BUDGET SURPLUSES IN ARKANSAS

HOW DO THEY GET THERE AND WHERE DO THEY GO?

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ARKANSAS ADVOCATES FOR CHILDREN & FAMILIES

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4 THINGS YOU SHOULD KNOW ABOUT BUDGET SURPLUSES IN ARKANSAS

1. Larger surpluses mean a smaller pool of money for major programs like pre-K and often end up benefiting "pet projects." Surplus spending is harder to track and is not subject to the same scrutiny as other "normal" budget spending.
2. Surpluses aren't pocket change. The 89th general assembly approved $382 million in projects for the General Improvement Fund, a major outlet of surplus money.
3. Surpluses are bigger than they used to be. Before 2005 Arkansas never has a surplus over $100 million, now it is common to see surpluses between $200 and $400 million.
4. Arkansas is the only state that fails to meet recent budget forecasting best practices from the Center on Budget Policy Priorities. Accurate and transparent forecasting practices are essential for making smart budget choices.

The state budget, or what the state chooses to spend money on, is essentially a list of priorities. As with any state budget, the financial demands on the Arkansas budget far exceed our state's ability to meet all needs. There is never enough state revenue to provide funding for all programs. Overly conservative state budgeting practices and budget surpluses can sometimes exacerbate this problem by unnecessarily restricting funding for critical programs that serve children and families. Some programs, like quality pre-K for example, have not received a dime of new funding in recent years while the state has large surpluses. Conservative budget estimates and larger surpluses generally allow Arkansas to avoid mid-year budget cuts, but they ultimately take away from the pool of money that could potentially go toward these projects from the outset.

It's only natural that the most valued or time sensitive expenses move to the front of the line. Typically, the legislature makes these tough choices by prioritizing how it will allocate the revenues it has collected to state agencies according to the Revenue Stabilization Act (RSA).[1] In some years, however, the state spends less than it budgeted and there is a surplus at year's end. As with other revenues, the legislature determines how surplus funds are spent.

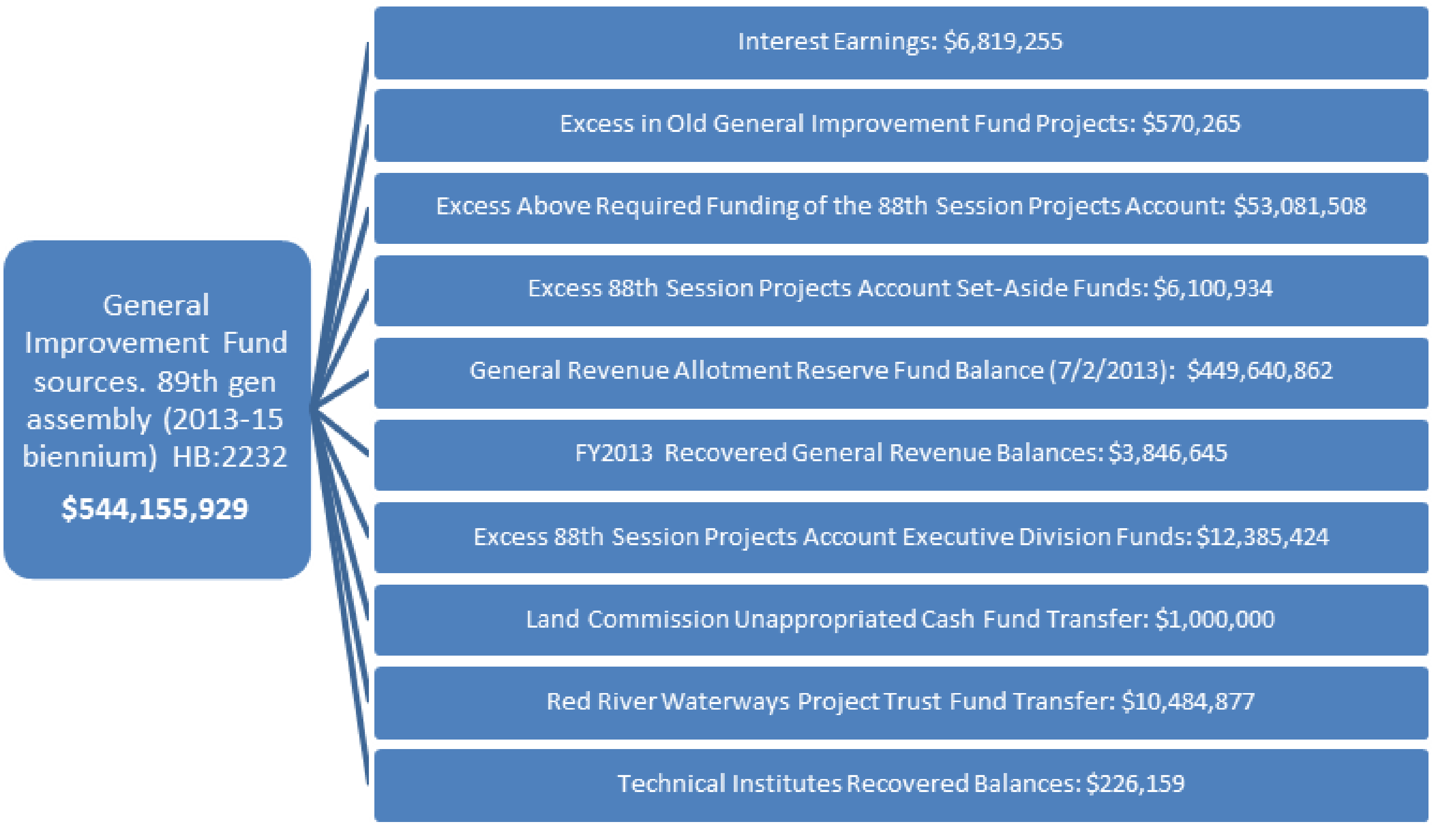
There is typically less public transparency, or at least less public understanding, about how surplus funds are spent compared to the allocation of new state revenues collected and distributed to state agencies via the Revenue Stabilization Act (RSA). Decisions about the spending of surplus funds often are made beyond closed doors and in the waning days of legislative sessions and are reflected in General Improvement Fund legislation. This lends itself to increased spending on "pet projects" through the General Improvement Fund.

WHY DO WE SOMETIMES HAVE A SURPLUS?

Surpluses happen when the state collects more tax revenue than expected, or if state expenses are under budget. Unexpected booms to the economy or overly conservative revenue estimates can result in a year-end surplus. Unexpected dips in big state expenses can also leave the state with extra funds. State agencies can also come in under budget because of things like salary savings from turnover, or delaying a project. When these types of things happen, the leftover funds could end up contributing to the surplus.

It is difficult for the state to calculate how much money will be available and how much it will need in the future. Even a relatively accurate revenue forecast can result in a year end budget surplus of hundreds of millions of dollars in some years. The Arkansas Department of Finance and Administration creates a forecast of how much money will be available to spend. The legislature then uses these estimates to establish a budget. Each yearly budget must include a prioritization of which funds to pay into first if there is a money shortfall.

The budget they come up with allocates money to funds like Human Services and General Education. The legislature usually divides new state general revenues into "A", "B", and "C" categories as part of the Revenue Stabilization Act (RSA). Allocations in the "A" category have top priority and normally are 100 percent funded. If there is money left over after funding the "A" category, the "B" category is also funded, and so on. The budget is "fully funded" if there are enough general revenues to cover all "A", "B", and "C" categories. If there is not enough money to fully fund the budget, all remaining funds get a percentage of their original allocation. If there is more than enough money to fund all categories, the state ends the fiscal year with leftover money, or a "surplus."



THE GIF: A MAJOR OUTLET OF SURPLUS FUNDS

The General Improvement Fund, or "GIF," is a major outlet for surplus funds. The legislature determines funds that contribute to the GIF during each biennium.[2] General revenue collections that come in above forecast, or "surplus" funds, automatically flow into the General Revenue Allotment Reserve Fund (GAD) and then can be distributed through The Revenue Stabilization Act, spent directly on projects (like in supplemental bills), or sent to the GIF. Although there are many worthwhile projects funded through the GIF, this surplus money generally does not receive the same level of public scrutiny or transparency as new state revenues collected and distributed to state agencies via the RSA and decisions about state agency budgets.

In recent years, the GIF has included a mix of "set asides" (such as supplemental funding for the Medicaid program), funding for programs/projects controlled by the governor, and smaller projects controlled by the legislature. Historically, the GIF has been most known for local projects passed and controlled by individual legislators. Amendment 14 to the Arkansas Constitution and subsequent Arkansas Supreme Court cases generally prohibit the General Assembly from enacting "local" legislation that designates GIF funds for a specific local project. In practice, however, the state agencies charged with distributing GIF funds "work with" the legislative sponsor of a general improvement bill to make decisions about which projects are funded. The most influential legislators usually have the greatest say over which projects get funds. The General Assembly usually uses GIF money for one-time expenses like a local capital improvement project or funding for a local program.

The General Assembly creates the GIF bill and decides how funding for GIF projects will be divided among three categories. The first of three main categories is the "set aside" or "off the top" projects, which are given first priority. The second category is the executive division (the governor) and the third is the legislative division. The GIF bill protects "set asides" from budget shortages so that any deficiency in funding comes out of the other two divisions first. The executive and legislative divisions are funded together. If there is a shortfall, they both take the same percentage cut. Any funding not allocated to one of these three categories is diverted to the GIF account for the next legislative session.

Some GIF funds are deposited into the Arkansas Rainy Day fund as a "set-aside," although the rainy day fund can also have multiple sources. With the roller coaster economy of the last decade, it is sound policy for states to use surpluses to build up a rainy day fund for future financial needs or emergencies. In such cases, there should be an explicit and publicly available policy and explanation of the rainy day fund, including how big it should be, what it can be used for in the future, and how decisions will be made about its future use. Arkansas has a rainy day fund to address unexpected expenses or lapses in revenue, but that is not where most surplus money ends up. In the 89th General Assembly, Rainy Day projects were only about four percent ($16 million) of total GIF funds.

89th General Assembly GIF Projects (2013-2015 biennium):	
Total Set-Aside Projects	$181,485,551
Total Legislative Division	$70,000,000
Total Executive Division	$114,375,596
Total Technical Institutes	$226,159
Total Rainy Day Projects	$16,100,934
Grand Total Funded	$382,188,240

Because surplus funds have gone to the GIF over the past two years, we can get an idea of recent surplus expenditures by looking at 89th general assembly GIF spending. Keep in mind that although surplus money can be a major source of GIF money, the GIF has multiple sources. The 89th general assembly approved GIF funding for $382 million worth of projects. Of the total approved amount, $181 million was for set-aside projects.[3] The biggest set-aside projects authorized during the 89th General Assembly include the DHS Medicaid program, various maintenance and upgrades for Institutions of Higher Education and Technical Institutes, and lease payments for the Department of Corrections.[4] The biggest executive division project is for public school academic facilities and the legislative division's biggest expense is for the Department of Finance and Administration. The DFA funds projects like economic development grants and scholarships for historically black colleges.

Specific Major Projects from GIF (Approved $)	
Set Aside:	Released as of 6/30/2014
DHS Medical Services - Medicaid Program	$107,735,551
Dept. of Correction Lease Payments	$13,000,000
Insts. of Higher Education and Technical Insts.	$28,000,000
Executive: Biggest release so far	
Education Public School Academic Facilities	$20,000,000
Legislative: Biggest release so far	
Department of Finance and Administration	$42,362,000

LARGE BUDGET SURPLUSES CAN REDUCE BUDGET TRANSPARENCY

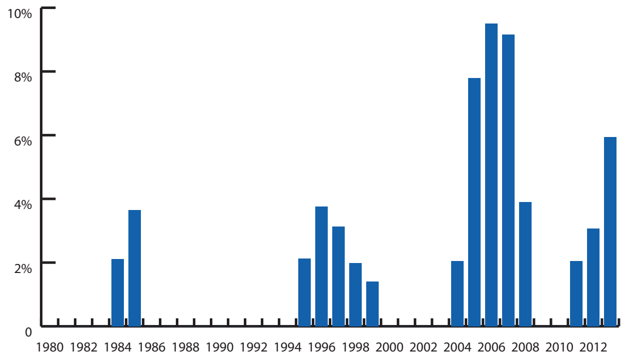
While conservative forecasting and budgeting practices has allowed Arkansas to avoid the major budget cuts (many in mid-year) that has occurred in other states, Arkansas has seen historic surplus levels over the past decade. During this time, the legislature has partly contributed to surpluses by not creating allocations for all of the money that they expect to come in from tax revenue. In the 1980s and 1990s it was more common to have a specific plan for any extra revenues by having significant backup allotments that exceeded the forecast estimates.

With a category A-B-C allocation plan in place for spending higher than anticipated revenue, Arkansas had smaller and less frequent surpluses in those years. Recently, it has been less common for the legislature to make a plan for all of the revenue that they expected to come in. By doing this, they are building an intentional surplus into the budget. This is like only budgeting to spend part of your paycheck so that you can have "pocket money" leftover. With crucial programs such as pre-K going underfunded year after year, it is important that the last dollar spent by the legislature is given just as much thought and consideration as the first.

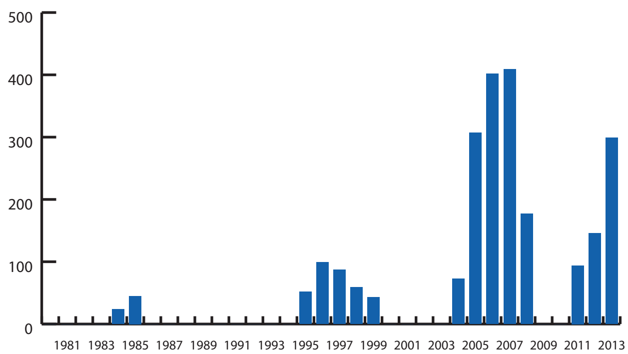
Underestimating state general revenue collections is another way to generate surplus money. Overly conservative revenue forecasts have contributed to higher surpluses in recent years. It is important that the predictions about how much money will be available are accurate. If revenue comes in below expectations, some programs might face sudden cuts, but coming in well above forecast can also be problematic. When actual revenues come in way above estimates because of an overly conservative revenue forecast, it amplifies the impact of any naturally occurring surplus. Rather than being deposited into a rainy day fund, surplus money has frequently ended up in the GIF and spent with relatively fewer restrictions and less public transparency. It also reduces state funding that might otherwise be available to support important programs like child welfare, juvenile justice, and pre-K that typically have been flat or underfunded because they are not budget priorities for the state. Programs for vulnerable populations are often at risk in such instances.

The amount of surplus revenue in Arkansas never surpassed four percent of state general revenue available for distribution until 2005. Since then we have seen surpluses as high as 10 percent of general revenue. 2005 was also a

ACTUAL SURPLUS AS A PERCENT OF ACTUAL REVENUE
Percent, by year



ACTUAL SURPLUS IN DOLLARS
By year, in millions

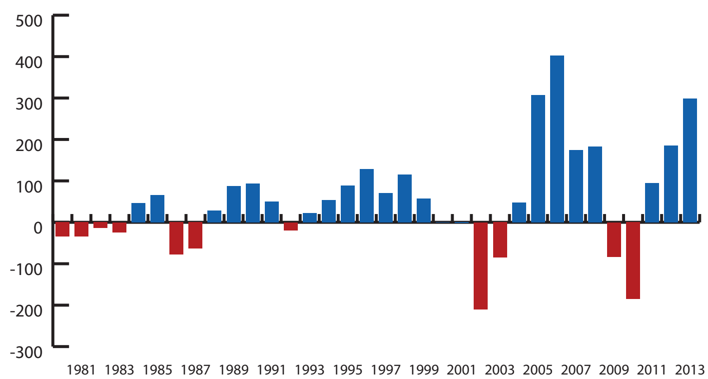


record year for overshooting the revenue estimate. Revenue in 2005 was eight percent (or $307 million) higher than the first prediction. In the 25 years before that, no budget overshot the forecast by more than five percent (or about $99 million). This suggests the legislature may be relying on DFA revenue forecasts that are too conservative, and that they may be building an unusual level of surplus into the budget. Accurate forecasts and prudent budgeting should lead to small and infrequent surpluses.

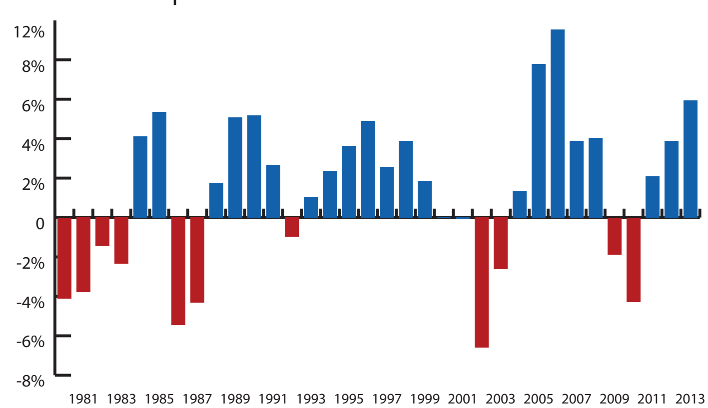
The actual net available revenue for distribution has tended to be much higher than the first DFA forecast in recent years. From 1980 to 2005, the actual revenue available for distribution was generally within $100 million of the original forecast. Since 2005, the initial forecast accuracy has been off by more than $150 million about half the time. But, $100 million difference means less today than it did 10 or 15 years because the overall budget is bigger. Another way to look at forecast accuracy is to measure the difference between the prediction and the actual as a percent of total revenue available for distribution. As a percentage of revenue, recent forecast inaccuracies are more in line with historical patterns. However, forecast inaccuracy as a percentage of revenue for 2013 was higher than at any time since 2007.

Forecast accuracy determines, in a large part, how much surplus we will have. Surpluses are not the same as the difference between the first forecast and the actual revenue collected, but they generally follow the same pattern. The pre-recession boom years of 2005, 2006, and 2007 had the greatest surpluses because of a fast growing economy that expanded revenues beyond expectations. If we eliminate these years from the discussion, recent years fall much closer the normal range in terms of forecast accuracy as a percent of revenue. The actual dollar amount of the surplus in 2013, however, is almost back to the boom levels of the mid-2000s even though our economy is only experiencing modest growth.

FORECAST ACCURACY IN DOLLARS
Actual net available for distribution minus the first prediction



FORECAST ACCURACY AS A PERCENT OF REVENUE
Difference between actual and forecasted net available for distribution as percent of actual revenue



SO WHAT CAN WE DO?

While conservative budgeting and forecasting has allowed Arkansas to avoid many of the large budget cuts that have plagued some other states during and coming out of the 2008 recession, it has likely contributed to the underfunding of some children's programs, such as pre-K, child welfare, and juvenile justice. It's clear that the high year-end surpluses that Arkansas has seen much of the past decade are grounded in our budgeting practices. Arkansas tied for last in a recent review of revenue forecasting practices by the Center on Budget Policy and Priorities (CBPP).

Our state meets only one out of five of the criteria set forth by the CBPP. Arkansas gets a single point by releasing forecasts and assumptions to the public. The CBPP recommends that states like Arkansas create a consensus forecast by including the legislature, governor, and outside experts in formulating the forecast from the beginning. The report also recommends increases in transparency by making forecasting body meetings open to any interested parties. The forecasting body should also review and adjust estimates regularly throughout the year to improve accuracy. (You can read more about how Arkansas compares to other states here. It is time for Arkansas to improve its forecasting and budgeting practices so that all of the state's tax revenue is spent as thoughtfully, and transparently as possible.

NOTES

1 http://www.arkleg.state.ar.us/assembly/2013/2014F/General%20Summary/2012FiscalSummary.pdf

2 http://www.arkleg.state.ar.us/assembly/2013/2013R/Acts/Act1518.pdf

3 They also approved an additional $43 million for teacher health insurance and $22 million supplemental funds transfer.

4 Have been funded as of June 30, 2014

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