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HEAVY WEATHER: ARE STATE RAINY DAY FUNDS WORKING?

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Summary

States are experiencing widespread and severe fiscal difficulties as a result of the recent economic slowdown. To balance their budgets, states are cutting spending, raising taxes and using reserve funds. Both tax increases and spending cuts have negative economic consequences to varying degrees for a state because they reduce demand for goods and services, thereby dampening sales, profits, and job growth. Using reserve funds, however, helps reduce the negative economic consequences of budget cuts and tax increases.

States have used a significant portion of their total reserve funds to help close budget gaps in 2002 and 2003. During 2002, total ending balances — which includes both general fund balances and rainy day fund balances — declined from $41 billion to $22 billion. Some 16 states addressed a third or more of their 2002 deficit with rainy day fund withdrawals. Enacted fiscal year 2003 budgets further reduced reserve balances to $18 billion. Overall, reserve balances have declined from 10.4 percent of budgets at the end of 2000 to 3.4 percent of budgets in 2003.

The remaining balance of $18 billion is heavily concentrated in a few states. In fact five states hold over half of the remaining total balance — Florida, California, Alaska, Georgia and Texas. In addition, a portion of the remaining balance is difficult to access due to restrictions placed on the use of rainy day funds and general fund balances.

For most states, the use of reserves can no longer be a significant part of budget balancing plans for the remainder of 2003 and 2004. Nevertheless, now is an excellent time for states to restructure their rainy day funds so that they can be more effective during the next downturn.

The effectiveness of state rainy day funds as a fiscal policy tool has been compromised by a number of factors:

- Five states do not have rainy day funds. They are Arkansas, Colorado, Illinois, Kansas and Montana. These states lack a separate fund dedicated to saving resources during good times to cushion the blow of a recession.[1]

[1] Kansas has a five percent general fund balance requirement, but does not have a separate rainy day fund. Illinois has a Budget Stabilization fund that is actually a cash flow fund because the entire balance must be paid back before the end of the fiscal year. Colorado has a four percent annual budget reserve requirement that does not function as a rainy day fund.

- State rainy day funds, despite being large by historic standards, have not been large enough to offset budget gaps in most states. The inadequacy of rainy day funds is in part the result of a political bias in favor of tax cuts and spending increases in good economic times. But it also reflects a structural flaw in rainy day funds themselves. Some 19 states have written into their rainy day fund legislation a provision that limits the total amount that may accumulate in the fund to five percent or less of state spending. This type of limit has proven quite inadequate, as state budget shortfalls have averaged close to 10 percent of annual spending in 2002, 2003 and 2004.

- Some states 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 program for scarce resources.

- A few states also have failed to aggressively deploy their rainy day funds to avert spending cuts, sometimes by choice but sometimes also as a result of rules controlling rainy day fund use. In some states, rules restrict access to the fund by requiring a super-majority vote to release the funds or by placing a limit on how much of the fund can be used. To the extent that the failure to use rainy day funds was a deliberate choice, it sometimes results from exaggerated concern about the impact of using rainy day funds on state bond ratings.

Rainy day funds, if properly designed, are an important policy option for state policymakers. There is clearly room for improvement in the design of rainy day funds. Most state rainy day funds have not been adequate to close budget gaps during the current fiscal crisis, and many need to be reformed to function properly.

States should take a common sense approach to designing or restructuring rainy day funds. This approach involves four elements:

- First, the notion of a cap on the size of rainy day funds is problematic because the caps have prevented the funds from reaching an adequate level of funding. Instead of restricting the size of rainy day funds to an inadequate standard of five percent of the budget, states should set a target level for the size of the fund that is at least 10 to 15 percent of the budget. Once that target is met, policymakers should give serious consideration to making additional deposits into the fund above the 15 percent level.

- Second, state policymakers could ensure that saving for a rainy day is a policy priority by including rainy day fund appropriations in the budget. Once the budget covers necessary (i.e. baseline or current service) spending needs, a specific percentage of the spending could be budgeted for the rainy day fund. The rainy day fund could have to be appropriated, for example, before new tax cuts or spending programs are approved. In addition, it would also make sense to deposit a portion of any year-end budget surplus into the rainy day fund.

- The third element to a common sense approach to rainy day funds is that states should have flexibility in using the funds once there is an economic downturn. The most straightforward method for accessing rainy day funds is through the normal appropriation process. This makes sense because state legislatures typically address shortfalls in the current budget when they are developing the budget for the upcoming fiscal year. Placing a super-majority requirement on accessing the funds does not make sense because it creates an unnecessary political hurdle to making a withdrawal from the fund. Super-majority requirements also give additional leverage to a minority of legislators that can distort priority-setting and policymaking.

- Finally, state rainy day fund policies should not include a replenishment rule. These rules create a disincentive for using the fund and may lead to rainy day fund deposits competing with other programs for scarce resources. Instead, the funding targets and process described above should be utilized to ensure that once a state fiscal crisis ends, a state begins to plan for the next one.

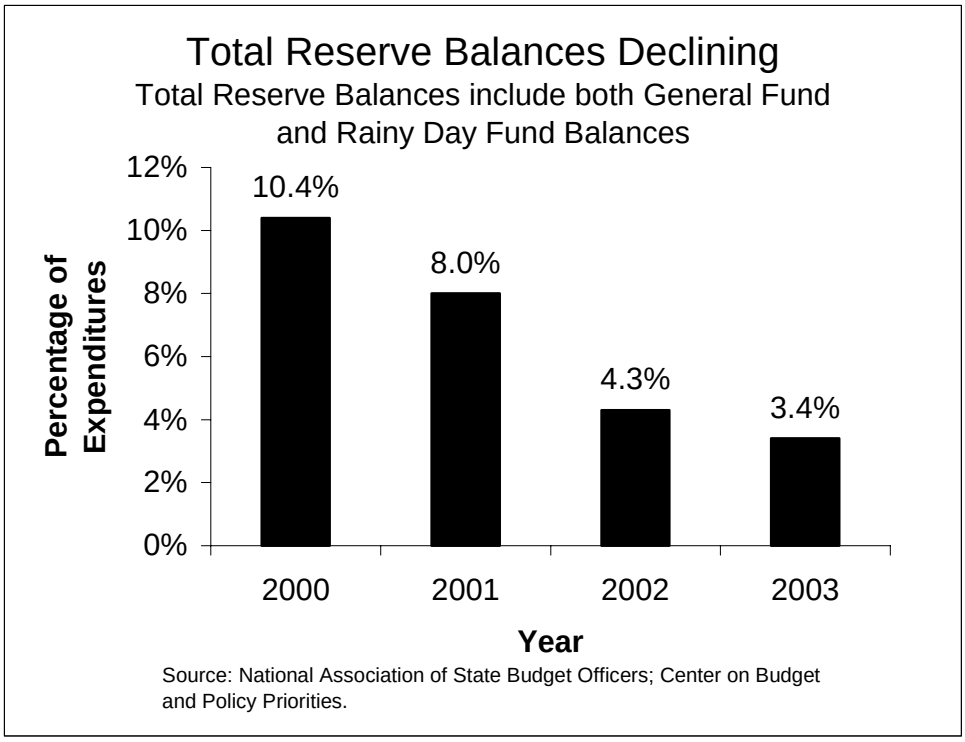
Rainy Day Funds Have Ameliorated the State Fiscal Crisis and Benefited the Economy — But Not As Much as They Could

Over the course of the 1990s, states increased total reserves to their highest level in twenty years. By the end of fiscal year 2000, states had total year-end balances (which includes both general fund balances and rainy day funds) of almost $48.8 billion, or 10.4 percent of expenditures. Prior to the last recession of the early 1990s, states had total balances of only $12.5 billion or 4.8 percent of expenditures. As a result, states were better prepared for this economic downturn than they were for the recession of the early 1990s.[2]

Reserve balances began to decline in 2001, falling from $49 billion at the end of 2000 to $41 billion at the end of 2001. This decline accelerated during 2002 as reserve balances fell to $22 billion at the end of 2002. Based on appropriated 2003 budgets, states are estimated to have reserve balances of $18 billion by the end of 2003 (see Appendix Table A for state-by-state figures on total reserves). Put another way, states had total reserve balances that equaled 10.4 percent of expenditures at the end of 2000 and now have reserve balances that equal 3.4 percent of expenditures (see Figure 1). While reserve balances in aggregate are quite low, several states have significant reserve balances available to help close 2003 and 2004 budget deficits. Some nine states and DC have reserve balances in excess of five percent of expenditures including, for example: Florida, Georgia, and Missouri.

[2] National Association of State Budget Officers (NASBO), *Fiscal Survey of the States*, November 2002.

Figure 1



Total reserve balances include both general fund balances and rainy day fund balances. Rainy day funds are reserve accounts funded during the recent economic expansion for the express purpose of assisting states in getting through an economic downturn. Several states drew heavily from their rainy day funds to help reduce the amount of counter-productive spending cuts or tax increases they otherwise would have had to make (see Appendix Table B for state-by-state data on rainy day fund balances). Some 16 states addressed a third or more of their 2002 deficit with rainy day fund withdrawals. For example,

- Maine solved almost 75 percent of its 2002 deficit with a rainy day fund withdrawal by using $110 million from its rainy day fund to help address a $150 million deficit.

- Massachusetts addressed about 60 percent of its 2002 deficit with a rainy day fund withdrawal by using $1.4 billion from its rainy day fund to help address a $2.3 billion deficit.

- Pennsylvania also covered almost 60 percent of its 2002 deficit with a rainy day fund withdrawal by using $740 million from its rainy day fund to help address a $1.3 billion deficit.

While states have been heavily drawing down on rainy day funds and other reserves, these funds are proving inadequate to balance state budgets. According to the National Conference of State Legislators (NCSL), states had total budget deficits of $37.2 billion or 7.2

percent expenditures in 2002 and estimated 2003 budget gaps of $79.0 billion or 15.1 percent of expenditures. The latest estimates of 2004 budget gaps indicate that states are facing deficits of at least $78.4 billion or 15.0 percent of expenditures.[3] These figures demonstrate the magnitude of the multi-year budget problems that states are facing. As indicated earlier, state total reserves peaked at $50 billion, or 10.4 percent of expenditures — less than one-third the amount needed to fund three years of budget gaps.

Why are State Rainy Day Funds Inadequate?

In any given year, elected officials generally would prefer to cut taxes or boost spending — measures that directly and immediately benefit constituents — than to save money for the future. And, indeed, in the mid to late 1990s, when many states were running surpluses, spending rose and taxes were cut.[4] States also saved significant resources in rainy day funds, but they did not save enough. But how much is enough?

The experience of this fiscal downturn confirms a previous Center on Budget and Policy Priorities analysis, which found that the common benchmark of five percent for reserve balances is not adequate. A 1999 study showed that on average states would need balances of about 18 percent to weather a three-year fiscal downturn, similar to the downturn of the early 1990s, without cutting spending or raising taxes. At the time, these estimates seemed high to many state policymakers. However, given the severity of the current downturn, these previous estimates now appear conservative.[5]

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.[6] [italics added]

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[3] National Conference of State Legislators (NCSL), *State Budget and Tax Actions 2002*, August 28, 2002; NCSL, *State Budget Update: April 2003*, April, 2003. NCSL reported that states had FY 2003 deficits of $49.1 billion when they were initially developing their budgets. Since the start of the FY 2003 fiscal year, additional deficits of $29.9 billion have developed.

[4] See Elizabeth C. McNichol and Kevin Carey, *Did States Overspend During the 1990s*, November 15, 2002, http://www.cbpp.org/10-15-02sfp.htm; and Nicholas Johnson, *The State Tax Cuts of the 1990s, The Current Revenue Crisis and Implications for State Services*, November 18, 2002, http://www.cbpp.org/11-14-02sfp.htm.

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

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

Clearly the data discussed above indicate that in the future states should plan on targeting the upper bound of GFOA's recommendation — reserves of 15 percent of operating expenditures. Somewhat surprisingly, many states have structured their rainy day funds in ways that prevent accumulations of more than even the minimum recommended by GFOA, five percent of revenue or eight percent of spending, much less the higher target, 15 percent of revenue or 16 percent of spending.

Bond rating agencies have also questioned the adequacy of the 5 percent benchmark level. Standard and Poor's considers total general fund balances (including rainy day funds) of 15 percent or more to be "strong," while balances of 5 percent or less to be "low" for local government tax-backed general obligation bond ratings. Standard and Poor's notes that the "approach to rating GO bonds of states is similar to that of local government units."[7]

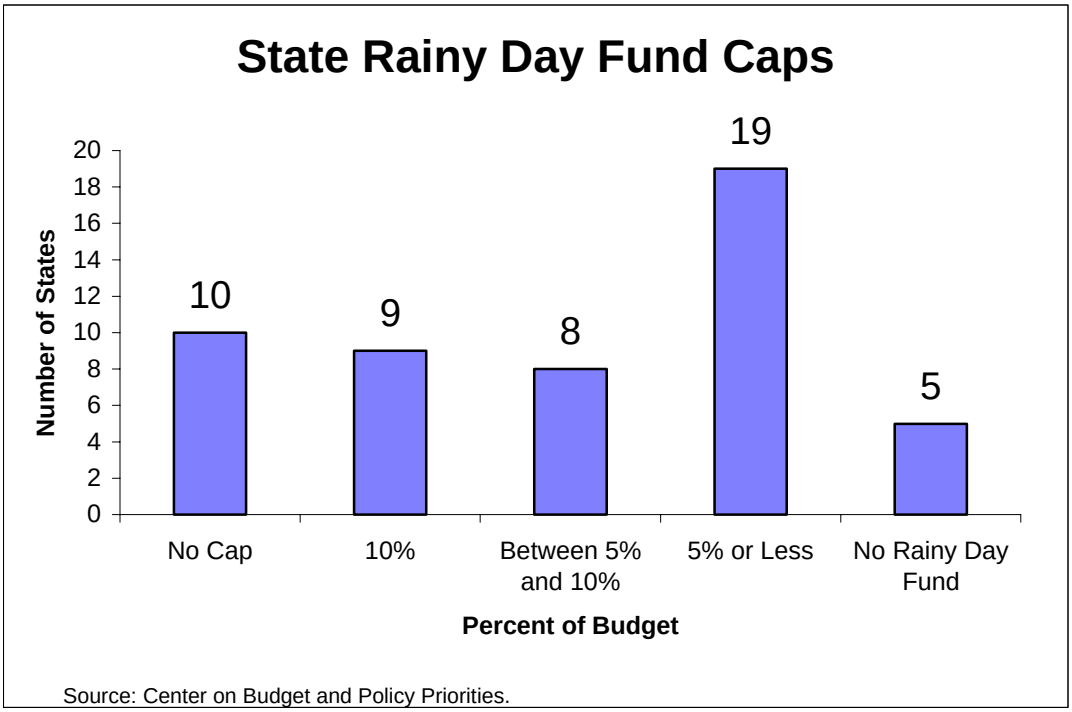
Rainy Day Fund Caps Should be Raised

One structural feature of rainy day funds that plays an important role in the size of the fund is whether or not there is a cap on the size of the fund. Rainy day fund caps place a limit on how large the fund can grow, typically measured as a percent of the budget. Clearly if the size of state rainy day funds are statutorily or constitutionally limited to an inadequate level, such as 5 percent of the budget or even less in some cases, then states are going to have difficulty accumulating adequate rainy day fund balances. While this may seem like an obvious point, this is exactly the case in over 40 percent of the states with rainy day funds. Specifically, 19 states have capped their rainy day funds at 5 percent or less (see Figure 2). These states are virtually guaranteed to find their rainy day funds inadequate. On the other end of the spectrum, 10 states have no cap and nine states have a cap set at 10 percent of the budget. (For a state-by-state summary of rainy day fund caps see Appendix Table C. For a summary of all the major rainy day fund provisions including: caps, super-majority requirements, limits on use, source of deposits and replenishment rules see Appendix Table D).

Rainy day fund caps clearly restricted rainy day fund growth since the end of the last recession. The rainy day funds in states with caps of five percent or less grew from 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 with caps of 10 percent or greater grew from 2.3 percent of expenditures at the end of 1993 to 9.0 percent of expenditure at the end of 2000. This indicates that raising rainy day fund caps is a critical policy option that states should pursue. 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 10 or 15 percent of the budget.

[7] Standard & Poor's. *Public Finance Criteria 2000*. New York: Standard & Poor's, a division of The McGraw-hill Companies Inc. 2000, pg. 29 and 27.

Figure 2



Source: Center on Budget and Policy Priorities.

Contribution Rules May Place Low Priority on Saving

A second structural reason contributing to the inadequacy of rainy day funds is that the rules for contributions do not give states much encouragement to save. The most common contribution rule — used in 30 out of 46 states with a rainy day fund — is that a portion of the state's year-end surplus must be placed in the rainy day fund.[8] This rule has the advantage of ensuring that the state is truly not in need of the funds before the deposit is made. The disadvantage is that the rainy day fund is last in line for receiving state resources. During the 1990s, for example, states moderately increased spending 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 raise spending or cut taxes were made. States are now paying the price for placing such a low priority on saving.

Other types of deposit rules can have the opposite effect; they may lead to required deposits when the state cannot afford to make them. 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 when the state is struggling to balance its budget. These rules are a particular problem in Missouri and Rhode Island where the deposits cannot be reversed. Deposits are made to the Missouri rainy day fund whenever the fund is below its targeted balance. In Rhode Island, an amount equal to two percent of revenues is set aside each year. In Hawaii and Maryland, on the other hand, annual contributions can be fully

[8] Some states define year-end surplus as revenues in excess of expenditures, while others define it as actual revenues in excess of projected revenues. The 46 states with a rainy day fund include DC.

withdrawn in a given year if needed. In Maryland, the state must deposit $50 million in its rainy day fund annually. In Hawaii, 40 percent of annual tobacco settlement funds are contributed to the rainy day fund.

Other states have rules intended to assure that rainy day fund contributions will be made when fiscal conditions are healthy. Some seven states — Arizona, Florida, Idaho, Indiana, Michigan, Tennessee, and Virginia — require deposits into the rainy day fund when growth in tax revenues or state economic growth is expected to exceed specified levels.[9] In Idaho, for example, the state contributes to its rainy day fund when revenues are projected to grow by more than four percent. In Arizona, Indiana, and Michigan, the deposit is tied to personal income growth.[10]

In some states, however, these rules can require states to make contributions when state finances are not particularly strong. In Tennessee, for example, 10 percent of any revenue increase 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. The personal income growth formulas are disconnected from the budget realities of estimated revenue growth and expenditure needs and may lead to deposits that are either not affordable or inadequate. For this reason, some states, such as Michigan, wisely use the contribution calculation as a guideline and not a requirement.

Why Haven't States Spent Money in their Rainy Day Funds?

While aggregate total reserve and rainy day fund balances have declined dramatically over the last two years, some states did not aggressively use rainy day funds to reduce the need for budget cuts or tax increases. This failure not only led to unneeded spending cuts, but also slowed the nation's economic recovery by holding funds out of the economy at a time when they were needed to boost demand thru additional spending. There are a number of reasons why states may choose not to use rainy day funds. In some cases, the failure to withdraw funds resulted from onerous rules requiring replenishment of withdrawn funds in an unrealistically short time frame. Other barriers to timely withdrawals included supermajority requirements and artificial limits on the amount of funds that may be withdrawn.

Replenishment

Six states — Alabama, Florida, Missouri, New York, Rhode Island and South Carolina — and the District of Columbia require that withdrawals from the rainy day fund be replenished over a specified period. Replenishment rules can be problematic for two reasons. In some cases they provide a disincentive to using the fund. When replenishment must occur soon after the

[9] Florida has two rainy day funds — the Budget Stabilization Fund and the Working Capital Fund. The Budget Stabilization fund requires a deposit when revenues increase from one year to the next. The Working Capital fund deposit rule is based on the year-end surplus and is included in the count of states which deposit a portion of the year-end surplus.

[10] In Michigan and Indiana a deposit is required when real personal income growth exceeds two percent. In Arizona a deposit is required when real personal income growth exceeds pre-determined trend level.

Claims about Impact of Using Rainy Day Fund on Bond Rating Are Overstated

A few state officials appear to believe that using Rainy Day Funds at this time would be seen negatively by bond rating agencies and result in a downgrade to a state's bond rating. Most recently, legislative budget leaders in Maryland expressed concern over former Governor Glendening's proposal to use $200 million of the state's $500 million rainy day fund to help close a FY 2003 budget gap of about $500 million. News accounts indicated that legislators were fearful that drawing down reserves would harm the state's AAA bond rating. This does not appear to be the case. For example, a recent Standard and Poor's publication indicated that prudent use of reserves would *not* affect a state's credit rating.

> 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] [Emphasis added]

Some policymakers are fearful of allowing the rainy day fund balance to drop below the arbitrary level of five percent of spending — even when the state is still battling the fiscal storm. Rainy day fund balance targets are intended to indicate the level of funding needed prior to the start of the economic downturn, not the level of funding the state must maintain throughout the crisis. In fact, seven of the 10 states with an AAA bond rating used one-third or more of their rainy day fund in 2002. Three of these top-rated states — Minnesota, North Carolina and South Carolina — used their entire rainy day fund in 2002.[b]

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

[b] Robin Prunty, Alexander M Fraser. *U.S. State Ratings and Outlooks: Current List*. Standard and Poor's, January 29, 2003.

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 fund, three — Alabama, Florida, and New York — allow replenishment to occur over a period of five years or more. Though not ideal, this lengthy period helps increase the likelihood that most of the replenishment will occur after the fiscal crisis is over. The average length of a state fiscal crisis is three to four years.

Shorter time periods, however, are problematic. In Missouri 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 in 2002, the District of Columbia, Missouri and Rhode Island did not use their rainy day funds.

States Should Not Hesitate to Use Remaining Rainy Day Fund Balances[a]

While states used rainy day funds extensively to balance 2002 and 2003 budgets, a number of states still have some money left in rainy day funds. States should not hesitate to use those remaining balances for a number of reasons:

- Drawing down rainy day funds is good for state economies. Both tax increases and spending cuts have negative economic consequences to varying degrees for a state because they reduce demand for goods and services, therefore dampening sales, profits, and job growth. Rainy day fund drawdowns can minimize those consequences.

- Continually preserving a rainy day fund for future problems is tantamount to not having a rainy day fund at all. Rainy day funds were specifically designed to provide a quick infusion of resources 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.

- The budget cuts and tax increases that a state can make most quickly often target the programs least appropriate to reduce in a recession or the taxpayers that can least afford to pay additional taxes. Using rainy day funds allows a state to maintain needed services in the short-term while it devises a more carefully considered solution to close whatever remaining budget gap it anticipates in this fiscal year and beyond.

- Using rainy day funds can help a state avoid cutting its "automatic economic stabilizers" — the programs for low-income families that rise in cost when need for such programs rises due to higher unemployment and lower wages.

[a] For a more detailed discussion of this issue, see Bob Zahradnik and Nicholas Johnson, *State Rainy Day Funds: What to Do When it Rains*, January 31, 2002, http://www.cbpp.org/1-31-02sfp2.pdf

Rainy Day Fund Rules Limit Use of Funds

Ten states have super-majority requirements governing the release of rainy day fund resources to address budget deficits.[11] 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.

Some 13 states set a limit on the amount of the rainy day fund that can be used at one time. In Idaho, Louisiana, Missouri, Oklahoma, Tennessee, and Virginia, only a specified percentage of the rainy fund (typically 50 percent) can be withdrawn at one time. In North Dakota, no more than $25 million can be withdrawn at one time. Arizona, Indiana, and Michigan use a more complex formula that ties the withdrawal amount to the severity of the state's economic problems. In D.C., only 44 percent of the total balance is available for a revenue shortfall; the remainder is set aside for a natural disaster. In Georgia, the Revenue

[11] Alaska, Delaware, Hawaii, Louisiana, Missouri, Oklahoma, Oregon, Pennsylvania, Texas and Washington.

Shortfall reserve is capped at 5 percent of revenues. The Governor can only recommend appropriating an amount equal to 2 percent of revenues. Only if state revenues fall short at the end of the fiscal year can the remaining amount, up to 3 percent of revenues, be used. In Oregon, proceeds from the rainy day fund must be spent on public education. These arbitrary limits 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.

Several states did not use their rainy day funds, or their use was limited, as result of replenishment rules, super-majority requirements and direct limits on use.

- Missouri's rainy day fund requires that the fund be replenished by one-third a year over the three years after the fund is used and that any lost interest must also be deposited into the fund. Missouri's governor proposed using a portion of the state's rainy day fund to help close a 2002 budget deficit. Repaying the fund with interest is an unusual requirement that legislative leaders cited as a reason for not using its $452 million rainy day fund to help balance a 2002 budget gap of $520 million, or 6.5 percent of the budget.[12] Instead of using the rainy day fund, they balanced the budget primarily through significant budget cuts in a wide range of government programs. Note, however, that even with the repayment requirement, using the rainy day fund is preferable to cutting spending or raising taxes (see the box on page 10.)

  In Missouri, the super-majority requirement was also a factor in limiting the use of the fund. The Senate easily approved the governor's proposal by a vote of 31-2. The House, however, was unable to garner the necessary two-thirds vote to authorize the use of the fund. The bill did gain a simple majority of votes in the House. In the absence of the super-majority requirement, Missouri would have been able to tap its rainy day fund and offset some of the budget cuts that were eventually implemented to balance the budget.

- The strict replenishment rules also influenced D.C. policymakers to avoid using its $250 million rainy day fund to address a $323 million shortfall identified in September, 2002. Instead, the deficit was eliminated entirely through substantial spending cuts and revenue increases.

- Virginia's limit that allows use of only 50 percent of the fund, coupled with its deposit rule, allowed policymakers to use only $248 million of its $716 million rainy day fund to address a $1.7 billion deficit in 2002. Virginia's rainy day fund balance at the beginning of 2002 was $716 million. The state made a mandatory deposit of $219 million, which increased the balance to $935 million. The 50 percent limit on the use of the fund meant that the state could withdraw up to

[12] "Hanaway takes heat for opposing use of rainy day fund to fix Missouri budget," *Kansas City Star*, May 16, 2002.

$467 million, which it did. However, the net withdrawal from the fund, factoring out the required deposit, was only $248 million.

- Louisiana's 2003 budget deficit is $86 million, but may grow to $186 million. The state can only access one-third, $86 million, of its $260 million rainy day fund in a single year. If the 2003 budget gap grows larger, policymakers will not be able to use the rainy day fund to reduce the gap further.

Common Sense Approach to Designing a Rainy Day Fund

Rainy day funds, if properly designed, are an important policy option for state policymakers. But there is room for improvement in the design of rainy day funds. Most state rainy day funds have not been adequate to close budget gaps during the current fiscal crisis. A few states still do not have separate rainy day funds (Arkansas, Colorado, Illinois, Kansas, and Montana), others are poorly designed and need to be reformed to function properly (for example, District of Columbia and Missouri).

There are four common sense steps states can take to design or restructure rainy day funds to make them more effective: use funding targets instead of caps and set the targets at levels that are in line with needs; develop an appropriate process for making deposits into the fund that lessons the probability that tax cuts or new spending programs will preempt saving in rainy day funds; allow flexibility in accessing the funds during a downturn; and avoid including onerous replenishment rules and eliminating those rules where they now exist.

First, the notion of a cap on the size of rainy day funds is problematic because the caps have prevented the funds from reaching an adequate level of funding. Instead of restricting the size of rainy day funds to an inadequate standard of five percent of the budget, states should set a target level for the size of the fund that is at least 10 to 15 percent of the budget. Once that target is met, policymakers should give serious consideration to making additional deposits into the fund above the 15 percent level.

Second, states could develop a more rational process for making rainy day fund contributions that would incorporate deposits into the budget development process prior to the beginning of the fiscal year in the following manner:

- 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 requirement. 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 allocated to new spending or tax cuts. 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.

The third element to a common sense approach to rainy day funds is that states should have flexibility in using the funds once there is an economic downturn. The most straightforward method for accessing rainy day funds is through the normal appropriation process. This makes sense because state legislatures typically address shortfalls in the current budget when they are developing the budget for the upcoming fiscal year. Placing a super-majority requirement on accessing the funds does not make sense because it creates an unnecessary political hurdle to making a withdrawal from the fund. Super-majority requirements also give additional leverage to a minority of legislators that can distort priority-setting and policymaking.

Using rainy day funds should be a state's first response to fiscal stress because other policy options, such as tax increases or budget cuts, require time for thoughtful consideration. A rainy day fund withdrawal provides a quick infusion of funds to keep the budget on track while other options are considered. Consequently there should be no artificial hurdles, such as a super majority requirement, to accessing the funds.

One option that makes sense is allowing the governor the discretion to use a portion of the rainy day fund without legislative approval. For example, the governor in Mississippi is authorized to use $50 million of the rainy day fund without legislative approval. In several states governors are required to make budget cuts to keep the budget in balance if a shortfall occurs during the fiscal year. If governors must unilaterally cut the budget, then they should have the option of reducing the magnitude of those cuts by unilaterally using a portion of the rainy day fund.

In addition to avoiding super-majority requirements, state rainy day fund policies should not place other hurdles on accessing the funds. Some states place a limit on how much states can withdraw from the rainy day fund in a given year or limit how the funds can be used. For example, Idaho and Virginia restrict withdrawals to only 50 percent of the balance in a given year. These types of provisions, like the super-majority requirement, unwisely reduce the flexibility that states have to tap rainy day funds when the need arises.

Finally, state rainy day fund policies should not include a replenishment rule. These rules create a disincentive for using the fund and may lead to rainy day fund deposits competing with other programs for scarce resources. If states appropriate deposits when the budget is developed, the need for replenishment rules would be greatly diminished. Overall, the funding targets and the deposit process described above should be utilized to ensure that once a state fiscal crisis ends, a state begins to plan for the next one.

Appendix Table A
Total State Ending Balances (General Fund Balances and Rainy Day Fund Balances)
(In Millions of Dollars and as a Percent of Expenditures)

	FY 2001 (Actuals)		FY 2002 (Preliminary Actuals)		FY 2003 (Appropriated)	
	Total Ending Balance	Total Ending Balance as a % of Expenditures	Total Ending Balance	Total Ending Balance as a % of Expenditures	Total Ending Balance	Total Ending Balance as a % of Expenditures
Alabama	74	1.4%	286	5.3%	261	4.8%
Alaska*	2,995	131.8%	2,483	104.6%	1,745	85.1%
Arizona*	387	6.1%	48	0.8%	36	0.6%
Arkansas	-	0.0%	-	0.0%	-	0.0%
California	3,037	3.9%	72	0.1%	2,509	3.3%
Colorado	470	7.0%	165	2.5%	116	1.8%
Connecticut*	626	5.2%	(224)	-1.9%	-	0.0%
Delaware	510	21.0%	482	19.6%	335	13.3%
Florida*	2,944	14.7%	3,318	17.2%	2,608	13.1%
Georgia	2,602	16.9%	1,226	7.9%	1,462	9.0%
Hawaii	370	11.0%	184	5.0%	73	1.9%
Idaho*	238	13.0%	54	2.7%	27	1.4%
Illinois	1,351	5.5%	482	2.0%	501	2.1%
Indiana	545	5.9%	269	2.8%	354	3.4%
Iowa	405	8.3%	232	5.0%	142	3.2%
Kansas	366	8.3%	12	0.3%	83	1.9%
Kentucky	240	3.4%	24	0.3%	58	0.8%
Louisiana	270	4.3%	260	4.0%	261	3.9%
Maine	183	6.9%	34	1.3%	(229)	-8.5%
Maryland	1,426	13.9%	857	7.8%	390	3.7%
Massachusetts	3,011	13.6%	1,217	5.3%	468	2.1%
Michigan	1,022	10.5%	376	4.1%	69	0.8%
Minnesota	1,574	12.4%	873	6.7%	318	2.3%
Mississippi	208	5.7%	107	3.0%	203	5.8%
Missouri*	561	7.3%	616	8.1%	527	6.7%
Montana	173	13.6%	82	6.0%	30	2.3%
Nebraska	406	16.4%	166	6.4%	93	3.5%
Nevada	262	14.3%	226	12.0%	132	6.5%
New Hampshire	55	5.2%	32	2.7%	(6)	-0.5%
New Jersey*	1,290	6.2%	100	0.5%	110	0.5%
New Mexico	449	11.7%	343	8.5%	328	8.4%
New York	1,098	2.8%	1,032	2.5%	716	1.8%
North Carolina	158	1.2%	25	0.2%	-	0.0%
North Dakota*	87	10.6%	68	8.4%	25	2.7%
Ohio	1,217	5.8%	536	2.5%	138	0.6%
Oklahoma	630	13.1%	147	2.9%	63	1.3%
Oregon*	363	6.9%	24	0.5%	128	2.5%
Pennsylvania*	1,372	6.9%	443	2.1%	318	1.5%
Rhode Island	211	8.5%	114	4.3%	102	3.8%
South Carolina	134	2.4%	50	1.0%	147	2.7%
South Dakota	111	13.8%	109	12.8%	79	9.0%
Tennessee*	209	3.0%	178	2.4%	178	2.3%
Texas	4,190	14.4%	2,337	7.6%	1,008	3.3%
Utah	133	3.5%	10	0.3%	10	0.3%
Vermont	47	5.3%	14	1.6%	18	2.0%
Virginia	716	5.7%	600	5.0%	498	4.1%
Washington	1,061	9.8%	495	4.4%	401	3.6%
West Virginia	241	8.9%	254	9.0%	62	2.0%
Wisconsin	208	1.9%	53	0.5%	145	1.3%
Wyoming*	114	15.8%	140	22.2%	33	4.4%
Dist. Of Col.	562	13.6%	865	23.1%	865	22.9%
Total US	40,910	8.0%	21,894	4.3%	17,936	3.4%

Sources: This table is based on data published by the National Association of State Budget Officers (NASBO) in *The Fiscal Survey of the States* , November 2002. The NASBO table has been adjusted by CBPP to reflect technical adjustments. The sources of these changes were conversations with NASBO, state officials and published state budget documents.

* The NASBO data for these states has been adjusted.

Appendix Table B
Rainy Day Fund Balances
(In Millions of Dollars and as a Percent of Expenditures)

	FY 2001 (Actuals)		FY 2002 (Preliminary Actuals)		FY 2003 (Appropriated)	
	Rainy Day Fund Balance	Total Ending Balance as a % of Expenditures	Rainy Day Fund Balance	Total Ending Balance as a % of Expenditures	Rainy Day Fund Balance	Total Ending Balance as a % of Expenditures
Alabama	8	0.2%	261	4.9%	261	4.8%
Alaska*	2,995	131.8%	2,483	104.6%	1,745	85.1%
Arizona*	373	5.9%	72	1.1%	30	0.5%
Arkansas	-	0.0%	-	0.0%	-	0.0%
California*	2,596	3.3%	-	0.0%	1,036	1.4%
Colorado	-	0.0%	-	0.0%	-	0.0%
Connecticut	595	5.0%	-	0.0%	-	0.0%
Delaware	126	5.2%	128	5.2%	129	5.1%
Florida*	1,383	6.9%	1,925	10.0%	1,138	5.7%
Georgia*	881	5.7%	847	5.5%	847	5.2%
Hawaii	21	0.6%	50	1.4%	53	1.4%
Idaho*	53	2.9%	53	2.7%	26	1.4%
Illinois*	-	0.0%	-	0.0%	-	0.0%
Indiana	526	5.7%	269	2.8%	279	2.7%
Iowa*	172	3.5%	25	0.5%	16	0.4%
Kansas	-	0.0%	-	0.0%	-	0.0%
Kentucky	240	3.4%	-	0.0%	-	0.0%
Louisiana	197	3.1%	260	4.0%	260	3.9%
Maine	144	5.4%	34	1.3%	-	0.0%
Maryland	888	8.7%	548	5.0%	494	4.7%
Massachusetts	2,294	10.4%	877	3.8%	347	1.5%
Michigan	994	10.2%	262	2.9%	31	0.3%
Minnesota*	622	4.9%	-	0.0%	318	2.3%
Mississippi	190	5.2%	92	2.6%	129	3.7%
Missouri*	452	5.8%	451	5.9%	451	5.7%
Montana	-	0.0%	-	0.0%	-	0.0%
Nebraska	170	6.9%	110	4.2%	62	2.4%
Nevada	136	7.4%	136	7.2%	36	1.8%
New Hampshire	55	5.2%	55	4.7%	55	4.6%
New Jersey	720	3.5%	-	0.0%	-	0.0%
New Mexico*	370	9.7%	312	7.7%	227	5.8%
New York	627	1.6%	710	1.7%	710	1.8%
North Carolina	158	1.2%	-	0.0%	-	0.0%
North Dakota*	25	3.0%	25	3.1%	25	2.7%
Ohio	1,011	4.8%	428	2.0%	71	0.3%
Oklahoma	340	7.1%	72	1.4%	36	0.8%
Oregon*	-	0.0%	-	0.0%	128	2.5%
Pennsylvania*	1,037	5.2%	300	1.4%	311	1.5%
Rhode Island	80	3.2%	82	3.1%	82	3.1%
South Carolina*	61	1.1%	-	0.0%	-	0.0%
South Dakota	111	13.8%	109	12.8%	79	9.0%
Tennessee*	178	2.5%	178	2.4%	178	2.3%
Texas	197	0.7%	916	3.0%	1,000	3.2%
Utah	120	3.2%	10	0.3%	10	0.3%
Vermont	43	4.9%	14	1.6%	18	2.0%
Virginia	716	5.7%	467	3.9%	467	3.8%
Washington	462	4.3%	113	1.0%	55	0.5%
West Virginia	79	2.9%	56	2.0%	58	1.9%
Wisconsin	-	0.0%	-	0.0%	-	0.0%
Wyoming*	109	15.1%	130	20.6%	28	3.8%
Dist. Of Col.	101	2.4%	257	6.9%	265	7.0%
Total US	22,654	4.4%	13,116	2.5%	11,489	2.2%

Sources: This table is based on data published by the National Association of State Budget Officers (NASBO) in *The Fiscal Survey of the States* , November 2002. The NASBO table has been adjusted by CBPP to reflect technical adjustments. The sources of these changes were conversations with NASBO, state officials and published state budget documents.

* The NASBO data for these states has been adjusted.
Colorado has a 4% annual budget reserve requirement that does not function as a rainy day fund.
Illinois' Budget Stabilization Fund is excluded because it functions as a cash flow fund and not a rainy day fund.
Iowa balance data excludes Cash Reserve Fund, which is a cash flow fund and not a rainy day fund.

Appendix Table C - Summary of Rainy Day Fund Caps

No Cap (10 States)	10% Cap (9 States)
Alaska	Connecticut
California	Florida**
Hawaii	Massachusetts
Maryland	Missouri
Michigan	Nevada
Nebraska	New Hampshire
New Mexico*	Oklahoma
North Dakota	Texas
Pennsylvania	Virginia
Wyoming	

Between 5% and 10% Cap (8 States)	No Rainy Day Fund (5 States)
Alabama	Arkansas
Arizona	Colorado
District of Columbia*	Illinois
Georgia*	Kansas
Indiana	Montana
Maine	
Mississippi	
Utah	

5% or Less Cap (19 States)	
Delaware	Oregon
Idaho	Rhode Island
Iowa	South Carolina
Kentucky	South Dakota
Louisiana	Tennessee
Minnesota	Vermont
New Jersey	Washington
New York	West Virginia
North Carolina	Wisconsin
Ohio	

* Cap calculation is based on totalling multiple funds.

**Florida has two funds, one with a 10% cap and one with no cap.

Source: Center on Budget and Policy Priorities.

Appendix Table D
A Summary of Rainy Day Fund Provisions

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
Alaska	Constitutional Reserve	None	Mineral litigation settlements	None when revenues decline from one year to the next For any other purpose 3/4 vote of legislature is required	None	None
Alabama	Education Trust Fund Rainy Day Account	6%	One-time funds	None	None	Within 5 years
Arizona*	Budget Stabilization Fund	7%	Deposit required when economic growth exceeds specified levels	None	Withdrawal amount based on depth of decline	None
Arkansas	None	NA	NA	NA	NA	NA
California	Special Fund for Economic Uncertainties	None	Year-end budget surplus*	None	None	None
Colorado	None	NA	NA	NA	NA	NA
Connecticut	Budget Reserve Fund	10%	Year-end budget surplus	None	None	None
Delaware	Budget Reserve Account	5%	Year-end budget surplus	3/5 vote of legislature	None	None
District of Columbia	Emergency Reserves	4%	None	None	Natural disaster or state of emergency	Within 1 year
District of Columbia	Contingency Reserve	3%	None	None	None	Within 1 year
Florida	Budget Stabilization Fund	10%	Deposit required when revenues increase from one year to the next	None	None	Within 5 years
Florida	Working Capital Fund	None	Year-end budget surplus	None	None	None

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
Georgia	Revenue Shortfall Reserve	5%	Year-end budget surplus	None	Governor can only recommend appropriating the 4th and 5th percentile of the revenue shortfall reserve. Only if state revenues fall short at end of fiscal year can the remaining 3% be used.	None
Georgia	Mid-Year Adjustment Fund	1%	Year-end budget surplus	None	None	None
Hawaii	Emergency and Budget Reserve Fund	None	Portion of tobacco settlement funds	2/3 vote of the legislature	None	None
Idaho	Budget Stabilization Fund	5%	Deposit required when revenue growth exceeds specified level	None	Only half of the full fund can be used in one year	None
Illinois	None	NA	NA	NA	NA	NA
Indiana	Counter-Cyclical Revenue and Economic Stabilization Fund	7%	Deposit required when economic growth exceeds specified levels	None	Withdrawal amount based on depth of decline	None
Iowa	Economic Emergency Fund	5%	None specified	None	None	None
Kansas	None	NA	NA	NA	NA	NA
Kentucky*	Budget Reserve Trust Fund	5%	Year-end revenue surplus*	None	None	None

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
Louisiana	Budget Stabilization Fund	4%	Year-end budget surplus and non-recurring funds	Requires 2/3 vote of legislature	Only 1/3 of fund can be withdrawn in a year	None
Maine*	Rainy Day Fund	6%	Year-end budget surplus	If fund is used for construction or bond payments, a 2/3 vote of legislature is required	None	None
Maryland	Revenue Stabilization Account	None	$50 million/year	None	None	None
Massachusetts	Commonwealth Stabilization Fund	10%	Year-end budget surplus	None	None	None
Michigan*	Counter-Cyclical Budget & Stabilization Fund	None	Deposit required when economic growth exceeds specified levels	None	Withdrawal amount based on depth of decline	None
Minnesota	Budget & Economic Stabilization Fund	$653 million (About 5%)	Year-end budget surplus	None	None	None
Mississippi	Working Cash Stabilization Reserve Fund	7.5%	Year-end budget surplus	None	None	None
Missouri	Budget Reserve Fund	10%	Required deposit when fund is below required balance	Withdrawal requires 2/3 vote of legislature	No more than ½ of the fund can be withdrawn	Equal payments over 3 years
Montana	None	NA	NA	NA	NA	NA
Nebraska	Cash Reserve Fund	None	Year-end revenue surplus	None	None	None
Nevada	Fund to Stabilize Operations of State	10%	Year-end budget surplus	None	None	None

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
New Hampshire	Revenue Stabilization Reserve Account	10%	Year-end budget surplus	To use the fund for any purpose (other than a revenue shortfall) a 2/3 vote of the legislature is required.	None	None
New Jersey	Surplus Revenue Fund	5%	Year-end revenue surplus	None	None	None
New Mexico	General Fund Operating Reserve	None	Year-end budget surplus and appropriations	None	None	None
New Mexico	General Fund Tax Stabilization Fund	None	Year-end budget surplus	None	None	None
New Mexico	Appropriations Contingency Fund	None	Year-end budget surplus	None	None	None
New York	Tax Stabilization Reserve Fund	2%	Year-end budget surplus	None	None	3 payments over 6 years
North Carolina	Savings Reserve Account	5%	Year-end budget surplus	None	None	None
North Dakota	Bank of North Dakota (Reserve Fund)	None	State bank profits	None	Withdrawal limited to $25 million	None
Ohio	Budget Stabilization Fund	5%	Year-end budget surplus	None	None	None
Oklahoma	Constitutional Reserve Fund	10%	Year-end budget surplus	None when revenues decline from one year to the next. When an emergency is declared, a 2/3 vote of legislature with concurrence of governor or a 3/4 vote without governor's concurrence	Only half of the fund can be withdrawn at a time	None

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
Oregon	Education Stability Fund	5%	15 percent of lottery revenue, increases to 18 percent on July 1, 2003	3/5 of legislature	Must be spent on public education	None
Pennsylvania	Budget Stabilization Reserve Fund	None	Year-end budget surplus	2/3 vote of the legislature is required	None	None
Rhode Island*	Budget Reserve and Cash Stabilization Account	3%	2% of revenues each year must be deposited	None	None	Must be repaid within 2 years, though law allows legislature to set longer repayment period
South Carolina	General Reserve Fund	3%	Year-end budget surplus	None	None	Must be repaid within 3 years
South Dakota	Budget Reserve Fund	5%	Year-end budget surplus	None	None	None
Tennessee	Reserve for Revenue Fluctuations	5%	Deposit required when revenues increase from one year to the next	None	When used for spending obligations, limit is greater of $100 million or half of the fund	None
Texas	Economic Stabilization Fund	10%	Year-end budget surplus and portion of excess oil taxes	Revenue shortfall - A 3/5 vote of legislature is required For any other purpose - A 2/3 vote of legislature is required	None	None
Utah	Budget Reserve Account	8%	Year-end budget surplus	None	None	None
Vermont	Budget Stabilization Reserve	5%	Year-end budget surplus	None	None	None

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
Virginia	Revenue Stabilization Fund	10%	Deposit required when revenue growth exceeds specified rate	None	Fund can be used to cover no more than half of a budget shortfall; also no more than half of the fund's balance can be used in one year	None
Washington	Budget Stabilization Account	5%	Year-end budget surplus	2/3 vote of legislature	None	None
West Virginia	Revenue Shortfall Fund	5%	Year-end budget surplus	None	None	None
Wisconsin	Budget Stabilization Fund	5%	Year-end revenue surplus	None	None	None
Wyoming*	Budget Reserve Account	None	Year-end transfer when appropriations exceed expenditures	None	None	None

* Notes:
Year-end budget surplus: When actual revenues exceed actual expenditures.
Year-end revenue surplus: When actual revenues exceed projected revenues.
Arizona: The legislature can waive the formula-based deposit or withdrawal through enactment of legislation with an "emergency clause."
Kentucky: Deposit to the rainy day fund also is required when spending falls below budgeted levels.
Maine: Based on statutory language, it appears that the Maine rainy day fund was created to be used only for bond payments or capital projects. But the fund has been used numerous times for other purposes. In practice, then, the Maine rainy day fund appears to be available for any purpose.
Michigan: The legislature can waive the formula-based deposit or withdrawal.
Rhode Island: The legislature is allowed to lengthen repayment beyond two years.
Wyoming: The governor is required to "recommend" that the legislature set five percent of annual revenues in the rainy day fund. This does not appear to be a mandatory contribution requirement.

Source: Center on Budget and Policy Priorities.