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RAINY DAY FUNDS: OPPORTUNITIES FOR REFORM

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Summary

States are in considerably better fiscal shape than they have been since 2001. State revenues have grown rapidly over the last few years, in marked contrast to the sluggish growth or declines in revenues between 2001 and 2004. This is good news. However, a return to budget deficits is inevitable at some point. In general, states have used the better times to prepare for this eventuality by rebuilding their reserves. But many states could do more.

The state experience coping with the fiscal crisis of the early part of the decade showed the importance of reserve funds but also highlighted the need for larger reserves than most states have traditionally kept on hand and for more flexible policies governing their use. Between 2001 and 2004 states struggled to close cumulative deficits of over $250 billion. The first place they turned to close these gaps were rainy day funds and budget reserves. At the end of 2000, state balances stood at $49 billion — 10.4 percent of spending. This was more than double the size of the reserves on hand prior to the last recession of the early 1990s. But even these significant reserves represented less than one-fifth of the cumulative deficits that states faced.

This experience reinforced the conclusions of a 1999 study by the Center on Budget and Policy Priorities as well as recommendations from the Government Finance Officer's Association that an adequate level of total reserves is 15 percent of a year's expenditures — or more.

Over the last few years, states have replenished their reserves more rapidly than they did after the downturn of the early 1990s. In aggregate, state budget reserves totaled more than 10 percent by the end of fiscal year 2006 — just two years after the end of the fiscal crisis. However, there are indications that rather than continuing to grow, this level may represent the peak for this expansion. In some states, the amount that can be deposited into a Rainy Day Fund is capped. Other states are considering or have adopted tax cuts or are considering new spending initiatives without ongoing funding. And there are some signs that state tax growth rates are leveling off. The combination of these factors are likely to reduce rather than increase state reserve levels at a time when reserves in many states are still well below the amount suggested by the Center's earlier paper. Only nine states — Alaska, Wyoming, North Dakota, Nebraska, Montana, Delaware, Louisiana, Alabama, and Idaho

[1] Former Center on Budget and Policy Priorities staff member Robert Zahradnik wrote an earlier version of this report.

— ended fiscal year 2006 with reserves greater than the 18 percent that the Center's report determined was necessary on average to maintain services during a moderate recession.

Both the level of reserves and the policies states use to manage rainy day funds determine the effectiveness of these budget "cushions." In addition to increasing the level of their reserves, state policymakers can adopt some critical policy changes to improve their reserve policies so that they are better prepared for the next fiscal crisis. These steps include the following.

- **Create rainy day funds**. Arkansas, Colorado, Illinois, Kansas and Montana do not have separate rainy day funds. These states should create separate funds dedicated to saving resources during good times to cushion the blow of a recession.

- **Increase or remove rainy day fund caps**. Rainy day fund caps place a limit on how large the fund can grow, typically measured as a percent of the budget. If rainy day funds are statutorily or constitutionally capped at an inadequate level, such as 10 percent of the budget or less, then states are going to have difficulty accumulating adequate reserve balances. The first step states could take to improve their rainy day funds is either to remove the cap — perhaps substituting targets for a fixed cap — or to increase it to a more adequate level such as 15 percent of the budget.

- **Improve rainy day fund deposit rules**. Most states place a low priority on saving by only depositing year-end surpluses into their rainy day funds. States could develop a process to integrate rainy day fund transfers into the budget as part of an overall reserve policy that places a high priority on saving.

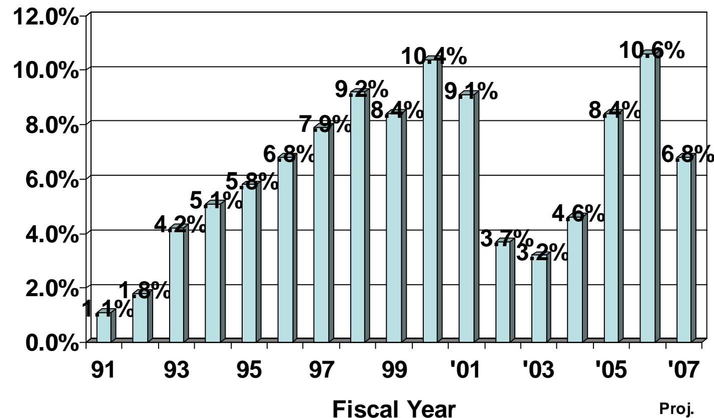
- **Eliminate onerous replenishment rules**. Six states — Alabama, Florida, Missouri, New York, Rhode Island and South Carolina — and the District of Columbia have created rules that require rainy day funds, after they are used, to be quickly replenished even if economic conditions have not improved. These replenishment rules both create a disincentive for using the fund and place the rainy day fund in competition with other programs for scarce resources during an economic downturn. These replenishment rules can be removed.

- **Remove limits on legitimate use**. Some states have reduced the effectiveness of rainy day funds in addressing budget deficits by requiring a super-majority of legislators to release the fund or by placing an arbitrary limit on how much of the fund can be released at any one time. These restrictions can be repealed.

Rainy Day Funds and other Reserves Helped States Weather the Recent Fiscal Crisis but Larger Funds Could Have Been More Effective

The experiences of the states during the severe fiscal crisis triggered by the 2001 recession shows that reserves in many states are inadequate. Between 2001 and 2004 states struggled to close cumulative deficits of over $250 billion. The first place they turned to close these gaps were rainy day funds and budget reserves. States had done a better job of saving during the years leading up the fiscal crisis than in the years leading up to the previous economic downturns. At the end of 2000, state balances stood at $49 billion — 10.4 percent of spending. Prior to the last recession of

FIGURE 1



Source: National Association of State Budget Officers, Fiscal Survey of the States, December 2006

the early 1990s, states had total balances of only 4.8 percent of expenditures. But even these significant reserves represented less than one-fifth of the cumulative deficits that states faced.

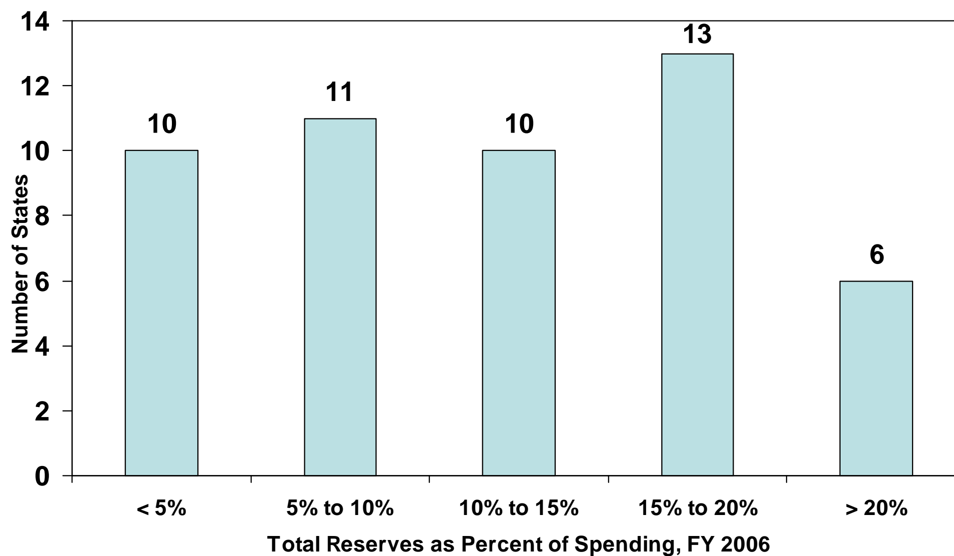
The reserves nevertheless were critically important during the early part of the fiscal crisis. Roughly $30 billion in state reserve funds were used to help close state budget deficits and prevent the need for additional spending cuts or tax increases. States were able to use reserves to close the unexpected deficits — particularly mid-year deficits — that occurred in the first years of the fiscal crisis, giving states needed time to develop longer-term tax increase and spending reduction proposals. Reserves closed about one-quarter of the deficits that developed through fiscal year 2003.

The state experience in the early part of the decade shows the need for larger reserves than most states have traditionally kept on hand. States have replenished their reserves more rapidly than they did in the 1990s. In aggregate, state budget reserves again totaled close to 11 percent at the end of fiscal year 2006 — just three years after the end of the fiscal crisis. However, there are indications that this level may represent the peak for this expansion.

Some states have reached or are approaching statutory caps placed on the amount that can be deposited into their Rainy Day Fund. Other states are considering or have adopted tax cuts or are considering new spending initiatives without the ongoing funding to support the tax cuts and expenditures. In addition, there are some signs that state tax growth rates are leveling off. The

FIGURE 2

Most States Have Inadequate Reserves



Source: National Association of State Budget Officers, Fiscal Survey of the States, December 2006

combination of these factors are likely to reduce rather than increase state reserve levels — budget balances plus rainy day funds — at a time when reserves in many states are still well below the level that research and experience suggest is adequate. The National Association of State Budget Officers projects that state reserves in aggregate will decline from 10.6 percent of budgets to 7.9 percent by the end of fiscal year 2007 based on the budgets adopted last year. (See graphs.) Even if states simply maintain the higher levels of fiscal year 2006, state reserves will fall short of the amounts needed.

- The amount of reserves on hand differs widely by state from less than one percent in reserves in Arkansas, Michigan, Mississippi, and Wisconsin to more than 70 percent in Wyoming and Alaska.

- Only nine states — Alaska, Wyoming, North Dakota, Nebraska, Montana, Delaware, Louisiana, Alabama, and Idaho — ended fiscal year 2006 with reserves greater than the 18 percent that the earlier Center report suggested was necessary on average to maintain services during a moderate recession. (See Tables 1 and 2.)

- Ten states — Vermont, Pennsylvania, Rhode Island, Colorado, Illinois, Maine, Michigan, Mississippi, Wisconsin, and Arkansas ended fiscal year 2006 with reserves of less five percent.

TABLE 1: CURRENT RESERVES - FISCAL YEAR 2006 PRELIMINARY ACTUAL				
State	Rainy Day Fund Balance	General Fund Balance	Total Reserves (GF balance plus rainy day fund)	Total Reserves as a % of Spending
Alabama	419	907	1,325	19.0%
Alaska	2,396	0	2,396	73.8%
Arizona	650	916	1,565	17.5%
Arkansas	-	0	-	0.0%
California	a	9,530	9,530	10.3%
Colorado	-	252	252	3.6%
Connecticut	1,112	b	1,112	7.6%
Delaware	a	691	691	21.7%
Florida	1,068	3,572	4,640	17.1%
Georgia	a	1,863	1,863	10.4%
Hawaii	54	732	786	16.8%
Idaho	109	302	411	18.5%
Illinois	276	590	866	3.6%
Indiana	328	411	739	6.1%
Iowa	392	149	541	10.8%
Kansas	-	734	734	14.3%
Kentucky	119	681	800	9.5%
Louisiana	682	827	1,509	19.5%
Maine	80	14	94	3.3%
Maryland	759	1,362	2,120	17.2%
Massachusetts	a	3,208	3,208	12.5%
Michigan	2	3	5	0.1%
Minnesota	1,095	901	1,996	12.6%
Mississippi	19	0	19	0.5%
Missouri	246	695	941	13.2%
Montana	-	406	406	25.7%
Nebraska	274	566	840	28.8%
Nevada	167	294	461	15.8%
New Hampshire	69	26	95	7.1%
New Jersey	a	1,455	1,455	5.4%
New Mexico	a	781	781	14.4%
New York	a	3,257	3,257	7.0%
North Carolina	629	749	1,378	8.1%
North Dakota	100	197	297	30.7%
Ohio	1,011	632	1,643	6.6%
Oklahoma	496	133	629	11.4%
Oregon	-	527	527	8.7%
Pennsylvania	512	514	1,026	4.2%
Rhode Island	95	24	119	3.8%
South Carolina	a	988	988	17.5%
South Dakota	137	0	137	13.0%
Tennessee	325	311	636	6.4%
Texas	405	5,078	5,483	17.0%
Utah	255	460	715	16.9%
Vermont	52	0	52	4.6%
Virginia	1,306	1,377	2,683	17.6%
Washington	-	702	702	5.2%
West Virginia	124	469	593	16.7%
Wisconsin	-	49	49	0.4%
Wyoming	892	10	902	72.6%
Total	**16,655**	**47,345**	**63,997**	**10.6%**

Source: National Association of State Budget Officers, Fiscal Survey of the States, December 2006.

Notes:
a. In these states the Rainy Day Fund is included in the ending balance. Amount identified as RDF in millions: CA ($9,009), DE ($161), GA ($904), MA ($2,160), NJ ($430), NM ($781), NY ($944), SC ($154)
b. In Connecticut the General Fund balance of $446 million is included in the Rainy Day Fund.
c. An additional $436 million balance in Colorado's General Fund was allocated by statute for transportation and capital construction.
d. The Texas ending balance would be $1.4 billion less if it took into account some large payments for education and health care that have been delayed by a few days or weeks into the 2007 fiscal year.

What are Sufficient Reserves?

Now that states have emerged from the fiscal crisis and are developing fiscal policies to deal with the next downturn the focal question is, how much saving is enough? In 1999, the Center on Budget and Policy Priorities released an analysis that simulated a FY 2000-2003 recession. That analysis suggested that states on average would need reserves equal to 18 percent of spending to weather a simulated recession without substantially cutting spending or raising taxes. At the time — when many policymakers used a benchmark of five percent for an adequate reserve level — the estimates in the study seemed high to many state policymakers. However, given the severity of the recent downturn, these previous estimates now appear quite conservative.[2]

The Government Finance Officers Association (GFOA) has also questioned the five percent reserve benchmark. In a statement of recommended practices released in 2002, GFOA stated that:

> The adequacy of unreserved fund balance [which includes rainy day funds] in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unreserved fund balance in their general fund of *no less than five to 15 percent of* regular general fund operating revenues, or of *no less than one to two months* [that is, eight to 16 percent] of regular general fund operating expenditures. A government's particular situation may require levels of unreserved fund balance in the general fund significantly in excess of these recommended minimum levels.[3] [italics added]

Clearly the experience of the last several years indicates that in the future states should plan on targeting the upper bound of GFOA's recommendation — reserves of 15 percent or more of operating expenditures.

Building a rainy day fund of 15 percent of spending or more requires both strong reserve policies, to be discussed next and sufficient time. If a state were set aside between 1.5 and 2.5 percent of revenue a year in a rainy day fund, it would take between 6 and 10 years to build a rainy day fund that equals 15 percent of spending. If states wait too long to begin saving, they will likely not build adequate reserves before the next economic downturn begins.

Policies to Improve the Adequacy of Reserves

Policymakers have an opportunity to enact some critical policy changes now to improve their reserve policies, these changes could make states better prepared for the next fiscal crisis.

Establish and Maintain a Rainy Day Fund

The most important element of an effective reserve policy is a separate rainy day fund designed to accumulate funds during good economic times that can be used to address budget deficits during an

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[2] Iris Lav and Alan Berube, When It Rains It Pours, March 11, 1999, http://www.cbpp.org/3-11-99sfp.htm.

[3] http://www.gfoa.org/services/rp/budget.shtml#10.

economic downturn. Up to this point, this paper has focused on total state reserves which include both rainy day fund balances and general fund balances, because total state reserves provide the broadest measure of the resources available to help states weather fiscal difficulties. However, in many cases relying solely on general fund balances does not constitute an adequate reserve policy because there may not be rules governing the accumulation of the balances and there are often a number of other claims on the funds.

Currently, all but five states — Arkansas, Colorado, Illinois, Kansas and Montana — have some type of rainy day fund. Oregon is the most recent state to establish a Rainy Day Fund.[4] Among the five states without Rainy Day Funds,

- **Colorado** does not have a separate rainy day fund but does have a four percent annual budget reserve requirement that functions in a manner similar to a rainy day fund. Colorado's situation is complicated by a series of restrictive revenue and spending limits embedded in the constitution known collectively as TABOR (Taxpayers Bill of Rights) which make the development of a rainy day fund difficult because all revenue in excess of the limits is returned to taxpayers through rebates, tax credits and other mechanisms. Colorado is currently operating under a five year time out from some of its constitutional fiscal policy constraints and the legislature is considering a measure to increase the size of the statutory reserve as a way to protect spending during recessions.

- **Illinois** has a Budget Stabilization fund that does not serve as a rainy day fund because the entire fund must be paid back before the end of the fiscal year.

- **Kansas** has a 7.5 percent general fund balance requirement, but does not have a separate rainy day fund.

- **Arkansas** has a history of inadequate savings. In 2000, when total reserve balances among the states were at their peak, Arkansas had no reserves.

- **Montana** has accumulated significant general fund reserves in the past, but does not have a separate rainy day fund.

Each of these states would benefit from a creating a well-designed rainy day fund. The features of a well-designed fund are described below. They include: a savings target at 15 percent of spending, appropriations to the rainy day fund in the annual budget, access to the funds during an economic downturn through a simple majority vote of the legislature, and rules that do not require the fund to be replenished before the economy has begun to recover.

Raise or Eliminate Caps

Rainy day fund caps place a limit on how large the fund can grow, typically measured as a percent of the budget. If rainy day funds are statutorily or constitutionally capped at an inadequate level, such as 10 percent of the budget or less, then states are going to have difficulty accumulating adequate reserve balances. While this may seem like an obvious point, low caps are the norm in about 67 percent of the states with rainy day funds. Specifically, 31 states have capped their rainy

[4] Oregon's new Budget Reserve Fund is in addition to an existing reserve fund that was limited to education spending.

day funds at 10 percent or less and 15 states have capped their rainy day funds at 5 percent or less of spending. These states are virtually guaranteed to find their rainy day funds inadequate. (See Table 2 which summarizes features of rainy day funds that states need to address.)

TABLE 2: SUMMARY OF RAINY DAY FUND FEATURES TO BE REFORMED

State	No RDF	Cap 10% or <	Deposit Rule	Replenishment Rule	Limit on Use	Super-Majority Requirement
Alabama		X	See notes	X		X
Alaska			See notes			X
Arizona		X	See notes		X	
Arkansas	X					
California			Year-end Surplus*			
Colorado	X					
Connecticut		X	Year-end Surplus			
Delaware		X	Year-end Surplus			X
District of Columbia		X	None	X	X	
Florida		X	Year-end Surplus	X		
Georgia		X	Year-end Surplus			
Hawaii			Tobacco funds			X
Idaho		X	See notes		X	
Illinois	X					
Indiana		X	See Notes		X	
Iowa		X	Year-end Surplus			X
Kansas	X					
Kentucky		X	Year-end Surplus			
Louisiana		X	Year-end Surplus		X	X
Maine			Year-end Surplus			
Maryland			Year-end Surplus*			
Massachusetts			Year-end Surplus*			
Michigan			See notes		X	
Minnesota			Year-end Surplus			
Mississippi		X	Year-end Surplus			
Missouri		X	See notes	X	X	X
Montana	X					
Nebraska			Year-end Surplus			
Nevada			Year-end Surplus			
New Hampshire		X	Year-end Surplus		X	X
New Jersey		X	Year-end Surplus			
New Mexico			Year-end Surplus			
New York		X	Year-end Surplus	X		
North Carolina		X	Year-end Surplus			
North Dakota		X	Year-end Surplus			
Ohio		X	Year-end Surplus			
Oklahoma		X	Year-end Surplus		X	X
Oregon			Lottery revenue		X	X
Pennsylvania			Year-end Surplus			X
Rhode Island		X	See notes	X		
South Carolina		X	Year-end Surplus	X		
South Dakota		X	Year-end Surplus			
Tennessee		X	See notes		X	
Texas		X	Year-end Surplus			X
Utah			Year-end Surplus			
Vermont		X	Year-end Surplus			
Virginia		X	See notes		X	
Washington		X	Year-end Surplus			X
West Virginia (see note)		X	Year-end Surplus			
Wisconsin		X	Year-end Surplus			
Wyoming			Year-end Surplus			
Total	**5**	**31**	**33 use Year-end Surplus**	**7**	**12**	**13**

* State uses more than one method to determine deposits. See notes.

TABLE 2: SUMMARY OF RAINY DAY FUND FEATURES TO BE REFORMED (Cont'd)

Notes:

NA: - Not applicable because state does not have rainy day fund.

AK: Mineral litigation settlements are deposited in the Rainy Day Fund.

AL: The constitutional RDF was fully funded at establishment, so the only revenues flowing into that fund would be repayment for transfers from the RDF to the Education Trust Fund during years in which anticipated revenues are projected to fall below appropriations. The statutory fund requires that at least 20% of unanticipated revenues from the ETF are transferred into the fund, although the legislature may choose to transfer funds in excess of the 20% (in the current budget year, they transferred 75% of the previous year's unanticipated balance).

AZ & MI: Personal income growth formula determines amount to be transferred to the rainy day fund. Legislature has discretion in determining actual transfer amount.

CA: State has two funds operating as rainy day accounts, one which is funded through year-end surpluses and one which is funded as a percent of estimated general fund revenues. Fifty percent of the funds in the most recently created account (in effect in 2007) are to retire deficit recovery bonds.

FL: State has two funds -- Working Capital and Budget Stabilization Fund.

IA: 60% approval is needed if an appropriation will reduce the fund below 3.75% of adjusted revenue estimate.

ID: Contribution is automatic when revenue growth exceeds 4%.

IN: Contribution is automatic based on personal income growth formula.

LA: Federal money (largely from Hurricane Katrina relief) is not included in calculation of surplus.

Year-end surpluses and oil and gas revenue above a certain amount constitute rainy day fund deposits.

MA: In addition to year-end surpluses, MA also deposits ½ of 1 per cent of the total revenue from taxes in the preceding fiscal year.

MD: State has two methods for depositing money into the rainy day fund: the total general fund surplus amount over $10 million plus a $50 million appropriation if the rainy day fund balance is below 7.5% estimated general fund revenues, or $100 million if below 3.0%.

MI: See AZ note above.

MO: Deposit required only when fund falls below required balance.

ND: State has the only state-owned bank in the nation and uses its profits, along with the Rainy Day fund, to stabilize the budget.

NY: State has 3 rainy day funds, 2 official, and one unofficial. The unofficial fund was developed in response to the impractical rigidity of the official funds. The unofficial fund, which functions the most like a real RDF, has no cap. The two official funds (one was most recently created in 2007) have a cumulative cap of 5%.

OR: In 2007 Oregon established an additional Rainy Day Fund for general budget purposes. Initially corporate tax revenues that exceed initial estimates will be deposited in this fund. In the future one percent of year-end surpluses will be deposited in the fund.

PA: State requires supermajority to use the rainy day fund but has, in the past, just abolished the fund with a simple majority vote. This action diverted the funds back to the general fund which the legislature used with a majority.

RI: 3% of revenue each year must be deposited, up to cap of 5% of revenue.

TN: Appropriation is automatic based on 10% of revenue growth.

UT: State has 2 reserve accounts, one rainy day fund and one education reserve. The combined total of the two cannot exceed 6% of the total general fund appropriation amount plus the Uniform School Fund appropriation amount for the fiscal year in which the surplus occurred.

VA: Appropriation is automatic based on formula using prior six-years of revenue growth.

WV: State added "part b" to its rainy day fund in June '06 which cannot be tapped unless the original fund is dry.

WY: State recently created an extra legislative stabilization account to offset volatile mineral reserve funds.

This fund is not included in statute.

Rainy day fund caps clearly restricted rainy day fund growth. The rainy day funds in states with caps of five percent or less grew from an average of 2.8 percent of expenditures at the end of 2002 to only 4.4 percent of expenditures at the end of 2006. The rainy day funds in states without caps or with caps of 10 percent or greater grew by more than 5 percentage points from an average of 5.9 percent of expenditures at the end of 2002 to 11.1 percent of expenditure at the end of 2006. The same pattern was evident in the 1990s.[5] This indicates that raising rainy day fund caps is a critical policy option that states should pursue.

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[5] The rainy day funds in states with caps of five percent or less grew from an average of 1.0 percent of expenditures at the end of 1993 to only 3.7 percent of expenditures at the end of 2000. The rainy day funds in states without caps or

The first step states should take to improve their rainy day funds is either remove the cap or increase it to a more adequate level, such as 15 percent of the budget. Even better, states could replace caps with target levels. For example, a state could set a target level for its rainy day fund of 15 percent of the budget. Once that target is met, policymakers could weigh their circumstances and options and decide whether to make additional deposits into the fund above the 15 percent level.

Improve Deposit Rules

The rules most states have set for contributions to rainy day funds do not give them much encouragement to save. The most common contribution rule — used in 33 out of 46 states with a rainy day fund — is that a portion of the state's year-end surplus *may* be placed in the rainy day fund.[6] This rule has the advantage of ensuring that that the deposited funds are truly surplus, and that the state does not need the funds for some other purpose. The disadvantage is that the rainy day fund is last in line for receiving state resources.

For example, if a state is projecting a surplus during the period of budget deliberations, it may choose to increase expenditures or cut taxes; the rainy day fund would receive funding only if the actual surplus exceeds the projected surplus that already was allocated. This is largely what happened during the 1990s, when states increased spending modestly and cut taxes extensively when they enacted their budgets. In states with a year-end surplus deposit rule, rainy day fund deposits were made at the end of the fiscal year, long after the decisions to boost spending or cut taxes were made.

Other types of deposit rules can have the opposite effect; they may lead to required deposits when the state cannot afford to make them. California[7], Hawaii, Maryland, Missouri, and Rhode Island have rules that require annual contributions to their rainy day fund without regard to the state's fiscal conditions, which can lead to deposits being required during an economic downturn when the state is struggling to balance its budget.

Other states have rules intended to assure that rainy day fund contributions will be made when fiscal conditions are healthy. Six states — Arizona, Idaho, Indiana, Michigan, Tennessee, and Virginia — use formulas based on growth in tax revenues or state economic growth to determine rainy day fund contributions.

The rules in these seven states have both positive and negative aspects. On the positive side, in four of these six states the deposit is made automatically at some point during the fiscal year. Unlike year-end surplus deposit rules, an automatic deposit assures that a deposit will be made.

But the rules in some of the seven states have other aspects that are less workable. In Florida, Idaho and Tennessee, the deposit formulas can require states to make contributions when state finances are not particularly strong. In Tennessee, for example, 10 percent of any revenue increase

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with caps of 10 percent or greater grew from an average of 2.3 percent of expenditures at the end of 1993 to 9.0 percent of expenditure at the end of 2000.

[6] The 46 states with a rainy day fund include DC.

[7] California has two funds that act as rainy day funds. A fixed percentage of revenues must be deposited in one of these funds.

from one year to the next must be placed in the rainy day fund, which means that a deposit would be required even if revenue growth is modest.

In other states the formula tries to estimate whether there is sufficient economic growth to support a rainy day fund deposit. Arizona, Indiana and Michigan have formulas based on personal income growth. In Indiana, deposits must be made when personal income growth exceeds a particular standard. In Arizona and Michigan, the contribution calculation is used essentially as a guideline for determining the amount of rainy day fund contribution. In Virginia, the formula is based on comparing current revenue growth to the average growth rate in revenue collections over the previous six years.

There is now over two decades of experience during which states have experimented with different rules for rainy day deposits. Considering the range of outcomes of these experiments, it is possible to design a deposit rule that might better meet the needs of states. Such a rule would balance the competing needs of ensuring sufficient annual funding for public services while building an adequate reserve. The following suggests how this might be accomplished.

- During the budget development process, the state budget office could compare projected revenue (prior to any tax changes) to projected spending needs for the upcoming budget year. Ideally, the estimate of projected spending needs would utilize a baseline or current services approach that takes into account inflation, caseload increases, workload changes, and statutory requirements. Some states already prepare these types of estimates and include them in the proposed budget document, but many do not. However, most states that do not prepare a formal baseline projection should be able to produce an estimate of the required spending needs for the next fiscal year.

- If projected revenues exceed projected expenditure needs, a portion of that surplus (25 percent to 50 percent) could be appropriated as a transfer to the rainy day fund.

- Only the remaining portion of the surplus would be available for other uses. The actual transfer to the rainy day fund would occur at the end of the fiscal year, assuming revenues and spending hold to projections.

- A portion of any additional year-end surplus could also be deposited in the rainy day fund.

This process would ensure that all necessary spending needs are being met, that funds are being deposited into the rainy day fund and that funds are available to meet additional needs.

Policies to Ensure that Rainy Day Funds Can be Accessed When Needed

There are three types of policies that may result in states not being able to effectively tap rainy day funds when needed. They are replenishment rules, super-majority requirements and limits on use.

Eliminate Replenishment Rules

Six states — Alabama, Florida, Missouri, New York, Rhode Island and South Carolina — as well as the District of Columbia require that withdrawals from their rainy day funds be replenished over a

specified period of time after a withdrawal has been made. Replenishment rules can be problematic for two reasons. First, in some cases they provide a disincentive to using the fund for fear monies will not be available to meet the replenishment requirements. Second, when replenishment must occur soon after the drawdown, rainy day deposits may compete with critical government programs and services for scarce resources during a time of fiscal strain.

Of the states that require replenishment of withdrawals from their rainy day funds, two — Alabama, and Florida — allow replenishment to occur over a period of five years or more. This lengthy period helps increase the likelihood, although does not insure, that most of the replenishment will occur after the fiscal crisis is over. Historically, state fiscal crises have lasted two to three years. The most recent one lasted five years.

In Missouri, New York, and South Carolina, withdrawals from the rainy day fund are repaid over a three year period, in Rhode Island, the replenishment period is two years, and in the District of Columbia the fund must be paid back in one year. These onerous replenishment rules have created a barrier that has prevented these funds from being used for their intended purpose. Despite significant deficits throughout the fiscal crisis, the District of Columbia, Missouri and Rhode Island did not use their rainy day funds.

Remove Super-Majority Requirements

Thirteen states have super-majority requirements governing the release of rainy day fund resources to address budget deficits.[8] Super-majority rules create an unnecessary political hurdle to accessing the funds. These rules allow a minority of lawmakers to block the sensible use of rainy day funds in times of fiscal crisis.

Remove Limits on Use of Funds

Some 12 states set a limit on the amount of the rainy day fund that can be used at one time.[9] These limits are a problem because they reduce the flexibility of state policymakers to address budget shortfalls in an effective manner. In addition, it may make sense for a state to use a large portion of the rainy day fund in the first year of the fiscal crisis because other budget balancing options, such as revenue increases or targeted budget cuts, may take more time to analyze and implement and are more appropriate for addressing the second or third year of the downturn.

In some cases these limits exist to minimize the use of the fund during periods of economic growth, a reasonable goal. But it is difficult to craft a restriction on the amount of funds that may be used that applies only to periods of growth and that does not also limit flexibility during a downturn. A better mechanism for ensuring that the funds are used for the intended purpose is to restrict the use of the funds to addressing a budget deficit.[10]

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[8] Alabama, Alaska, Delaware, Hawaii, Iowa, Louisiana, Missouri, New Hampshire, Oklahoma, Oregon, Pennsylvania, Texas and Washington.

[9] Arizona, the District of Columbia, Idaho, Indiana, Louisiana, Michigan, Missouri, New Hampshire, Oklahoma, Oregon, Tennessee, and Virginia.

[10] For example New Mexico's rainy day fund statute indicates that the fund may be used: "In the event that the general fund revenues, including all transfers to the general fund authorized by law, are projected by the governor to be insufficient either to meet the level of appropriations authorized by law from the general fund for the current year or to

meet the level of appropriations recommended in the budget and appropriations bill…for the next fiscal year, the balance in the tax stabilization reserve may be appropriated by the legislature up to the amount of the projected insufficiency for either or both fiscal years."