COMMONWEALTH of VIRGINIA
Office of the Governor

Stephen E. Cummings
Secretary of Finance

September 1, 2022

MEMORANDUM

TO: The Honorable Glenn Youngkin, Governor of Virginia
The Honorable Janet D. Howell, Chair, Senate Committee on Appropriations and Finance
The Honorable Barry D. Knight, Chairman, House Committee on Appropriations

FROM: Stephen E. Cummings

SUBJECT: Recommendations Regarding the Revenue Stabilization Fund and the Revenue Reserve Fund

Pursuant to paragraph C.2, Item 267, Chapter 2, 2022 Acts of Assembly, Special Session I, I respectfully submit the attached report which includes recommendations for consideration of adjustments to the existing cap on the combined balance of the Revenue Stabilization Fund and the Revenue Reserve Fund.

Specifically, with regard to the statutory maximum combined balance of the two funds, I recommend removing the temporary increase to 20 percent, and instead, I recommend maintaining the 15 percent combined maximum enacted in 2019. An analysis of other AAA-rated states shows that Virginia is well protected against an economic downturn with reserve balances and otherwise strong balance sheet that is well above those of many other highest-credit quality states.

Additionally, I recommend the Governor and General Assembly convene a workgroup to consider potential legislation to modify or eliminate the statutory provisions requiring the Governor to include in his budget proposals an additional "super" deposit to the Revenue Stabilization Fund when revenue growth exceeds eight percent, as the creation of the Revenue Reserve Fund provides a more effective vehicle for accumulating reserves to protect against unforeseen revenue downturns.

Lastly, given the complexity of the Constitutionally-mandated formula for determining required deposits to the Revenue Stabilization Fund, I recommend the formation of a workgroup to consider potential constitutional amendments to simplify and bring greater transparency to the process, while maintaining the objective of directing extraordinary and/or unanticipated general fund revenues to the Fund.

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RECOMMENDATIONS REGARDING THE REVENUE STABILIZATION FUND AND REVENUE RESERVE FUND

A REPORT TO THE GOVERNOR AND TO THE CHAIR OF SENATE FINANCE AND APPROPRIATIONS AND THE CHAIRMAN OF HOUSE APPROPRIATIONS

COMMONWEALTH OF VIRGINIA

SEPTEMBER 2022

Stephen E. Cummings
Secretary of Finance

RECOMMENDATIONS REGARDING THE REVENUE STABILIZATION FUND AND REVENUE RESERVE FUND

Enabling Authority

This report is submitted pursuant to paragraph C.2, Item 267, Chapter 2, 2022 Acts of Assembly, Special Session I:

"2. The Secretary of Finance shall prepare a report to include recommendations for consideration of any adjustments to, or a removal of, the existing cap on the combined balance of the Revenue Stabilization Fund and the Revenue Reserve Fund, pursuant to subsection E of § 2.2-1829 and subsection F of § 2.2-1831.3, Code of Virginia, which shall be delivered to the Governor and the Chairs of the House Appropriations Committee and Senate Finance and Appropriations Committee by September 1, 2022."

Introduction

The Commonwealth's balance sheet is in an extremely strong position. The projected combined balances of the Revenue Stabilization Fund and Revenue Reserve Fund will total more than $3.8 billion by FY 2023 year end and more than $4.2 billion by FY 2024 year end, up from $791.9 million at the end of FY 2019. FY 2022 year-end balances in the Water Quality Improvement Fund totaled $113.3 million, a 228 percent increase of FY 2019 totals, and the year-end balance in the Transportation Trust Fund totaled $2.7 billion, a 66 percent increase over FY 2019. Additionally, actions authorized by the 2022 General Assembly provide an additional $1.0 billion to the Virginia Retirement System, raising the funded status to its highest level since 2008. Virginia's long-term liability burden is low and well managed. Tax supported debt issuance is carefully monitored through both constitutional limitations and stringent institutional practices. Likewise all of the Commonwealth's debt is fixed rate.

Recent conservative budget actions have positioned the Commonwealth well for the future, including a $4.1 billion revenue cushion in FY 2023. And despite recent record budget surpluses, we must continue to carefully balance the risk of potential economic downturns against current spending needs. We have, and will continue to, prudently safeguard our financial position and protect our triple-AAA credit rating while recognizing that funds entrusted to the stewardship of the Commonwealth belong to taxpayers and not the government. With this overarching principle in mind, we submit the following analysis and recommendations.

Background

Revenue Stabilization Fund

In 1992, Article X, Section 8, of the Virginia Constitution established the Revenue Stabilization Fund ("RSF" or "Rainy Day Fund") to offset anticipated shortfalls in revenues when general fund appropriations based on previous forecasts exceed expected revenues in subsequent forecasts.

Deposits to the Rainy Day Fund are required if the combined growth in individual and corporate income taxes and sales taxes, as certified by the Auditor of Public Accounts, exceeds the prior six-year average combined growth rate. The amount of the deposit is equal to one-half of the growth above the six-year average. The amount of the deposit certified by the Auditor of Public Accounts is restricted on the balance sheet at the close of the fiscal year. The actual deposit to the Fund occurs in the second fiscal year following the surplus.

In addition, Chapter 755 of the 2003 Acts of Assembly (House Bill 1872, O'Bannon) requires the Governor to include in his annual Budget Bill additional "super" deposits to the Revenue Stabilization Fund under certain conditions. The statute, § 2.2-1829 of the Code of Virginia, requires the Governor to include in his budget recommendations an additional amount for deposit to the Revenue Stabilization Fund in excess of any mandatory deposit required by Article X, Section 8 of the Constitution of Virginia if the annual percentage increase in the certified tax revenues is eight percent or greater than the certified tax revenues for the immediately preceding fiscal year and if such annual percentage increase is also equal to or greater than 1.5 times the average annual percentage increase in the certified tax revenues for the six fiscal years immediately preceding the most recently ended fiscal year. The amount of the deposit is calculated as at least 25 percent of the product of the certified tax revenues collected in the most recently ended fiscal year multiplied by the difference between the annual percentage increase in the certified tax revenues collected for the most recently ended fiscal year and the average annual percentage increase in the certified tax revenues collected in the six fiscal years immediately preceding the most recently ended fiscal year (one-half of the amount required for the mandatory deposit). Such additional deposits to the Fund are required to be included in the Governor's budget recommendations only if the estimate of general fund revenues for the fiscal year in which the deposit is to be made is at least five percent greater than the actual general fund revenues for the immediately preceding fiscal year.

<u>Revenue Reserve Fund</u>

Chapter 827 of the 2018 Acts of Assembly (House Bill 763, Jones), established the Revenue Reserve Fund ("RRF") to offset shortfalls in the budget of two percent or less of certified tax revenues collected. Under the statute, § 2.2-1831.3 of the Code of Virginia, a deposit to the RRF may be required whenever there is a fiscal year in which general fund revenues exceed the forecast but do not result in a mandatory deposit to the Revenue Stabilization Fund as required by Article X, Section 8 of the Constitution of Virginia. Whenever such conditions are met, the Comptroller must commit in his year-end report, the surplus for deposit to the Fund. The amount of the commitment is equal to the lesser of (i) the amount of general fund revenues in excess of the official forecast, less any deposit to the Water Quality Improvement Fund, or (ii) one percent of general fund revenues collected during the year in question. The Governor, in his budget recommendations, must include a deposit to the Revenue Reserve Fund that is at least equal to the committed amount.

Maximum Fund Balance

<u>Revenue Stabilization Fund</u>

Under the Constitution, the RSF is capped at fifteen percent of the Commonwealth's average annual tax revenues derived from taxes on income and retail sales as certified by the Auditor of Public Accounts for the three fiscal years immediately preceding.

When the RSF was first created in 1992, the maximum fund balance was established as **ten percent** of such revenues. An amendment ratified November 2, 2010, and effective January 1, 2011, **increased the maximum to fifteen percent**.

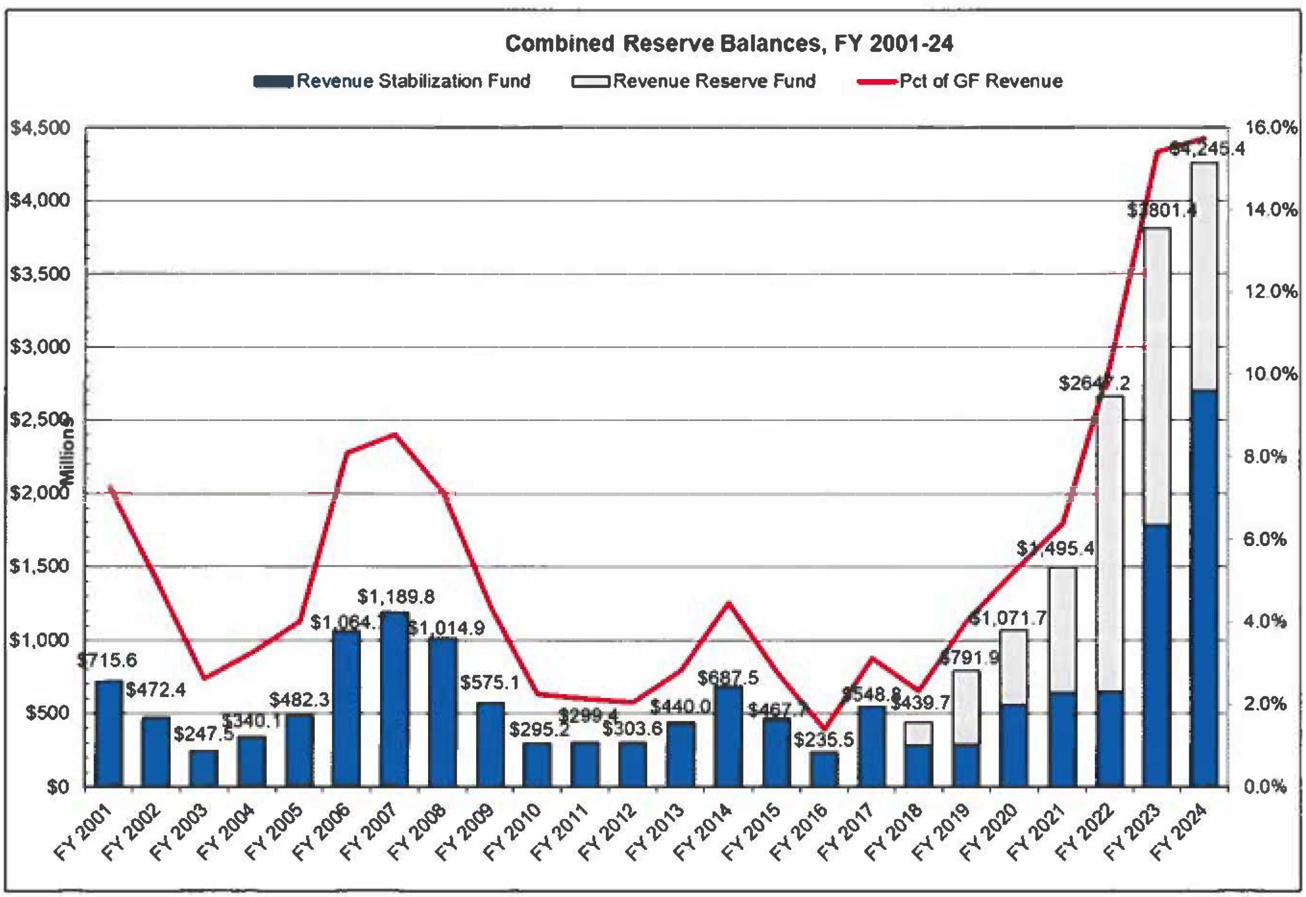
<u>Combined Balances</u>

In 2019, Chapter 347 of the 2019 Acts of Assembly (House Bill 2354, Jones) established a maximum combined balance of the Revenue Stabilization Fund and Revenue Reserve Fund of not more than 15 percent of average income and sales tax revenues for the past three years, as certified by the Auditor of Public Accounts for the three fiscal years immediately preceding.

The 2022 appropriation act, Chapter 2, 2022 Acts of Assembly, Special Session I, increased through June 30, 2024, the maximum combined balance from 15 percent to 20 percent of the Commonwealth's average annual tax revenues derived from taxes on income and retail sales.

Reserve Balances and History

Reserve balances are strong. By the end of FY 2023, combined balances in the Rainy Day Fund and Revenue Reserve Fund will total $3.8 billion, which will be 15.4 percent of income and retail sales tax revenues over the past three years. If the Super Deposit that has been reserved on the balance sheet is made in FY 2023, conditioned upon the five-percent revenue test and appropriation by the General Assembly, the combined balance would be $4.2 billion. Excluding the potential super deposit, the projected balance at the end of FY 2024 is $4.2 billion as a result of the additional Rainy Day Fund deposit of $405.9 million in FY 2014 ($904.6 million minus the $498.7 million "advance reservation" included in Chapter 1).



Recommendation No. 1: Maintain Maximum Combined Fund Balance at 15 Percent

The General Assembly should consider a budget amendment to remove the temporary increase in the maximum combined balance from 15 percent to 20 percent.

Virginia is well protected against an economic downturn with reserve balances well above those of many other highest-credit quality states. Virginia is one of only 14 states whose fiscal management has garnered a AAA credit rating, and Virginia is one of only 13 who have the distinction of being rated AAA by all three of the major credit rating agencies. An analysis of peer AAA-rated states indicates that Virginia's projected combined reserves fund balances at the end of FY 2023 will be the fourth highest and 134 percent higher than the median balance among the 14 AAA-rated states.

Rainy day funds (in millions of dollars)*

AAA State	FY 2021	FY 2022	FY 2023
Texas	$10,274	$10,057	$12,615
Georgia	$4,289	$4,286	$4,295
North Carolina	$1,982	$3,116	$4,250
Virginia	$1,495	$2,647	$3,801**
Florida	$631	$1,160	$3,588
Maryland	$1,674	$2,730	$3,024
Indiana	$1,302	$1,644	$1,652
Tennessee	$1,450	$1,550	$1,600
South Carolina	$1,707	$1,210	$1,299
Utah	$887	$1,033	$1,033
Iowa	$801	$817	$898
Missouri	$604	$772	$748
South Dakota	$216	$307	$307
Delaware	$252	$280	$280
AAA Median	**$1,376**	**$1,380**	**$1,626**
50-State Median	**$985**	**$1,268**	**$1,372**

*Source: National Association of State Budget Officers "The Fiscal Survey of States" (Spring 2022 Report)

** Balance in 2024 will reach $4.2 billion, reflecting constitutionally-mandated rainy day fund deposit of $905 million in FY24, $400 million of which will be deposited in FY23.

In addition, based on analysis from the Commonwealth's financial advisor, most peer states target maximum reserve fund balances of between five and 15 percent of general fund revenues. Many states have also experienced more revenues than anticipated due to the impact of COVID stimulus funds and revenues attributable to the strong labor and stock markets.

The chart below shows the Rainy Day Fund position of all AAA-rated states relative to GF expenditures. Importantly this data compiled by the National Association of State Budget Officers (NASBO) compares fund balances to expenditures, calculated at 12.2 percent for Virginia, whereas our formula compares fund balances to income and sales tax revenues.

Rainy Day Funds as a Percent of GF Expenditures*

AAA States	FY 2021	FY 2022	FY 2023
Texas	20.2%	15.6%	21.5%
North Carolina	8.3%	12.0%	15.8%
South Dakota	11.4%	15.1%	15.5%
Georgia	15.7%	14.9%	15.0%
Maryland	3.3%	5.5%	13.9%
Virginia	6.6%	10.0%	12.2%
South Carolina	20.3%	11.7%	11.4%
Iowa	10.3%	10.1%	11.0%
Utah	10.4%	10.0%	9.8%
Indiana	7.3%	9.0%	8.7%
Florida	4.6%	6.3%	8.1%
Tennessee	10.0%	8.8%	7.7%
Missouri	6.2%	7.3%	5.7%
Delaware	5.6%	5.5%	4.6%
AAA Median	**9.1%**	**10.0%**	**11.2%**
50-State Median	**9.9%**	**11.6%**	**11.4%**

*Source: National Association of State Budget Officers "The Fiscal Survey of States" (Spring 2022 Report)

Additionally, as another metric reflecting the strength of the Commonwealth's balance sheet, Virginia is well positioned with respect to unfunded pension liabilities with a FY21 pension funded ratio of 86 percent. This does not include the $750 million appropriation in FY22 which has estimated cost savings of $1.4 billion over the next twenty years, nor the $250 million contingent appropriation reserved on the FY22 year-end balance sheet, which has estimated cost savings of $509 million over the next twenty years. More than a dozen states used budget surpluses and rainy-day funds to make supplemental payments this year or approved them in 2022–23 budgets. And the average US state pension-funded ratio rose significantly in FY21, to 81.7 percent from 68.9 percent in fiscal 2020, due to extraordinary investment returns.

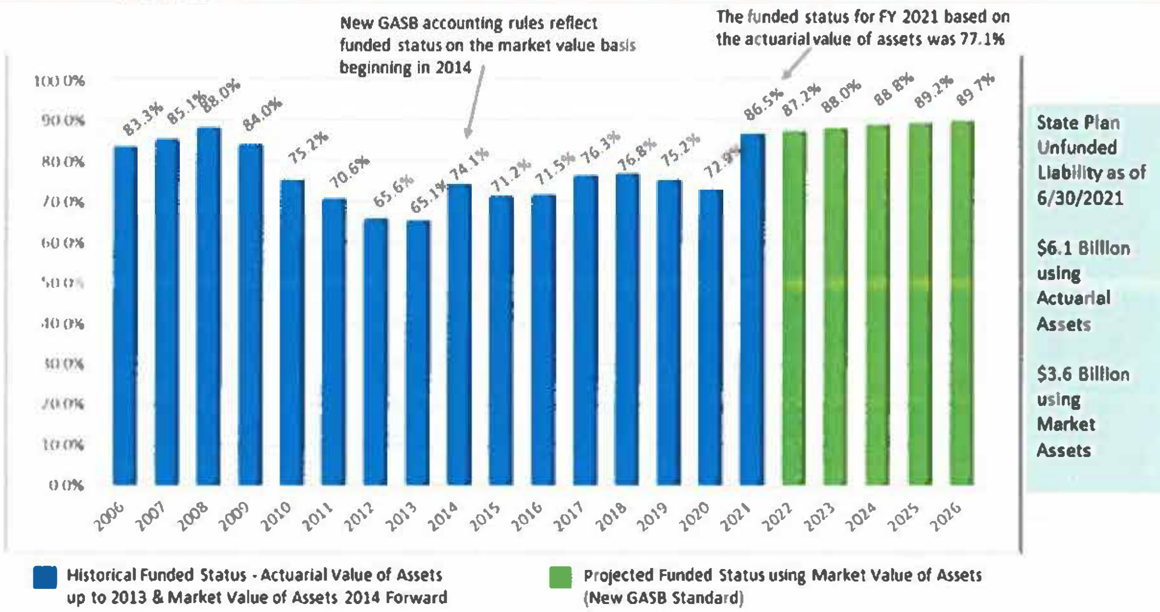
Unfunded Pension Liability

AAA State	FY21 Aggregate Funded Ratio*
Delaware	108%
South Dakota	106%

AAA State	FY21 Aggregate Funded Ratio*
Utah	105%
Iowa	100%
North Carolina	95%
Georgia	92%
Florida	91%
Tennessee	91%
Texas	86%
Virginia	85%
Maryland	81%
Indiana	75%
Missouri	63%
South Carolina	62%

*Source: S&P Global Ratings State Pension Report (August 3rd, 2022)

Funded Status: State



Notes:

- Projected funded status based on assumed investment returns of 6.75% and inflation of 2.5%.
- GASB Accounting rules reflect funded status using Market Value of Assets effective 6/30/14 for Plan Reporting and 6/30/15 for Employer Reporting.
- Projections do not include the impacts of additional payments included in the Appropriation Act.

In conclusion, the Commonwealth's balance sheet is in an unprecedented position. Based upon FY22 results, and prior to a potential Super Deposit being triggered and appropriated, the combined balance of reserve funds will be $3.8 billion ($1.8 billion Revenue Stabilization Fund and $2 billion Revenue Reserve Fund) representing 15.4 percent of average income and retail sales tax revenues for the past three years, and $4.2 billion after mandated deposits in FY24 (over 16% of revenues). In addition, taking into account the supplementary $1 billion in deposits as allocated by the Appropriation Act to further reduce the unfunded pension liability, it is expected to increase the funded status of the Pension Plan by 100 basis points, reaching the highest funding level since 2008. And further, the appropriation infusions will help to moderate contribution rates in the future.

Recommendation No. 2: Form a Workgroup to Consider Modifications to the Statutory "Super" Deposit Requirement

We recommend the Governor and General Assembly convene a joint workgroup to consider potential legislation to modify or eliminate the statutory provisions requiring the Governor to include in his budget proposals an additional deposit to the Revenue Stabilization Fund when the annual percentage increase in income and sales tax revenues is eight percent or greater than revenues for the immediately preceding fiscal year and also at least 1.5 times the average annual percentage increase in such revenues for the six fiscal years immediately preceding.

The Super Deposit requirement was created in 2003 to require that additional reserves be set aside on the balance sheet in periods of high growth. Although it has been triggered multiple times, the additional deposit to the RSF has not been enacted by the General Assembly in fifteen years.

Moreover, with the establishment of the Revenue Reserve Fund in 2018, another vehicle was created that has accelerated the combined balance growth and provides more flexibility for the use of reserve funds in times of need, thereby addressing the original intent of the Super Deposit language introduced in 2003. We believe that maintaining the two vehicles provides a more effective tool by which the Governor and General Assembly can manage the Commonwealth's financial affairs in times of stress.

RRF Deposits (in millions, excluding interest)	
Fiscal Year	**Deposit Amount**
2018	$156.4
2019	$342.7
2020	$0
2021	$339.0
2022	$1,148.7

Recommendation No. 3: Form Workgroup to Consider Simplification of Revenue Stabilization Fund Deposit Formula

We recommend that the Governor should convene a workgroup, in consultation with the Chairs of the House Appropriations and Senate Finance and Appropriations Committees, and with the participation of the State Comptroller, State Treasurer and Director of the Department of Planning and Budget, to consider potential constitutional amendments to simplify and bring greater transparency to the Constitutionally-mandated formula for determining required deposits to the Revenue Stabilization Fund.

Under current law, a constitutionally-mandated deposit is triggered when the combined growth rate of individual income, corporate income, and sales taxes in a single fiscal year exceeds its prior six-year average growth rate. Because the required deposit is tied to revenue growth rates, rather than to unplanned revenues (revenue surplus), the amount of the deposit required to be set aside on the Commonwealth's balance sheet is often unrelated to the size of any revenue surplus. In fact, over the last 10 years, the amount of the required deposit has varied from 9.9 percent to 110.2 percent of the fiscal year's revenues in excess of forecast. Potential revisions to the formula should result in required deposits that more closely align with actual revenue surpluses.

Required RSF Deposits, Percent of Revenue Surplus (in millions)			
End of Fiscal Year	**Amount Restricted for RSF Deposit**	**Amount of Revenue Surplus / (Shortfall)**	**Required Deposit % of Rev Surplus**
2013	$243.2	$264.3	92.0%
2014	$0	($437.8)	0.0%
2015	$605.6	$549.6	110.2%
2016	$0	($268.9)	n/a
2017	$0	$134.1	n/a
2018	$262.9	$552.6	47.6%
2019	$77.4	$778.8	9.9%
2020	$0	($234.2)	n/a
2021	$1,127.7	$2.557.7	44.1%
2022	$904.6	$1,936.6	46.7%

Conclusion

An analysis of the Commonwealth's reserve funds relative to general fund revenues and expenditures, as well as our funded status with respect to pension liabilities, shows that Virginia is well protected against a potential downturn in revenue collections. While it might be argued that a larger reserve provides greater security, it is our responsibility to maintain a level of cash on the balance sheet that is commensurate with the risk of potential downturn in revenues. Based on our analysis, we believe that a maximum combined balance of 15 percent is appropriate. Virginia compares well to peer AAA-rated states at current reserve fund levels, supporting the recommendation to maintain the statutory 15 percent cap on the combined balance of the Revenue Stabilization and Revenue Reserve Funds. In addition, it is recommended that the statutory provisions requiring the Governor to include in his budget proposals an additional Super Deposit to the Revenue Stabilization Fund be considered for elimination, as the creation of the Revenue Reserve Fund provides a more effective vehicle for accumulating reserves and responding to unforeseen revenue downturns. Lastly, the formation of a workgroup is recommended to consider potential constitutional amendments to simplify the Constitutionally-mandated Revenue Stabilization Fund deposit formula.

APPENDIX: FUND WITHDRAWALS

Revenue Stabilization Fund

Article X, Section 8 of the Constitution of Virginia provides the General Assembly may appropriate an amount for transfer from the Fund to compensate for no more than one-half of the difference between the total general fund revenues appropriated and a revised general fund revenue forecast presented to the General Assembly prior to or during a subsequent regular or special legislative session. However, no transfer shall be made unless the general fund revenues appropriated exceed such revised general fund revenue forecast by more than two percent of certified tax revenues collected in the most recently ended fiscal year. Furthermore, no appropriation or transfer from such fund in any fiscal year shall exceed more than one-half of the balance of the Revenue Stabilization Fund.

Revenue Reserve Fund

§ 2.2-1831.4 of the Code of Virginia provides that in the event that a revised general fund forecast presented to the General Assembly reflects a decline when compared with total general fund revenues appropriated, and the decrease is two percent or less of general fund resources collected in the most recently ended fiscal year, the General Assembly may appropriate an amount for transfer from the Fund, not to exceed 50 percent of the amount in the Fund, to the general fund to stabilize the revenues of the Commonwealth.

Furthermore, when the General Assembly is not in session, after review of the May general fund revenue collections and certification to the General Assembly that actions to curtail spending will not be sufficient to avoid a cash deficit, the Governor may withdraw amounts appropriated to the Fund to avoid such cash deficit.