas' ESF constitutes one of the largest rainy day funds in the country, both in absolute numbers and relative to state revenues (Pew Charitable Trusts, 4-10), and is currently around 6.5 percent of the 10 percent constitutional ESF cap (LBB 2016), diversions for non-emergency reasons could quickly deplete the fund.

While there is no requirement that the Legislature tap the fund to cover a current or future budget shortfall, the ESF is available to compensate for some, if not all, of a budget deficit thereby reducing or eliminating the need for harmful tax hikes to balance the budget in the midst of economic downturns, which was common before 1987. In addition, the fund lessens the need to enact drastic spending cuts, which can be costly for particular groups; but there should remain a desire to cut excessive, ineffective programs during budget shortfalls, as was done in 2003.

Problems and Recommended Reforms

Given legislators' lack of constraint with ESF dollars and the research supporting reforms, we recommend the following:

- **First and foremost, pass a constitutional amendment that constrains its use for non-emergency purposes (i.e., any use that is not a current or future budget shortfall or emergency) by increasing the number of votes required in each chamber to use the fund "at any time and for any purpose" from the current two-thirds of members present (and voting) to four-fifths of all members (25 senators and 120 representatives).**

  Since the Texas Constitution does not specify a purpose for the ESF other than covering current or future budget deficits, the Legislature is relatively free to appropriate emergency funds for non-emergency purposes, even when doing so would substantially decrease the fund's balance and unnecessarily grow the overall budget. Moreover, the legislative support needed to tap the fund is scarcely tougher for non-emergency situations (two-thirds of members present) than current and future budget shortfalls (three-fifths of members present); the former theoretically requires only two additional senators and ten representatives more than the latter (Parks 2016, 6).

If the fund is intended to serve as an emergency backup for budget shortfalls, lawmakers should not easily have the ability to hamstring this purpose by tapping the fund for other spending items. Raising the approval requirement for non-emergency spending to a four-fifths vote of all members in each chamber will better safeguard the ESF against legislative abuses, ensuring that non-budgetary uses of the ESF have almost unanimous support.

For example, the four-fifths bar could have prevented the passage of HB 1025 (2013) in 2013, which backfilled education cuts from 2011 and created the SWIFT. While the Senate approved the bill 28-3, the House passed the bill with less than 80 percent support, 110-29. Even considering the leanings of the non-voting representatives, HB 1025 would likely have fallen short of the four-fifths vote, the bill would have died, and legislators could have discussed how to fund these items from GR. The conditions surrounding HB 1025 demonstrate that a four-fifths vote requirement could work more effectively to constrain the use of the ESF than the current two-thirds vote. This level of support would allow appropriations for natural disasters and other emergency events that fall outside the budgetary shortfall category, while impeding the use of ESF funds for regular spending needs that are best covered with GR.

- **Consider passing a constitutional amendment that replaces the inefficient situation today of a constitutional maximum limit and legislatively stated floor in favor of a single maximum limit of 7 percent of biennial GR-related funds.**

The ESF has a constitutional maximum limit set at 10 percent of the previous biennium's GR-related funds (Parks 2016, 12), whereby severance tax transfers from GR that exceed this cap cease and are available in GR. In addition, the Joint Select Committee to Study the Balance of the ESF sets an implicit floor that was $7 billion in the 2016-17 biennium, or around 5 percent of biennial GR-related funds (Parks 2016, 11). However, this constitutional cap and legislatively stated floor dynamic does not necessarily represent ESF levels that are appropriate and prudent, rather the amounts legislators feel comfortable having in the fund.

The Texas rainy day fund cannot be compared equally with other states and rules. Most states operate on an annual budget, thereby determining their rainy day fund cap based on a percentage of annual GR. This perspective is also adopted by credit rating agencies, which consider emergency funds proportional to annual GR, not biennial GR-related funds as in Texas (LBB 2015, 111). Accordingly, the effective balance of the ESF should be doubled in any comparisons made to agency guidelines or other states. Holding that the biennial revenues are roughly double that of a single year, the 10 percent biennial cap is really a 20 percent annual cap of GR-related funds.

Problems plague the present cap/floor dynamic. Under the methodology laid out above, the current cap is actually 20 percent of annual GR-related funds, a number substantially higher than any other state, except Alaska, and two to three times higher than the guidelines set by the three major credit rating agencies, with Fitch having the highest upper bound of 10 percent of annually recurring non-federal revenue (LBB 2015, 110-113). In addition, the legislatively stated $7 billion floor is around 5 percent of biennial GR-related funds, but is not meaningful if it can be altered or eliminated at the whim of legislators. This harms budget predictability and reliability, damaging Texans' confidence in fiscal stability. Also, there is less need for a floor given that credit rating agencies prefer that states spend their resources if there is great need, and do not tend to punish states that drain their emergency funds with a downgrade in their credit ratings (LBB 2015, 111-113).

In addition, research indicates that Texas would have to save around 14 percent of annual (or 7 percent of biennial) GR to cover most expected GR shortfalls in the 75th percentile of a 5.8 percent shortfall to the 90th percentile of a 15.3 percent shortfall (Elder, 18-23). In other words, to attain a constant-GR shortfall during a "severe" recession, there would need to be an annual amount in the ESF of somewhere between 5.8 percent and 15.3 percent. Therefore, our recommendation a 7 percent biennial (14 percent annual) cap of GR-related funds instead of GR funds would more than contribute to keeping state revenues from falling substantially below expenditures during most recessions while legislators also make budget cuts.

Texas was fortunate to survive the Great Recession generally unscathed, mainly because of a diversified economy along with the shale boom in West and South Texas (Phillips and Slijk, 5-6). However, while the state's economy has become more resilient to oil price fluctuations, it is not immune, and the government's budget is increasingly vulnerable to economic events outside of the state (Ginn and Roach). The state is also vulnerable to natural disasters in the form of hurricanes and drought, which can substantially damage or destroy vital industries like trade and agriculture. Given this, the state should err on the side of caution in determining the size of the fund.

Finally, the ESF balance should be considered in light of revenue shortfalls the Texas budget has faced during the last 15 years. In the 2002-03 biennium, the state overestimated its tax collections by 3.2 percent (Texas Transparency 2016a, 2). Moreover, the state overestimated the combined tax collections of the 2008-09 and 2010-11 biennia by roughly 7.0 percent (Texas Transparency 2016a, 2). The ESF should be large enough to have covered part of these shortfalls, although spending cuts can help each dollar in the fund go even further.

To fully actualize the purpose of providing relief for budget shortfalls, legislators should replace the suboptimal cap/floor dynamic with a single maximum cap of 7 percent of biennial GR-related funds. The ESF would accumulate transfers from severance taxes or direct appropriations until it reaches the cap, and then stay at 7 percent of biennial GR-related funds until it is tapped to cover some, if not all, of a budget shortfall, and then be replenished again in a timely manner.

- **Consider passing a constitutional amendment that requires funds above the cap to either be returned to the taxpayer through the Sales Tax Reduction (STaR) Fund (Heflin and Ginn 2014) or used to make payments on state liabilities (Ginn et al.).**

Instead of the current situation when the ESF reaches its cap and additional transfers remain in GR, legislators should consider other options. The first is to return those dollars to taxpayers through a temporary reduction in the state's sales tax, which is the broadest, most visible, and easiest tax to administer. This could be accomplished with the Sales Tax Reduction (STaR) Fund, a budget-cutting tool that could be funded by either funds above the ESF cap or from legislators appropriating dollars during the regular legislative process; legislators would then cut the sales tax for a period until the fund is depleted. After the determined period, the tax rate would automatically revert to its original level. The second option is to reduce the burden of state liabilities (i.e., debt and state pensions) by prioritizing payments that will have the biggest bang for the buck to reduce the cost on current and future generations of Texans.

Conclusion

The ESF is a critical component for maintaining fiscal conservatism in Texas. It has the potential to serve as a vital economic tool, a supply of funds that can eliminate the need for tax hikes or massive spending cuts when state revenues decline. Lawmakers should reform the ESF so it can serve as an effective source of emergency funds. It should be constrained to primarily providing revenue support to close budgetary gaps by raising the two-thirds vote requirement for non-emergency spending to a four-fifths vote while considering replacing the cap/floor dynamic with a maximum cap of 7 percent of biennial GR-related funds and allocating transfers above this cap to cut the budget by returning those dollars to taxpayers through the STaR Fund or making payments on state liabilities.

Texas is already in much better shape than most states when it comes to the rainy day fund. However, better than other states is not synonymous with fiscal responsibility and financial discipline. The recommendations outlined here will allow the ESF to finally actualize its purpose as a truly effective rainy day fund, as voters intended when they approved the ballot language to create the fund to cover unforeseen revenue shortfalls. By giving legislators the ability to appropriately cover fiscal emergencies without taking unexpected action, the reformed ESF will contribute to more economic prosperity statewide as entrepreneurs have greater certainty about the future. ✯

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