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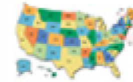
SPECIAL SERIES | Dealing with Deficits: How States Can Respond



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IS IT RAINING YET? Yes, And It's Time for Many States To Use Their Rainy Day Funds

By Elizabeth C. McNichol

Executive Summary

After they emerged from the fiscal crisis earlier in the decade, many states began preparing for the next economic downturn by setting aside "rainy day funds," or reserve accounts designed for use when revenues decline or expenditures increase unexpectedly because of downturns, natural disasters, or other events. A rainy day fund serves as a state's first line of defense against the budget pressures caused by declining revenues and rising need for public services during a downturn.

The next downturn appears to have arrived. Revenues are well below projections in many states, and state expenditure needs have begun to increase as residents lose jobs and income and experience growing hardship. In addition, as the softening housing market reduces property tax revenues, pressure will grow for states to assist local governments.

In large part as a result of the economic slowdown, some 25 states are facing budget gaps for the upcoming fiscal year (fiscal year 2009), which starts July 1 in most states. If the economy continues to deteriorate — as many prominent economists predict — this number will grow substantially.

States are somewhat better prepared to deal with the current slowdown than they were at the start of the last recession, seven years ago. Due to the robust revenue growth of the last several years, states had

KEY FINDINGS

- With the economic slowdown creating budget gaps in many states, now is the appropriate time for them to tap the "rainy day" reserve funds they have set aside for just such a contingency.
- Most states have sufficient rainy day funds to reduce the amount of spending cuts or tax increases that would be needed to balance their budgets in the near term.
- Unlike spending cuts and tax increases, which worsen a downturn by further reducing overall demand, tapping a state's reserve fund helps maintain overall demand by injecting savings into the economy.
- States concerned that the downturn could be deep and prolonged should respond not by hoarding their reserves but rather by devising a multi-year plan to address recession-induced budget problems.

total reserve balances (including rainy day funds as well as general fund balances and other reserves) equal to 11.5 percent of annual expenditures on hand at the end of fiscal year 2006, before the housing slump began to affect state tax collections. This is above states' total reserve balances of 10.4 percent of expenditures in 2000.[1]

Currently, rainy day fund balances alone total more than 4.5 percent of states' annual expenditures. While not enough to obviate the need for budget cuts or tax increases in a prolonged downturn, both of which can damage the economy, rainy day funds can minimize the need for such steps. (See Table 1 for state-by-state data.)

Unfortunately, some state policymakers now facing budget gaps are reluctant to spend funds from rainy day accounts, in part because they fear their economic problems may become even worse in future years. For example, Kentucky's governor has ordered across-the-board cuts in state agency budgets to address a current-year (fiscal year 2008) revenue shortfall, even though the state has $232 million in its rainy day fund. In Virginia, some legislators have objected to the governor's plan to use a portion of the state's substantial rainy day fund to partially address a budget shortfall. In several other states as well, governors and legislators are planning significant budget cuts while making little or no use of their rainy day fund.

Four Reasons Why States Should Use Their Rainy Day Funds Now

During an economic slowdown, cutting state programs while leaving a rainy day fund untouched is generally unwise. Just as states were prudent to build up balances during good economic times, most states now facing deficits should use some or all of these funds this fiscal year to bolster their economies and prevent cuts in programs that rise in cost as residents lose jobs and income. There are four reasons why.

1. **It's good for the state's economy.** Both tax increases and spending cuts reduce demand for goods and services, dampening sales, profits, and job growth. This is the opposite of what a state needs during a downturn. Using rainy day funds, in contrast, takes money from savings and puts it into the state's economy in a way that can maintain demand for goods and services.

2. **It gives the state time to respond sensibly to its budget problems.** Often, the budget cuts and tax increases that a state can make most *quickly* to close a budget gap are the least *appropriate* measures to take in a recession. For example, they often fall most heavily on the people who can least afford them. Using rainy day funds allows a state to maintain needed services while it devises a more carefully considered solution to close whatever remaining budget gap it anticipates in this fiscal year and beyond.

   For example, a state could gain time to appropriately target budget reductions on the programs that could be cut at least damage to the economy, such as programs with dedicated reserve funds or the ability to levy user fees. Similarly, with the cushion of time afforded by the use of rainy day funds, a state could expand its revenue options to encompass tax increases that make economic and fiscal sense but would not produce additional revenues until the subsequent fiscal year.

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[1] National Association of State Budget Officers, *Fiscal Survey of the States,* December 2007.

TABLE 1: ESTIMATED RAINY DAY FUND BALANCES		
	FY 2008 Appropriated	FY 2008 Appropriated
State	Rainy Day Fund Balance	Rainy Day Fund Balance as a % of Spending
Alabama	700	8.2%
Alaska	3,042	70.3%
Arizona	705	6.6%
Arkansas	0	0.0%
California	4,070	4.0%
Colorado*	0	0.0%
Connecticut	1,363	8.3%
Delaware	183	5.1%
Florida	1,354	4.6%
Georgia	1,196	5.9%
Hawaii	74	1.3%
Idaho	135	4.8%
Illinois	276	1.0%
Indiana	360	2.8%
Iowa	592	10.1%
Kansas	0	0.0%
Kentucky	232	2.5%
Louisiana	694	8.1%
Maine	116	3.7%
Maryland	694	4.8%
Massachusetts	2,130	7.5%
Michigan	2	0.0%
Minnesota	1,036	6.1%
Mississippi	302	6.1%
Missouri	278	3.3%
Montana	0	0.0%
Nebraska	542	16.4%
Nevada	268	8.1%
New Hampshire	89	5.8%
New Jersey	490	1.5%
New Mexico	730	12.7%
New York	1,206	2.2%
North Carolina	787	3.8%
North Dakota	200	16.6%
Ohio	1,012	3.8%
Oklahoma	572	10.0%
Oregon	331	4.6%
Pennsylvania	750	2.8%
Rhode Island	104	3.1%
South Carolina	187	2.5%
South Dakota	134	11.6%
Tennessee	750	6.5%
Texas	1,222	3.0%
Utah	340	6.0%
Vermont	59	5.0%
Virginia	1,314	7.4%
Washington	227	1.6%
West Virginia	547	13.2%
Wisconsin	56	0.4%
Wyoming	217	12.9%
Total	**31,668**	**4.6%**

Sources: CBPP calculations of data from the National Association of State Budget Officers' Fiscal Survey of the States, December 2007, which reflected projected rainy day funds as of the beginning of the state fiscal year.
Note: Colorado has no Rainy Day Fund but maintains a 4 percent general fund cash reserve ($238.5 million in FY 2008.)

3. **It can help a state avoid cutting its "automatic economic stabilizers."** These are the programs for low-income families that rise in cost when the need for them rises due to higher unemployment and lower wages; examples include health care and cash assistance.

4. **Never using the state's rainy day fund is tantamount to not having one at all.** Rainy day funds were specifically designed to provide a quick infusion of resources into the economy during a downturn to help avoid debilitating cuts to public services at the very time the services and programs are needed most. It makes little sense to save money as a means of preventing possible cuts in the future if doing so means making definite cuts in the present.

It is important to remember, however, that rainy day funds are meant for use during a cyclical economic downturn, not to support policies that cannot be sustained when the economy recovers and revenues rebound. For example, if a state is phasing in a tax cut, it should not use rainy day funds to allow that tax cut to continue to phase in. The more appropriate action would be to suspend the tax cut and reevaluate its affordability when the economy recovers.

Similarly, if a state is not experiencing fiscal distress now, it should retain its reserves because it might need them if the economy worsens.

Using Rainy Day Funds Would Protect State Economies

When revenues fall below previous estimates during the current budget year or are projected to fall below the amount needed to maintain current services in the upcoming budget year, states must rebalance their budgets. Generally they have three options: using savings from rainy day funds to maintain current levels of spending, raising taxes to maintain current levels of spending, or cutting spending. Of these, using rainy day funds to maintain current levels of spending is the *only* option that does not shrink the overall level of consumption in the state.[2]

Cuts in direct state spending or reductions in assistance to low-income families reduce demand on a dollar-for-dollar basis. In other words, every $1 reduction in payments to employees, contractors, or suppliers means that at least $1 less will be spent in the economy buying goods and services. Moreover, when consumption falls, businesses tend to reduce their workforces, which deepens the recession further.

Tax increases also reduce demand, by leaving taxpayers with less money to spend. Unlike a spending cut, however, a tax increase does not reduce consumption on a dollar-for-dollar basis, because businesses and individuals pay for the tax increase in part by using savings. In general, higher-income taxpayers are more likely to use savings to pay the increased tax, while lower-income taxpayers will generally have to reduce their consumption. In either case, however, a tax increase reduces consumption to at least some extent and thus can further weaken a slow economy.[3]

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[2] States have some other short-term "budget gimmicks" for addressing budget shortfalls, such as debt restructuring, shifting pay dates, or accelerating tax collections. But these options are limited in size and availability. In addition, over-reliance on budget gimmicks can seriously jeopardize states' ability to achieve long-term budget stability. Such measures should be adopted only when necessary and only on a temporary basis, and should be accompanied by specific plans to reverse them in the future.

[3] Nicholas Johnson, "Budget Cuts or Tax Increases at the State Level: Which Is Preferable During an Economic Downturn?" Center on Budget and Policy Priorities, January 8, 2008, http://www.cbpp.org/1-8-08sfp.htm.

Use of Rainy Day Funds Won't Hurt a State's Bond Rating

A few state officials appear to believe that using rainy day funds at this time would cause bond rating agencies to downgrade the state's bond rating. This does not appear to be the case. For example, a Standard and Poor's report published during the last recession indicated that prudent use of reserves would not affect a state's credit rating. According to the report:

> Use of reserves is not a credit weakness in and of itself. *These reserves are accumulated in order to be spent* during times of budgetary imbalance and extraordinary economic events. The last month has highlighted the importance and critical nature of these reserves from a credit standpoint. Given this period of economic uncertainty, a balanced approach of adjusting spending and drawing on reserves will reduce out-year structural imbalance.[a]

[a] Robin Prunty, Alexander M. Fraser, and Steven J. Murphy, "Commentary: The State of the States," Standard and Poor's, October 18, 2001 (emphasis added).

Using rainy day funds, in contrast, means taking money out of savings in order to *increase* consumption, which in the short run has a positive impact on the economy. While most states will not have sufficient rainy day funds or other reserves to completely avoid spending cuts or tax increases, the funds allow states to minimize these damaging measures.

Rainy Day Funds Should Be a State's First Response to Fiscal Stress

Often, states' first response to developing budget gaps is to cut spending. Although spending reductions usually cannot be avoided when deficits are as deep as those projected in some states, there are economic and practical advantages in taking the time to consider carefully *which* programs should be cut.

When looking for budget cuts that can be enacted and implemented quickly (especially when deficits arise in the middle of a fiscal year), policymakers often decide on across-the-board cuts or cuts that target the portion of the budget that has not yet been committed. There are problems with both of these approaches:

- Across-the-board cuts do not distinguish between programs that are vital and those that are not. The across-the-board approach is particularly problematic in a recession, when some programs need to grow to assist residents who have lost jobs and income.

- Often the most convenient programs to cut are those that spend funds monthly, such as cash assistance and Medicaid, rather than those for which commitments are made at the beginning of the fiscal year or biennium, such as education, payments to local governments, or capital projects. As a result, cuts often are made in the very programs that a state's residents need the most to weather an economic downturn.

If given the time to consider budget cuts more carefully, policymakers can focus the cuts on areas that are less economically damaging and fall less heavily on low-income residents. For example, some programs, such as higher education or transportation, may have reserve funds that can be

drawn upon to compensate for reductions in their current budgets. Or, some programs may be able to raise user fees temporarily to offset budget cuts.

Policymakers can gain the time to make these types of considered decisions by using rainy day funds to shore up state finances in the interim.

Similarly, policymakers who want to close budget gaps through tax increases also may need time to develop and consider options. During the last two recessions, states placed heavy emphasis on raising regressive taxes, such as sales and excise taxes. These arguably are the easiest taxes to increase, involving only a change in rate that can easily be publicized and implemented. Such increases also begin yielding new revenue very soon after they are implemented. But these taxes place a disproportionate burden on low- and moderate-income families, so raising them exacerbates the already regressive nature of most state and local tax systems. (It also takes money out of the pockets of the people who are most likely to spend it, a counterproductive step during a downturn.)

Other revenue-enhancing options may be preferable on policy grounds but may not generate new revenue immediately. For example, closing corporate tax loopholes or suspending tax cuts that have yet to take effect may not yield additional revenues until the first full fiscal year after the change is enacted. Since state fiscal stress could easily last through fiscal year 2009 or beyond, such changes make sense to enact, and the up-front use of rainy day funds can bridge the gap between enactment of the tax increase and the time the change begins to yield revenue.

Protecting Programs Needed to Fight Rising Hardship During a Recession

Economic downturns naturally increase the need for programs that serve low-income households such as Medicaid and TANF. These programs are called "automatic economic stabilizers" because their spending automatically goes up when people lose jobs and income, thereby helping to stabilize overall demand — and cushion the increase in hardship — during a recession.

Maintaining these programs is an appropriate use of rainy day funds. It also can help states avoid repeating the experience of the last downturn, during which states that were looking for immediate savings to address mid-year budget shortfalls often targeted programs that spend funds on a monthly basis. This led a number of states to cut or freeze income assistance and health programs that primarily affected the poor. Some 34 states cut eligibility for public health programs, for example, causing at least 1 million people to lose health coverage. At least 23 states cut eligibility for child care subsidies or otherwise limited access to child care.

In recent weeks, a number of states have begun considering weakening their safety net through legislative action, mid-year budget cuts, or cuts in governor's proposed budgets. For example, Rhode Island's governor has proposed rolling back public health coverage for parents of low-income children by raising the income eligibility level. In California, the governor's proposed budget would terminate cash assistance to certain children after their parents reach the program's time limit, cut Medicaid payments to doctors and hospitals that serve low-income patients by over $1 billion, and suspend cost-of-living increases in supplemental cash assistance for low-income seniors and persons with disabilities.

By tapping their rainy day funds, states can reduce the need for further steps like these, which are economically counterproductive and will place further burdens on low-income residents at a time when they need state services the most.

Use Rainy Day Funds Now, While Also Preparing for a Possible "Rainier" Day

If the current economic slowdown becomes a full-blown recession, recent experience suggests that states are likely to feel the effects for 18 to 24 months or more. Many state policymakers are understandably concerned that their state's fiscal problems will only worsen over the next year or two.

This is no reason, however, for states not to take full advantage of their rainy day funds now. Continually preserving a rainy day fund for the *next* potential problem is essentially the same as not having a rainy day fund at all. Instead, states should now be devising a multi-year plan to address recession-induced budget problems in case an additional funding squeeze occurs.

As noted above, a number of types of deficit-closing actions states can take — such as closing corporate tax loopholes, delaying the phase-in of a previously enacted tax cut, or some types of income tax increases — may not yield immediate revenues but can help close expected budget gaps next year. Similarly, states can enact temporary tax increases or targeted spending reductions that yield only small savings this year (because they would be in effect for only part of the year) but would provide a full year of deficit relief next year. Because of the uncertainty over the economy, these actions could be designed to take effect only if certain economic measures indicate they are needed.

For the same reasons that states should be spending their rainy day funds now, they should not begin replenishing their rainy day funds until the fiscal crisis is resolved. But states can begin designing improvements in their rainy day funds to enable them to do an even better job in the next fiscal crisis of heading off damaging budget cuts and tax increases.

For example, states that do not have such funds can create them. States that have constitutional provisions such as revenue limits that make rainy day funds more difficult to finance can consider amending those provisions. Finally, states can develop more ambitious funding strategies to build up their rainy day funds further.[4]

[4] For examples of ways to improve state rainy day funds, see: Elizabeth C. McNichol and Brian Filipowich, "Rainy Day Funds: Opportunities for Reform," Center on Budget and Policy Priorities, April 16, 2007, http://www.cbpp.org/4-16-07sfp.htm.