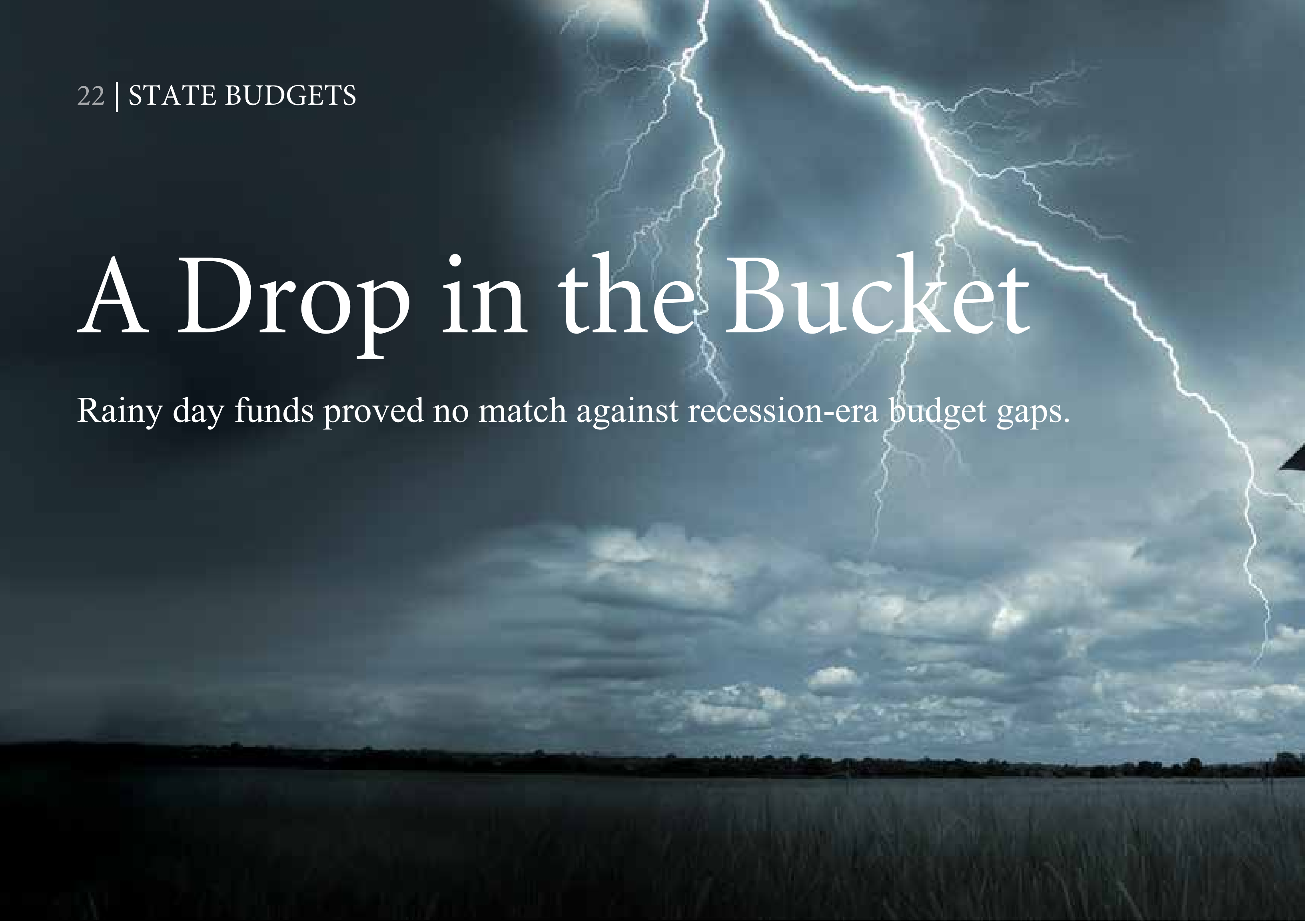

A Drop in the Bucket

Rainy day funds proved no match against recession-era budget gaps.

BY TODD HAGGERTY AND JONATHAN GRIFFIN

Rainy day funds are one of the most common tools states have to soften the blow of economic downturns and budget shortfalls. With the severe fiscal drought of the last decade you might assume the funds had all but dried up. Not so. Although they still remain below their pre-recession peak, they have steadily been rising.

When the balances of Alaska and Texas are removed from the tally (because their large reserves skew state averages), state rainy day funds fell from a total of $25.9 billion in FY 2007 to $10.4 billion in FY 2010, and now sit at an estimated $21.6 billion.

The funds played a role in helping lawmakers balance budgets throughout the last two recessions, but the role they played was a secondary one. This was partly due to a sense of uncertainty among policymakers—a feeling that despite how bad things are, they could get worse—that has led states to preserve balances rather than exhaust them during risky fiscal climates.

The main reason rainy day funds did not save the day single-handedly, however, is that the majority of them were simply not large enough to fill the deep budget gaps states faced.

In FY 2002, for example, the median rainy day fund balance stood at $95.7 million while the median budget gap was $394.8 million. This difference was even more pronounced in FY 2010, when the median rainy day fund was $105.7 million and the median budget gap was $1.3 billion. These figures each reflect just one year, understating the fact that in both recessions, states faced budget gaps four or more years in a row.

This illustrates that, by design, rainy day funds are intended to solve short-term budget problems, not to address severe or prolonged budget problems.

How Much is Enough?

Legislators, budget experts and observers have debated how much states should allocate for these "budget stabilization funds" since they were first developed. In fact, what size to cap these funds at has been the most controversial aspect of them over the years.

In the early 1980s, rating agencies recommended that states, in general, should set aside 3 percent to 5 percent of their revenues for the reserves. More recently, the Government Finance Officers Association suggested up to 15 percent or two months of general fund revenues might be more helpful.

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A Little Background

As their name suggests, budget stabilization funds exist to minimize the vulnerability of state budgets to economic fluctuations. Florida established the nation's first rainy day fund in 1959. Known as the Working Capital Fund, it was created to help pay for the day-to-day costs of services during the region's slow summer months, and to stave off the effects a 1958 crop freeze had on the state's economy.

In 1980, 10 states had adopted rainy day funds, and by 1989, 20 more. Today, 46 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands have some kind of rainy day fund.

Colorado, Kansas, Montana and New Mexico don't have "official" rainy day funds, although defining what is a state rainy day fund is no easy task. One state's definition of a stabilization fund is altogether different from another's. Colorado has a "required reserve," and New Mexico has a "restricted reserve," which some public finance experts count as rainy day funds because they serve to help stabilize the general fund budget.

Whatever the definition may be, the original concept of a rainy day fund is straightforward: Money is saved when state finances are sunny for use when the state's economy gets hit with a downpour.

It may not be politically feasible, however, for a state to maintain the level of reserves that many experts recommend, and appropriate reserve levels vary by state. Specific circumstances, such as the volatility of the state's revenue stream or the availability of other funds to augment the general fund influence what level is appropriate for each state.

In general, most states cap rainy day funds between 5 percent and 15 percent of their general fund revenues. Others base limits on appropriations. For example, New Jersey caps its Surplus Revenue Fund at 5 percent of total anticipated general fund revenues, while Connecticut limits is Budget Reserve Fund to no more than 10 percent of net general fund appropriations for the current fiscal year.

Responding to Reality

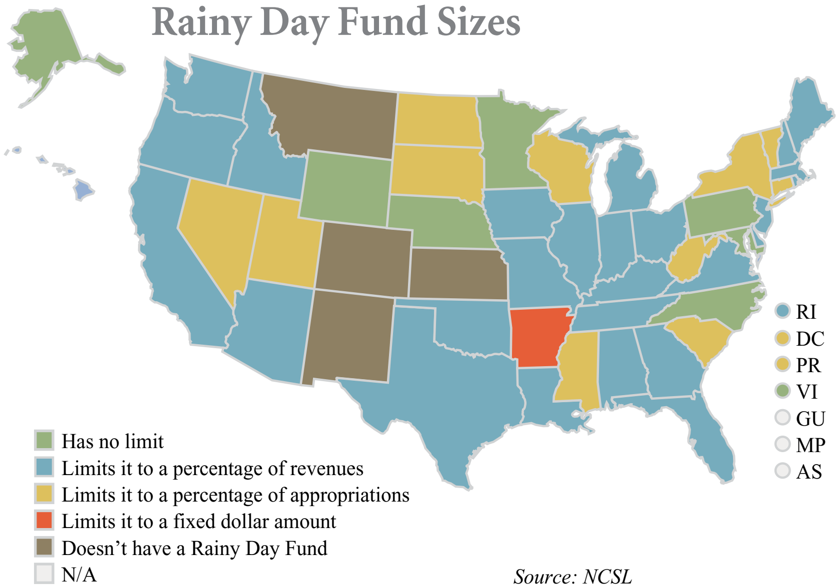
Given the insufficiency of rainy day funds throughout the last two recessions, lawmakers have made several changes in recent years.

Alabama repealed its statutory fund, and later added a second fund to its constitution when voters approved it in November 2008. Utah added an education-specific rainy day fund. West Virginia deposited the remainder of its Tobacco Settlement Medical Trust Fund into its rainy day fund. Vermont created a new rainy day fund similar to its Budget Stabilization Trust Fund, that gives the General Assembly, rather than the state's commissioner of finance and management, control over all withdrawals.

Several states also have increased the funds' size limits. Nevada recently increased the maximum fund balance from 10 percent to 20 percent of general fund appropriations. Georgia, Oklahoma and Virginia increased their caps from 10 percent to 15 percent, and Mississippi, Rhode Island, South Carolina and West Virginia also raised cap amounts. North Dakota is the only state that has reduced its cap, from 10 percent to 9.5 percent.

Nine states also have altered their methods for withdrawing funds. Oklahoma lawmakers, for example, changed their fund's rules so they could use $10 million from it to support manufacturing establishments facing the threat of downsizing the workforce.

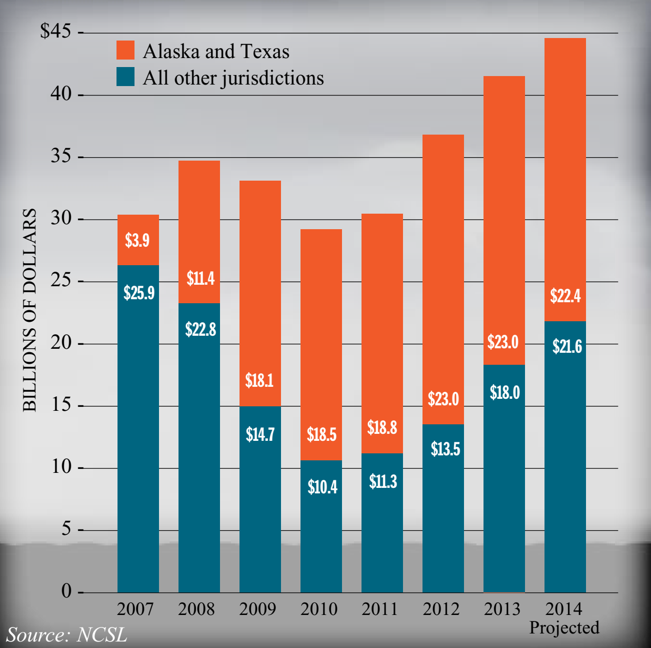
Restrictions on Rainy Day Fund Sizes



Source: NCSL

Rainy Day Fund Balances

Large rainy day reserves in energy-rich Alaska and Texas have skewed state averages, especially in the last few years. In FY 2007, these two states accounted for 13.1 percent of the cumulative rainy day fund balances. By FY 2012 this figure had climbed to 63 percent. This chart separates them out to give a more accurate snapshot of the volume of state funds.



Source: NCSL

Massachusetts added a provision that 90 percent of capital gain revenue in excess of $1 billion be transferred to the budget stabilization fund.

Structure of Rainy Day Funds

Although rainy day funds differ in design and purpose from state to state, there are four common elements that govern most. Lawmakers considering further changes to their funds may want to start with these four questions.

- What are the methods currently used to determine deposits?
- What rules govern withdrawals?
- What provisions have been set for repayment?
- What is the cap on the size of the fund?

Deposits to rainy day funds typically are based on year-end surpluses. For example, Utah requires 25 percent of its general fund surplus, while New Jersey, West Virginia and Wisconsin require 50 percent. Other states trigger deposits when revenues or economic growth exceed specified levels.

Triggers vary in variety and complexity. In Indiana, deposits are triggered when the annual growth rate in adjusted personal income exceeds 2 percent. In Idaho, deposits are triggered when revenue growth exceeds the average growth rate of the previous six years.

When states need to tap these funds, withdrawals typically require the approval of the legislature. A couple of states, like Mississippi and North Dakota, give their governors authority to make transfers from their budget stabilization funds to prevent cash deficits during the fiscal year.

Some states also cap the size of withdrawals made (for example, $50 million in Iowa and three-eighths of the fund's balance in Missouri).

After these funds have been tapped, several states stipulate how they are to be repaid. The terms and conditions for repayment vary by state. In Iowa and Mississippi, for example, withdrawals must be repaid by the end of the fiscal year. While in Florida, withdrawals must be repaid in five equal annual transfers from the general revenue fund beginning in the third fiscal year after the withdrawal was made. Minnesota law requires repayments only after an "upturn in the state's economy."

The Forecast for Rainy Day Funds

Recent experience demonstrates that rainy day funds alone cannot eliminate the disruptions caused by severe economic downturns, but they are one tool state lawmakers can use to resolve budget shortfalls and avoid potential deficits.

As state fiscal conditions appear to be stabilizing and settling into a period of modest growth, lawmakers are dealing with the competing demands to restore funding to programs, reduce taxes, invest in infrastructure and prepare for the next economic downturn.

Given the boom-and-bust nature of state finances, a case can be made that putting money into a rainy day fund is the most prudent course of action. Lawmakers, however, still must answer the same questions that have surrounded rainy day funds since their inception:

- What is the appropriate amount to accumulate in the rainy day fund?
- Would the state be better off using these funds for ongoing expenditures or returning them to taxpayers?
- Does the rainy day fund only delay finding permanent solutions to tough budget challenges?