Limits on State Government Spending: Initiative 601 and Its Possible Effects on Spending and Tax Policies in Washington

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Prepared for the Pacific Northwest Economic Conference
Seattle, 1994

April, 1994
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INTRODUCTION

Note: The analysis of I-601 presented here is based on the most recent legal interpretations of the initiative as provided by the Office of the Attorney General and the most recent available inflation, population, and personal income estimates and forecasts by the Office of Financial Management, the Economic and Revenue Forecast Council, the federal Bureau of Economic Analysis, and Data Resources Incorporated. Pertinent legal interpretations and economic/population data are subject to change.

On November 2, 1993, the Washington voters approved Initiative 601 (I-601). I-601 is an expenditure limit designed to limit growth in the state government's general fund to the rate of inflation and state population growth. This new spending limit replaces Initiative 62 (I-62), a revenue limit based on personal income growth and adopted by the voters in 1979.

I-601 had a definite impact on the fiscal policy debate in the most recent legislative session and is expected to continue to have a significant effect on the future development of the state's tax and spending policies.

Outline of Discussion

This paper will:

- provide a description of I-601 and compare it to certain features of I-62,
- look at general fund spending patterns over the fiscal period 1976 to 1993,
- compare spending in FY 1976 to FY 1993 with the growth allowed under I-601 and with other general measures of economic growth,
- compare the performance of I-62 with I-601 over the fiscal period of 1980 to 1993,
- examine the effect of adjusting the I-601 limit for actual spending and the choice of time period for the growth factors,
- examine growth patterns of major state budget drivers and compare these to the I-601 growth factors, and
- discuss some implications for the state budgeting process under I-601.

The Basic Provisions of I-601

I-601 replaces the revenue limit in I-62 with an annual expenditure limit. The I-62 revenue limit covered state general fund revenue while the I-601 expenditure limit applies to general fund spending.

Note: State general fund revenues are derived mainly from the the business and occupations tax and sales and use taxes. The state general fund supports mainly K-12 education, human services, higher education, and general government. Non general fund revenue sources include federal grants and matching funds, higher education tuition, the gas tax (used for transportation), and business contributions to the workers compensation and unemployment insurance trust funds.

The I-601 expenditure limit is designed to limit growth in the state government's general fund to the rate of inflation and state population growth. The expenditure limit must be lowered if program costs or moneys are shifted out of the state general fund.

Any revenues received in excess of the I-601 expenditure limit must be deposited in a newly created emergency reserve fund which replaces the current budget stabilization account. The Legislature can appropriate monies from the reserve fund by a two-thirds vote of each house, but only if the expenditure limit is not exceeded as a result. If the emergency reserve fund balance exceeds five percent of the biennial general fund revenues, the excess is deposited in a newly created education construction fund which may be appropriated for common school or higher education construction by a majority of each house of the Legislature. The education construction fund may be appropriated for any purpose by two-thirds vote of each house of the Legislature and approval of voters at the next general election.

The I-601 expenditure limit may be exceeded, for natural disasters, upon declaration of an emergency for a period not to exceed 24 months by a law approved the a two-thirds vote of each house of the Legislature and signed by the Governor. The expenditure limit may be exceeded for other purposes after a two-thirds vote of each house of the Legislature plus approval of voters at a November general election.

In addition, I-601 established some new restrictions on increasing revenues. No new tax, increased taxes, or revenue-neutral shifts may be imposed before July 1, 1995, without approval of the voters. After July 1, 1995, the Legislature can raise revenue up to the expenditure limit or enact revenue-neutral shifts only by a two-thirds vote of each house. No fee may be increased by a percentage in ex[illegible]s of the fiscal growth factor without legislative approval.

I-62 prohibited the [illegible]lature from requiring local governments to offer new or expanded services unless the co[illegible] are reimbursed by the state. I-62 did not specify what counts as reimbursement. In 1990, the Legislature amended the initiative to count increased local revenue and state revenue-sharing payments as reimbursement. I-601 strengthened the limits on imposing new programs or increased levels of service for existing programs on local governments by requiring full reimbursement by specific appropriation.

COMPUTATION OF THE SPENDING LIMIT

The I-601 spending limit applies to the state general fund, which represented approximately half of all budgeted funds in the 1991-93 Biennium. (see "Note" on p.3). The spending limit calculation is based on a three year rolling average of inflation and population growth, adjusted for shifts of program costs and revenue streams from the general fund to other funds.

Application of Three Year Rolling Average of Inflation and Population Growth

Although FY 1996 is the first year in which the spending limit actually applies, the calculation of the spending limit for FY 1996 depends on the computation of hypothetical spending limits for FY 1990 through FY 1995, as prescribed in section 2 of the initiative. Beginning with actual state general fund expenditures in FY 1990, the hypothetical spending limit for FY 1991 is computed by multiplying FY 1990 actual expenditures by the average of inflation and population growth for fiscal years 1987, 1988, and 1989. The spending limit for subsequent years is computed by multiplying the <u>spending limit</u> of the previous year by the average of inflation and population growth for the three prior years.

Re-Basing to Actual Expenditures

Beginning with the computation of the spending limit for FY 98, the spending limit for a given fiscal year is computed by multiplying <u>actual expenditures</u> of the previous year by the average of inflation and population growth for the three prior years. Using actual expenditures for the prior year, rather than the mathematically determined spending limit as the base for computing a future spending limit, is known as "re-basing." As discussed below, this is a very important feature of I-601, which distinguishes it from the revenue limit it replaced (I-62).

> **Note**: One of the early questions raised about key provisions of I-601 was whether re-basing is required. The Attorney General has advised that the initiative <u>requires rebasing</u>.

Adjustment of the Limit for Shifts of Program Costs and Revenues

In order to prevent evasion of the general fund spending limit through shifts of program costs and revenue streams to other funds, I-601 requires that the spending limit be reduced for these types of expenditure or revenue shifts.

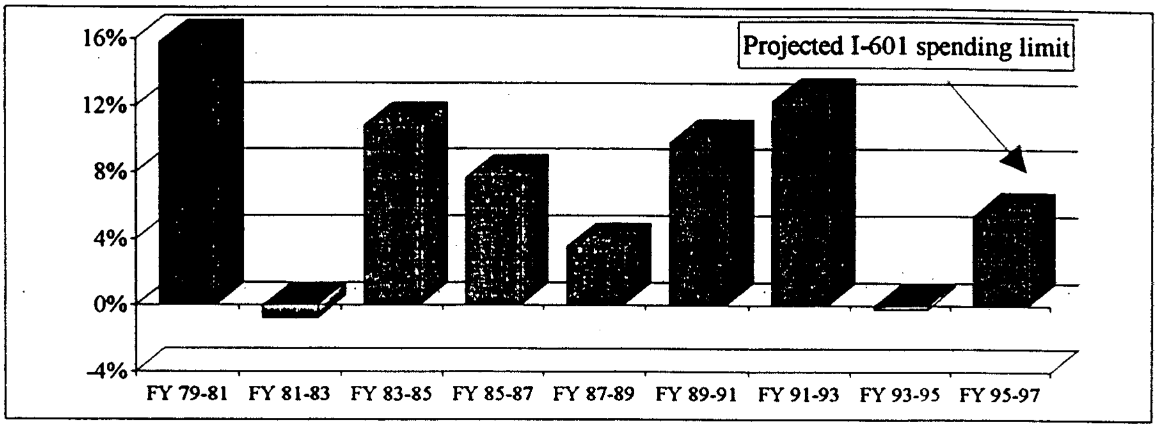
Forecasted Spending Limits

Based on present estimates and forecasts of inflation and population growth and current legal interpretations, the forecasted state general fund spending limit for the 1995-97 Biennium is

$17.708 billion. This would represent an 5.6 percent increase in real spending over the 1993-95 Biennium supplemental budget adopted by the 1994 Legislature.. This compares to average biennial real spending growth for the previous nine biennia of 8.1 percent. See Figure 1. After adjustments for tax reductions adopted by the 1994 Legislature, the state's official February 1994 general fund revenue forecast is $68 million below the estimated spending limit for the 1995-97 Biennium.

Figure 1

The projected spending limit for 1995-97 is about 2.5 percentage points below historical biennial real growth in state GF spending



CONCEPTUAL COMPARISON OF I-601 SPENDING LIMIT AND I-62 REVENUE LIMIT

I-62 first limited revenue in FY 1981 and was based on revenue from FY 1979. State personal income growth was the basis for growth in the I-62 revenue limit. The I-601 limit starts with FY 1996 and is based on spending in FY 1990, with allowable growth pegged to increases in population and inflation.

The Limiting Factors

The limiting factors in I-601 (inflation and population growth) compared to that of I-62 (personal income growth) suggest that I-601 will constrain growth of government more than I-62. This is because personal income generally grows faster than the combination of inflation and population growth. This can be seen from the following identity:

Personal Income Growth =

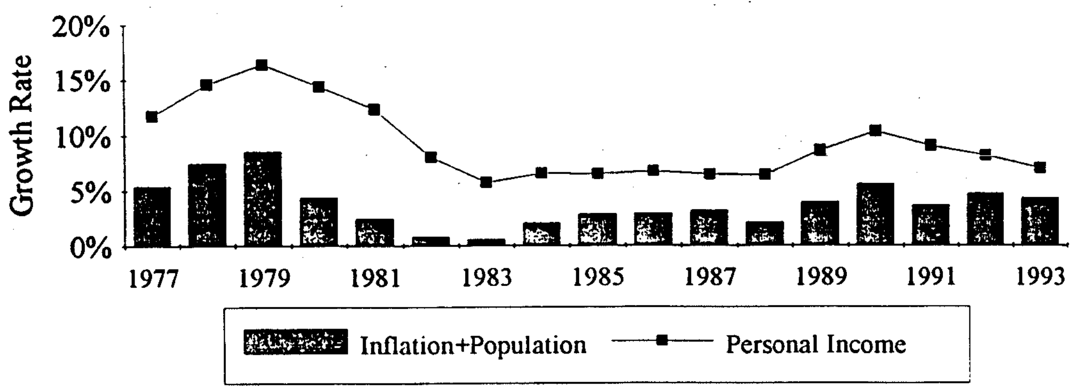
Inflation + Population Growth + Real Per Capita Personal Income Growth

Unless real per capita income growth is negative, personal income growth exceeds the sum of inflation and population growth. Thus, in the long run, I-601 will probably limit spending growth more than I-62 limited revenue growth.

The expected annual average difference between the two growth limits is roughly equal to real annual average growth in state per capita personal income. Historically, from FY 1976 to FY 1993, real average annual per capita personal income growth in Washington has been 1.6 percent per year. See Figure 2

Figure 2

Personal income grows more quickly than inflation plus population



Re-Basing

Based on a comparison of their limiting factors alone (inflation plus population growth for I-601 versus personal income growth for I-62), I-601 should restrain growth in general fund spending more than I-62. However, a more important reason why I-601 is expected to hold down spending more than I-62 is the inclusion of "rebasing" in I-601, and its absence in I-62.

Each year, the I-62 revenue limit was calculated by taking the previous year's limit and multiplying it by a three year rolling average of state personal income growth. In contrast, the I-601 limit is increased by a three year rolling average of inflation and population growth. However, beginning with the FY 1998 calculation, the I-601 limit is not calculated from the previous year's limit but, instead, from the previous year's actual expenditures. When revenues fell below the limit under I-62, the limit was not "rebased" to actual revenues. This, in fact, occurred during the period immediately following the adoption of the limit and is generally considered the reason that the I-

62 revenue limit never constrained revenue even during the rapid revenue growth of the late 1980's. Under I-601, failure to spend up to the limit will cause a rebasing of the limit to actual expenditures and a reduction in future limits.

As long as the state takes in enough revenues in any fiscal year so that it can spend what is allowed under the spending limit, there is no difference between a rebasing and non-rebasing system. However, if revenues slow down, due either to a recession or a reduction in tax rates, it is possible that available revenues will be less than the mathematically derived spending limit, causing spending in that year to be less than the spending limit. In this situation, the difference between a rebasing and non-rebasing system becomes apparent: In a re-basing system, the limit is permanently lowered when actual spending in any year is below the limit.

SIMULATED COMPARISON OF I-62 AND I-601: FY 1981 to FY 1993

A simulation was prepared comparing the I-62 revenue limit and the I-601 spending limit (as it might have applied in the 1980s) to actual state general fund revenue growth. The simulation assumes that the Legislature would have adopted tax increases sufficient to allow spending up to the limit under I-601. The simulated effects of I-601 were also examined without re-basing.

Impacts of Different Limiting Factors

As Figure 3 shows, over the course of the simulation period, actual revenue collections are never constrained by the I-62 limit, although the limit is almost reached in FY 1990. The effects of I-601 are much more dramatic, as shown in Figure 4. Even without re-basing, I-601 would have brought spending below actual revenue collections after FY 1989. From FY 90 to FY 93, the I-601 (without re-basing) would have been about $400 million per year below revenue collections. This gap essentially represents the difference between pegging spending and revenue growth to personal income (as in I-62) and basing it on inflation plus population growth (as in I-601).

Figure 3

Actual revenues grew more slowly than the I-62 limit allowed

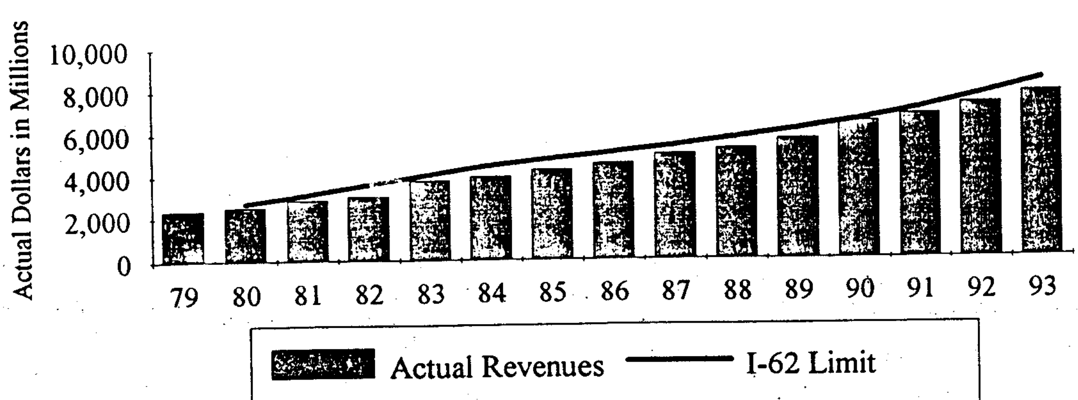
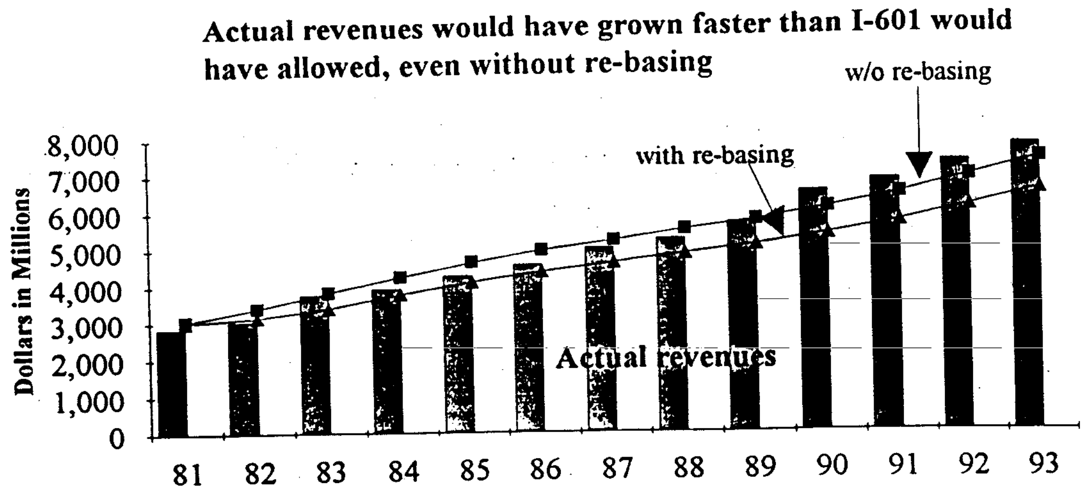


Figure 4



Impacts of Re-Basing

With re-basing, the effect of I-601 is even greater. Under I-601, spending would have been less than actual revenues over nearly the entire simulation period. From FY 1983 to FY 1993, spending under I-601 would have averaged about $600 million per year below revenue collections, reaching $1.2 billion in FY 1993. See Figure 4.

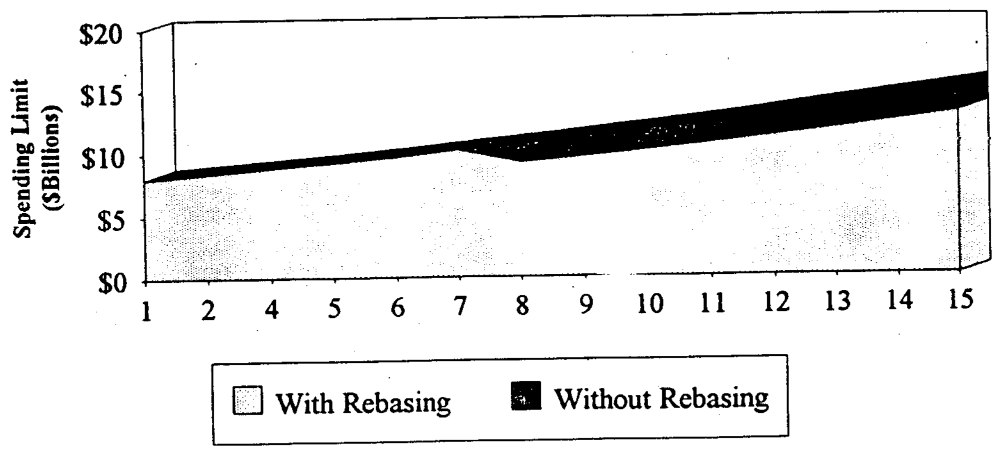
The basic goal of I-62 was to prevent revenues from growing faster than the "economy" (with personal income used to represent general economic growth). While this goal was achieved in the long run, revenues were able grow faster than the economy over shorter time spans. This was due mainly to the absence of a re-basing provision in I-62. Revenues, in fact, grew at an annual average rate of 8.8 percent between FY 1981 and FY 1993, compared to personal income growth of 7.4 percent per year.

The basic goal of I-601 is to prevent spending from growing faster than the "objective"need for government services (with inflation and population growth used as the indicator of objective needs). In contrast to I-62, the I-601 goal of limiting spending growth to no more than inflation and population will be met over any time span (unless emergency provisions of I-601 are used to spend faster than the limit). Indeed, due to the re-basing provision in I-601, spending in the long run may grow even <u>more slowly</u> than inflation and population growth as measured from the starting point of the initiative, FY 1996.

Spending growth that is slower than the basic goal set forth in I-601 is distinctly possible under the initiative because in recessionary periods, revenues and reserves may be insufficient to allow spending up to the limit. When this occurs, re-basing will cause the spending growth curve to shift downward, below the original spending limit line. Because re-basing above the spending limit is not possible under I-601, each instance of downward re-basing due to a recession will permanently reduce the spending limit. Thereafter, the limit will never "catch up" with inflation and population growth relative to the original spending base. See Figure 5.

Figure 5

Due to rebasing, a one-time reduction in revenues could permanently reduce all future spending limits

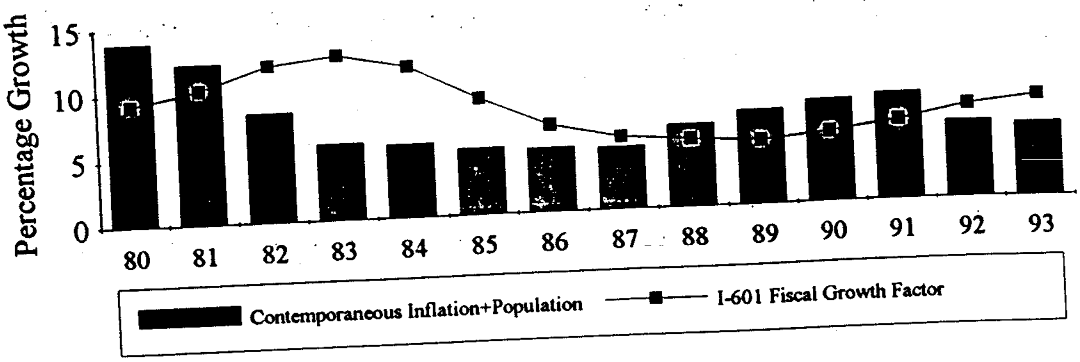


Impact of Lagged Growth Factors

Controls on revenues or spending, such as I-62 and I-601, have preferred to rely more on recent economic and population data to set growth limits, rather than on forecasts of these data. Reliance on recent actual data means that growth limits will not necessarily reflect contemporaneous economic conditions and population growth, but rather those of the prior several years. In addition to the absence of re-basing, I-62 failed to constrain revenue growth because its initial limits were based on several years of very rapid state personal income growth, from 1976 to 1979. Strong personal income growth of the late 1970s was then used to establish revenue limits for the early 1980s -- a period of very slow economic growth. In this case, the economy, rather than I-62, placed the real limit on revenue growth.

Figure 6

Because of lagged growth factors, I-601 limits would have been, on average, nearly 3 percentage points different from actual inflation and population growth



The I-601 spending limit for a given fiscal year is based on average inflation and population growth for the three year period ending two fiscal years prior to the one for which the limit is being calculated. Thus, the spending limit for FY 1996 (termed the "budget year") will be based on the average of inflation and population growth for FY 1992, FY 1993, and FY 1994 (termed the "base years"). If, for example, inflation is low during the base years, but rises sharply in the budget year, the spending limit will be set below the level required for the cost of government services to keep pace with inflation. On the other hand, if inflation was high during the base years, but dropped sharply in the budget year, the limit would be set higher than what is needed for the cost of services to keep pace with inflation.

Between FY 1980 and FY 1993, the average difference between the I-601 lagged growth factors for a budget year and the actual inflation and population growth for that year was 2.9 percentage points. The average difference was 2.4 percentage points for years in which the lagged factors underestimated actual growth, and 3.2 percentage points for years in which growth was over-estimated. See Figure 6.

THE MAGNITUDE OF THE SPENDING SLOW DOWN UNDER I-601

The simulated comparison of I-601 and I-62 already provides some insight into the magnitude of likely spending reductions required under I-601. This section takes a longer and simplified look at that question by moving the beginning of the analysis back three biennia, to FY 1976, and by examining historical state general fund spending growth against the basic limiting standard of I-601 -- inflation plus population growth.

This section also extends the analysis beyond the total state general fund (SGF) budget to include more specific areas of state government spending, such as K-12 education, human services, and corrections.

Two approaches to assessing the magnitude of the spending slow down under I-601 are considered:

(1) a comparison of historical I-601 fiscal growth factors (i.e., inflation and population growth) with historical spending growth, (2) a comparison of forecasted I-601 fiscal growth factors with forecasted spending in the absence of I-601 The latter is considered to provide the more appropriate perspective on the impact of I-601 on future spending.

Historical I-601 Fiscal Growth Factors Compared to Historical Spending Growth

The extent to which I-601 will alter spending behavior can be gauged by an examination of past spending and revenue growth in relation to the I-601 growth standards of inflation and population growth.

Between FY 1976 and FY 1993, state general fund spending increased at an annual average rate (AAR) of 9.7 percent (4.2 percent in real terms), compared. to an AAR of 7.7 percent (2.2 percent in real terms) for inflation and population. Thus, actual state general fund spending growth has been about two percent per year higher than that allowed by the basic I-601 growth limit standard. However, since the ten year outlook for inflation, population growth, and revenue growth is different from historical experience, the real impact of I-601 on spending is probably less than two percent per year.

Forecasted I-601 Fiscal Growth Factors Compared to Forecasted Spending in the Absence of I-601.

The more appropriate comparison is between forecasted I-601 fiscal growth factors and forecasted spending in the absence of I-601. ***To simplify the discussion, this analysis assumes average economic growth over the next ten years (i.e., no recessions or periods of economic boom) and no legislatively mandated tax reductions. It also assumes no re-basing. This means that the Legislature and Governor are assumed to always have sufficient revenue or revenue reserves to spend up to the limit. Also, this analysis does not reflect the lag required by I-601 between the base year and the budget year in the spending limit calculation.***

The following identify provides a basis for a ten year state general fund (SGF) revenue forecast (FY 1993 to FY 2003) reflecting forecasts of inflation, population, per capita personal income, and revenue elasticity:

SGF Revenue Growth = Personal Income Growth X Revenue Elasticity =

(Population Growth + Inflation + Real Per Capita Personal Income Growth) X Revenue Elasticity

Relying upon the Office of Financial Management (OFM) long term population growth forecast (1.3 percent for FY 1993 to FY 2003), the Data Resources Incorporated (DRI) long term Implicit Price Deflator (IPD) forecast (3.3 percent), the DRI long term real per capita income forecast (1.2 percent), and historical Washington revenue elasticity (0.95), state general fund revenues are expected to grow as follows:

Expected SGF Revenue Growth = (1.3 + 3.3 + 1.2) x 0.95 = 5.5 percent per year

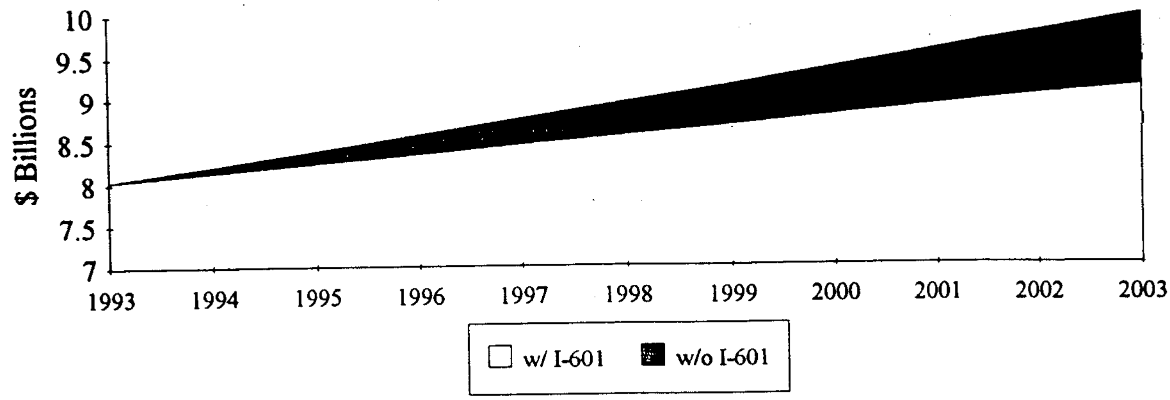
whereas,

Allowable Growth Under I-601 = Population Growth + Inflation = (1.3 + 3.3) = 4.6 percent per year

If one assumes that state general fund spending growth would equal state general fund revenue growth in the absence of I-601 limits, then without I-601, spending would grow about 5.5 percent per year over the next ten fiscal years. Under I-601, however, spending would be kept down to the rate of inflation plus population growth, which is expected to be about 4.6 percent per year. Thus, under the simplifying assumptions set forth earlier, with FY 1993 as the base year, state general fund spending would be reduced by nearly one percentage point per year under I-601. In FY 1994 dollars, this is a difference of about $219 million in spending after the first biennium, rising to about $1.6 billion in the fifth biennium. After five biennia, the cumulative difference is about $4.4 billion in state general fund spending. See Figure 7.

Figure 7

Under I-601, general fund spending will likely slow down by about one percentage point per year compared to forecasted spending in the absence of I-601



In reality, the typical business cycle will likely cause revenue collections to fall below the mathematically derived spending limit in at least one of the next five biennia. If, at that time, revenue reserves are insufficient to spend back up to the limit, the limit would be permanently re-based downward. If this occurs, spending will have grown more slowly than inflation and population growth relative to the FY 1993 base.

A Third Perspective - Forecasted I-601 Spending Compared to Historical Spending

Under I-601, expected allowable spending growth is 4.6 percent per year for the FY 1993 to FY 2003 period. This is only about one percentage point below the rate of spending growth which would have been expected in the absence of I-601. However, expected allowable spending growth under I-601 is about five percentage points below actual state general fund spending for the previous 17 fiscal years. As shown in the table below, the I-601 limit explains only a relatively small part of the difference between actual annual average spending in the FY 1976 to FY 1993 period, and expected allowable spending under I-601.

Spending will slow down compared to the previous 17 fiscal years, not only because of I-601, but also because slowdowns are expected in inflation, population growth, and real per capita income growth.

	Annual Average
Actual Spending Between FY 1976 and FY 1993	*9.7*
Expected Allowable Spending Under I-601	*4.6*
Difference	***5.1***

Explanation of Difference

Inflation	2.2
Population Growth	0.9
Real Per Capita Personal Income	0.4
Tax Changes and Revenue Elasticity	0.7
I-601 Limiting Factors	***0.9***
TOTAL	***5.1***

Possible Spending Slow Downs in Specific Program Areas

It is of course impossible to anticipate how the Legislature and Governor will allocate the slow down in state general fund spending that will likely be required under I-601. However, it is instructive to examine historical growth rates in state general fund spending in major functional areas of the state general fund budget and compare them to the expected rate of total spending under I-601. Because comparable budget data by major functional area were available only for the FY 1980 through FY 1993, this period will be used in the analysis of spending in major functional areas.

As discussed earlier, based on OFM and DRI forecasts, inflation and population will grow at an average annual rate of 4.6 percent between FY 1993 and FY 2003. Under the simplifying assumptions adopted earlier, this will be the approximate annual rate of spending growth allowable under I-601. Between FY 1980 and FY 1993, the state general fund total budget increased at an annual rate of 8.5 percent per year, as shown in the table below. The table also shows the annual average rate of spending increase by major functional area for the FY 1980 to FY 1993 period.

Table 1

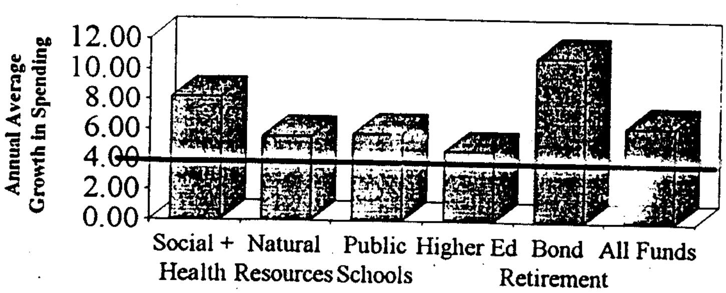
Functional Area	Spending, State General Fund Annual Average Rate of Growth, FY 80 - FY 93	Adjusted Using Contenporaneous Inflation and Population Growth
Social & Health Services	10.3	8.2
K-12 Education	7.9	5.8
Natural Resources	7.6	5.5
Higher Education	6.8	4.7
Bond Retirement	12.9	10.8
General Fund Total	8.5	6.4

However, to make allowable growth under I-601 comparable with historical growth, the latter must be adjusted for differences between historical inflation and population growth, and the growth expected in these factors over the next ten fiscal years. After these adjustments, annual average state general fund spending in the FY 1976 to FY 1993 period is 6.4 percent (rather than 8.5 percent). The same reduction must be made for spending in each of the major functional areas, as shown in the table above.

As Figure 8 shows, the largest differences between historical growth and expected allowable spending growth under I-601 are in human services and debt service (or bond retirement), where adjusted spending has increased between 8 and 11 percent per year. Of course, spending in all functional areas will not need to be reduced to the overall expected allowable spending growth under I-601 -- 4.6 percent per year. It will be the responsibility of future Legislatures to decide how the overall reduction in state general fund spending under I-601 is allocated among the various budget categories.

Figure 8

Since FY 1980, spending in several major program areas has been faster than expected allowable growth under I-601 -- 4.6% per year



Functional Areas

SOME IMPLICATIONS FOR THE STATE BUDGETING PROCESS UNDER I-601

I-601 is likely to cause some changes in fiscal policy in Washington. The two-thirds vote requirement for tax increases and the general limit on state general fund spending may affect the use of expiration dates on newly adopted taxes. The use of dedicated funds, and the adoption of tax exemptions are likley to be affected.

Expiration Dates on Newly Adopted Taxes

It is common for the Legislature to pass new taxes with expiration dates. Recent examples include the tire tax (adopted in 1985, changed in 1989, expires in 1994), taxes on cigarettes, soda pop, liquor beer and wine (adopted in 1989, expires in 1995), the Medicaid tax (adopted in 1991, scheduled to expire in 1993 but was eliminated earlier due to federal regulation changes), and the 6.5 percent business and occupation surtax (adopted in 1993, expires 1997). Since under I-601, the extension of expiration dates on taxes will also require the same two-thirds vote as the original adoption of a new tax, it is likely that fewer expiration dates will be used on new tax legislation.

Use of Dedicated Funds

Since the I-601 limit applies to state general fund spending and not to spending from dedicated funds, one would expect a movement of programs away from the state's general fund toward dedicated funds. This is especially the case with programs which are expected to grow more rapidly than the general fund limit.New programs are the most likely candidates for movement away from the general fund.

Although created six months before the adoption of I-601, the health service account illustrates the principle of using a dedicated fund outside the general fund. Since health care reform is just getting underway, the health services account, created as part of Washington's 1993 health care reform bill, is expected to grow rapidly during the initial five years of the program under enrollment goals in the Basic Health Plan and Medicaid are met. Had these expenditures been placed in the general fund, the general fund limit would have forced reductions in other general fund spending.

Also, under-funded general fund programs which lend themselves to funding by users fees may, in the future, be supported more by dedicated funds. Fee increases can then be used to pay for program expansion without crowding out other programs within the general fund limit. However, under I-601, the SGF spending limit will have to be reduced if the costs of programs are shifted to another fund.

Tax Exemptions

In the pre I-601 world, the "cost" of creating new tax exemptions was a reduction in revenues and therefore a reduction in program expenditures. In the I-601 world, if revenues are expected to exceed the spending limit (plus some cushion for a reserve) the "cost" may not be a reduction in program expenditures. In this case, the limit prevents use of the revenue for program expansion. A reduction in revenue through tax exemption does not reduce program expenditures, but reduces deposits into the I-601 reserve account. It is likely this reduction in "cost" will give rise to increased passage of tax expenditures (rate reductions, exemptions, etc.). In addition, it is likely that these tax expenditures will be adopted with sunset clauses since a repeal of an exemption will require a two-thirds vote in the future. Of course, tax exemptions and rate reductions reduce the amount of funds flowing into the reserve account, which increases the risk of spending below the limit during recessions, and permanently reducing the spending limit.

The 1994 Legislative session provided some evidence that this change in cost has an effect. Sales and business and occupation taxes were reduced by $48 million for the 1993-95 budget period and $183 million for the 1995-97 budget period. During the 1994 Legislative session it was estimated that, before tax reductions, resources would exceed the permissible expenditure limit by over $450 million. Since tax reductions did not appear to require program reductions, there was an incentive to cut taxes rather than place excess revenues in the emergency reserve account.

The concern about re-basing leads to the necessity of building up a sufficient reserve amount in good economic times in order to maintain appropriate spending levels during recessions. If a sufficient reserve amount is not maintained, then a single bad revenue year would affect spending decisions in the state for every following year. The reserve account acts to smooth the spending so that drastic actions are not required whenever the state experiences a downturn in the business cycle. The concern about re-basing and the need to maintain reserves adequate to avoid re-basing, also limits the amount of tax reductions and exemptions that can be legislated.