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State Rainy Day Funds: What to Do When it Rains?

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Introduction

In the 1990s, many states set aside rainy day funds – reserve accounts funded during the recent economic expansion – to be the first line of defense against the pressures that declining revenues and rising need for public services in a recession might place on state budgets. That recession and the resulting fiscal stress have now arrived. Revenues are well below projections and in many states have actually declined from last year, and state expenditure needs have increased due to the economic hardships caused by job losses. In addition, the recent terrorist attacks are placing new spending demands on state budgets in the areas of public safety and public health. As a result, most states are facing large budget deficits that must be closed before the end of this fiscal year, and states expect to confront additional difficulty in fiscal year 2003 as well.

States are somewhat better prepared to deal with the current economic hardship then they were ten years ago at the start of the last recession. Due to the robust revenue growth of the last several years, states had total reserve balances (total reserves including rainy day fund balances, general fund balances and other reserves) equal to 7.7 percent of annual expenditures on hand at the end of fiscal year 2001 — before the fiscal effects of the recession were broadly felt. By contrast, states had total reserve balances of just 4.9 percent of expenditures in 1989, prior to the start of the last recession.[1]

As state legislatures convene this month to craft budget balancing plans for fiscal years 2002 and 2003, states continue to have significant rainy day fund balances available to assist in closing budget deficits. Current rainy day fund balances in aggregate equal 3.3 percent of expenditures; about one-third of the states have balances in excess of 5 percent of expenditures. (See table.) These reserve estimates are conservative because they only include rainy day fund balances and do not include general fund balances and other reserves.

Some policymakers are reluctant to spend these funds, in part because they fear their economic problems may be worse in future years than they are now. For example, in a

[1]National Association of State Budget Officers, *The Fiscal Survey of the States*, March 1990 and Dec. 2001.

Table 1
Estimated Rainy Day Fund Balance as of January 2002

State	Rainy Day Fund Balance ($ in Millions)	Rainy Day Fund Balance as a % of General Fund Expenditures
Alabama	13	0.2%
Alaska	2,399	99.4%
Arizona	147	2.2%
Arkansas	0	0.0%
California	0	0.0%
Colorado	0	0.0%
Connecticut	595	5.0%
Delaware	128	5.2%
Florida	941	4.6%
Georgia	735	5.0%
Hawaii	52	1.4%
Idaho	53	2.6%
Illinois	0	0.0%
Indiana	526	5.5%
Iowa	490	10.1%
Kansas	0	0.0%
Kentucky	119	1.6%
Louisiana	193	3.0%
Maine	102	3.9%
Maryland	563	5.2%
Massachusetts	1,293	5.7%
Michigan	739	7.9%
Minnesota	653	5.0%
Mississippi	168	4.7%
Missouri	152	1.9%
Montana	0	0.0%
Nebraska	110	4.1%
Nevada	136	7.4%
New Hampshire	55	4.8%
New Jersey	720	3.2%
New Mexico	396	10.2%
New York	627	1.5%
North Carolina	288	2.0%
North Dakota	0	0.0%
Ohio	600	2.7%
Oklahoma	341	6.5%
Oregon	0	0.0%
Pennsylvania	1,223	5.9%
Rhode Island	81	3.1%
South Carolina	63	1.1%
South Dakota	38	4.5%
Tennessee	178	2.4%
Texas	884	2.8%
Utah	125	3.2%
Vermont	44	4.9%
Virginia	903	7.3%
Washington	384	3.4%
West Virginia	63	2.1%
Wisconsin	0	0.0%
Wyoming	125	19.8%
Total US	17,445	3.3%
Dist. of Col.	101	2.8%

Sources: This table is based on one published by the National Association of State Budget Officers (NASBO) in *The Fiscal Survey of the States*, December 2001, which reflected projected rainy day funds as of the beginning of the state fiscal year. The NASBO table has been adjusted by CBPP to take into account actions taken by states since the start of the fiscal year and other technical adjustments. The sources of these changes were conversations with state officials and published state budget documents.

December special session to balance the current year's budget, Florida enacted some $1 billion in budget cuts without drawing down any of the state's $941 million rainy day fund. Governors and legislative leaders in other states are planning significant budget cuts while avoiding or minimizing rainy day fund use.

Retaining rainy day funds while cutting budgets often is not the best use of state resources. Just as states were wise to build up balances during good economic times, it makes sense for most states to spend these funds now to bolster their economies and prevent cuts in programs that rise in cost as residents lose jobs and income. In most states, the most appropriate policy would be to use a large portion of their rainy day funds this fiscal year.

- 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. For example, a state could gain time to appropriately target budget reductions to programs for which cuts would be less damaging to the economy, such as those that have reserve funds or the ability to levy user fees. Similarly, with the cushion of time afforded by use of rainy day funds a state could expand its revenue options to encompass tax increases that make economic and fiscal sense, but that may not produce additional revenues until the subsequent fiscal year.

- 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.

There is, however, one caveat to the general principle of using rainy day funds as the first response to fiscal distress. Rainy day funds are meant to provide a way for states to maintain

States Using Rainy Day Funds This Year

A few states have already tapped their rainy day funds to address their FY 2002 budget shortfall. In addition, several governors have submitted proposals to their legislatures requesting to tap their state rainy day fund. Examples of such use include:

- The governor of **Maine** has proposed using $98 million, or about 95 percent, of the state's $102 million rainy day fund to help close a budget deficit of about $250 million over the biennium.

- The governor of **Missouri** has proposed using $135 million, or about 90 percent, of the state's $152 million rainy day fund to reduce the level of spending cuts in the 2003 proposed budget from $613 million to about $480 million.

- **Kentucky's** governor spent some $120 million, or half of the state's rainy day fund, in late 2001 to avoid additional budget cuts.

- The governor of **Utah** proposed a budget plan that combines spending cuts with a transfer of $65 million, just over 50 percent, of the state's $125 million rainy day fund to address a $200 million revenue shortfall.

- Lawmakers in **Ohio** passed a deficit reduction plan that included using $411 million, about 40 percent, from the state's $1 billion rainy day fund.

programs during a cyclical economic downturn. In some states, the current problems are a combination of cyclical and structural problems. Using rainy day funds to compensate for structural budget deficits — long term imbalances between the growth rate of revenue and the growth in the cost of basic programs — is not good policy because it uses one-time money to fund an ongoing, rather than a cyclical, deficit. Thus states in which structural imbalances exist should take care to use rainy day funds only to offset cyclical deficits and create the climate in which more permanent fiscal problems can be addressed appropriately.

Using Rainy Day Funds Would Protect State Economies

When revenues fall below estimates, as they are projected to do this year in 43 states, states generally must balance their budgets in one of three ways: using savings from rainy day funds to maintain current levels of spending, raising taxes to maintain current levels of spending,

Use of Rainy Day Fund Won't Hurt Bond Rating

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. 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.]

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

or cutting spending. Of these options, using rainy day funds to maintain current levels of spending is the only option that avoids reducing the overall level of consumption in the state.[2]

Cuts in direct state spending or reductions in low-income transfer payments are damaging to the state economy because they reduce demand on a dollar-for-dollar basis. In other words, every dollar of a spending reduction results in at least one less dollar spent in the economy buying goods and services. When consumption falls, businesses tend to reduce their workforces, which further deepens the recession.

Tax increases also are damaging to the economy, because they leave taxpayers with less funds 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 and in part by reducing consumption. The precise impact depends on the characteristics of the affected taxpayer; 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 is damaging to the economy.[3]

[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 their size and availability. In addition, over-reliance on budget gimmicks can seriously jeopardize states' abilities to achieve long-term budget stability. To the extent that such measures are necessary and are supposed to be temporary, they should be accompanied by specific plans to reverse them in the future.

[3] Peter Orszag and Joseph Stiglitz, *Spending Cuts vs. Tax Increases at the State Level: Is One More Counter-*

(continued...)

Using rainy day funds, unlike either raising taxes or cutting spending, does not reduce consumption at all. In fact, using rainy day funds means taking money out of savings in order to increase consumption, which in the short run has a positive impact on the economy. Most states will not have sufficient rainy day funds or other reserves to completely avoid spending cuts or tax increases. However, using rainy day funds allows states to minimize the damaging effects of spending cuts and tax increases.

Rainy Day Funds Should Be First Response to Fiscal Stress

In this recession, states appear largely to be using budget cuts as the first response to developing budget gaps. Although spending reductions usually cannot be avoided when deficits are as deep as they currently are in some states, there are economic and practical advantages in taking the time to consider carefully which programs should be cut.

When policymakers look for budget cuts that can be enacted and implemented quickly, especially when deficits arise in the middle of a fiscal year, they often decide on across-the-board budget cuts or budget cuts that target the portion of the budget that has not yet been committed. There are problems with both these approaches. Across-the-board cuts do not distinguish between vital programs and programs for which there are lesser consequences from deferral or cancellation. This approach is particularly problematic in a recession when some programs, as described below, need to grow to assist residents who have lost jobs and income. Similarly, the most convenient budget cuts to make often are in programs that spend funds monthly, such as cash assistance and Medicaid, rather than in programs for which commitments are made at the beginning of the fiscal year or biennium, such as education, payments to local governments, or capital projects. Thus cuts often are made in the very programs that are most needed in a recession.

If policymakers are able to take time to consider budget cuts carefully, they may be able to direct cuts to areas that are less economically damaging and that fall less heavily on low-income residents. For example, some areas such as higher education or transportation may have some reserve funds that can be drawn upon in the short run to compensate for reductions in their current budgets. Or, some programs may have the ability to raise user fees temporarily to offset budget cuts. In both these cases, the budget cuts are likely to be less economically damaging than alternative reductions that would directly reduce consumption and economic activity in the state. And to the extent that it is possible to target budget cuts in this way, it is more likely that budget reductions can fall more lightly on the types of programs that are designed to help low-income families weather a recession. Policymakers can gain the time to analyze budget options and make these types of considered decisions by using rainy day funds to shore up state finances in the interim.

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[3](...continued)
Productive Than the Other During a Recession?, Center on Budget and Policy Priorities, October 31, 2001.

Policymakers that want to close budget gaps through tax increases also may need time to develop and consider options. During the last recession, states placed heavy emphasis on raising regressive taxes, such as sales and excise taxes. These types of taxes arguably are the easiest to increase — involving only a change in rate that can easily be publicized and implemented — and begin yielding new revenue very soon after the tax increase is implemented. They are, however, also the type of taxes that place a disproportionate burden on low- and moderate-income families, and increases in these taxes exacerbate the already regressive nature of most state and local tax systems.[4] Moreover, increasing the tax burden on low-income families is counter-productive during a recession because it takes money out of the pockets of the people who are most likely to spend it.

Some other revenue enhancing options may be preferable, but they may not generate new revenue immediately. For example, some corporate loophole closings or suspensions of previously enacted tax cuts that are scheduled to phase in may not yield additional revenues until the first full fiscal year after the change is enacted. Since state fiscal stress is expected to last well into fiscal year 2003 at a minimum, such changes make sense to enact even though they do not produce new revenues immediately. To the extent that policymakers find these type of changes preferable to increases in regressive sales and excise taxes, 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.

Using Rainy Day Funds Can Protect Programs for Low-Income People

Economic downturns naturally increase the need for programs that serve low-income households. These programs are called "automatic economic stabilizers" because spending on these programs automatically goes up (absent legislative intervention) when people lose jobs and income. Recent data indicate the automatic stabilizers are working. Enrollment and spending for unemployment insurance, the food stamp program, TANF, and Medicaid are rising rapidly. By meeting these growing needs, states can help support consumer spending by providing resources to the households most likely to spend immediately the financial assistance they receive.

Ensuring that programs to assist temporarily needy families are maintained is an appropriate use of rainy day funds. Such use can help states avoid repeating the experience of the early 1990s. The cuts in spending that plagued states in the early 1990s had severe consequences for low-income residents at a time when those residents needed state services most. As states with mid-year budgetary shortfalls looked for immediate savings, they often targeted programs in which funds were expended on a monthly basis. This led a number of

[4] Nicholas Johnson and Daniel Tenny, *The Rising Regressivity of State Taxes*, Center on Budget and Policy Priorities, January 15, 2002.

states, both mid-year and during the difficult give-and take at budget time, to adopt spending cuts or freezes in income assistance and health programs that primarily affected the poor.[5]

The threat of cuts to low-income programs is a real one; several states have already made significant cuts to low income programs in the latter months of 2001.[6] Some examples of actions taken in states that have already moved to weaken the safety net, either through legislative action or through executive budget cuts or proposed governor's budgets, include the following:

- The **Florida** legislature met for two special sessions before passing $1 billion in cuts to the state budget, which included $48.6 million from Medicaid services to individuals, $5 million from long-term care programs, $4.7 million from child protection programs, and $2.4 million from home and community services for the elderly. These cuts could have been avoided or moderated if Florida had used its $941 million rainy day fund.

- **Massachusetts** enacted a budget fix that cut child care services by $15.8 million, the Department of Social Services by $13.1 million, the Department of Mental Health by $11 million, the Department of Mental Retardation by $7.7 million, and a pharmacy program for seniors by $1.3 million. Massachusetts used some of its rainy day fund to close its budget gap, but made these cuts with $1.3 billion in rainy day reserves still available.

- The governor of **Washington** included $246 million in cuts to human services programs as part of his budget-balancing proposal — more than the reductions in higher education, K-12 education, natural resources, and general government combined. While human service programs comprise 32 percent of the state's general fund budget, they account for 43 percent of the governor's proposed reductions. The governor's budget-balancing proposal also includes using $150 million of the state's current $384 million rainy day fund, which leaves a $234 million rainy day fund balance that could have been used to further moderate the proposed budget reductions.

As states implement additional budget-balancing actions for fiscal years 2002 and 2003, rainy day funds can be tapped to reduce the need for further counter-productive cuts to programs for low-income people.

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[5] Iris Lav, Ed Lazere, Bob Greenstein and Steven D. Gold, *The States and the Poor: How Budget Decisions Affected Low-Income People in 1992,* Center on Budget and Policy Priorities, 1993.

[6] Kevin Carey and Iris J. Lav, *States are Cutting Low Income Programs in Response to Fiscal Crisis: Less-Counterproductive Options are Available*, Center on Budget and Policy Priorities, January 17, 2002.

Rainy Day Funds and Structural Deficits

There is a caution to use of rainy day funds, however, and it applies to states that suffer from "structural deficits." In these states, the fiscal systems do not generate sufficient revenue to support the normal growth of government spending. For example, because many states have failed to modernize their sales tax and corporate income tax systems, revenues generally do not keep pace with growth in the economy.[7]

The nature of a structural deficit makes it inappropriate to address with one-time fixes such as rainy day fund expenditures. The appropriate solution to structural deficits is to consider reforming the tax system through such measures as broadening the sales tax base to include more services as well as goods, closing corporate loopholes that allow multistate corporations to pay reduced income taxes, or replacing flat rate income taxes with progressive bracket structures. States like Florida and Minnesota are already considering broadening their sales tax bases, and Alabama and Ohio have tightened their corporate income tax laws. States in which structural imbalances exist should take care to use rainy day funds only to offset cyclical deficits and create the climate in which these more permanent solutions can be considered.

How Should States Prepare for a "Rainier" Day?

The recession, as formally defined, is likely to end late in the current fiscal year or early in the next year, according to consensus economic forecasts. Recessions typically last less than a year, and never in the last half-century more than 16 months, suggesting that the current downturn will end by spring or summer. By this time next year, an economic recovery is likely to have begun in most or all states.

Nevertheless, states are likely to continue to experience fiscal problems through fiscal year 2003 and into fiscal year 2004 due to the projected length and severity of the recession and its impact on state revenues and spending. Even after the recession ends, forecasters predict the economy will grow rather slowly for some time. Past experience suggests that unemployment is likely to continue to rise even after the recession is declared over. This will place continued downward pressure on state revenues, and also upward pressure on budgets for public assistance programs. Just as the recession of the early 1990s ended in March 1991 but affected fiscal year 1992 and in many places 1993 and even 1994 as well, states may find themselves confronting budget problems again next spring.

Many state policymakers are understandably and appropriately concerned that the end of the recession may not mean the end of states' fiscal problems. For this reason, some may be

[7] A recent discussion of the shortcomings of these taxes as currently structured can be found in Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?", *New England Economic Review*, Issue Number 4, 2001.

reluctant to take full advantage of their rainy day funds. Saving rainy day funds against the likelihood of a prolonged fiscal crisis, however, is not the answer. Instead, states should be devising now a multi-year plan to address recession-induced budget problems. As noted above, a number of types of deficit-closing actions states can take — such as closing corporate 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 effective for fiscal years 2002 and 2003 that yield small savings this year because they are effective for only part of the year, but that provide a full year of deficit relief next year.

Some policymakers also are worried that forecasters could be wrong, or that unforeseen events could cause the recession to deepen. The economy could even go through a "double-dip" recession such as that of the early 1980s. Or a natural disaster could place unanticipated pressures on a state budget.

Continually preserving a rainy day fund for the next potential problem, however, is essentially the same as not having a rainy day fund at all. There will always exist the possibility of an additional downturn or other emergency down the road. One way states can respond is to identify now a "contingency plan" in case such an additional funding squeeze occurs. For example, the governor of Missouri is proposing to use virtually all of the state's rainy day fund in the coming fiscal year and also has asked the legislature to give him the authority to securitize the state's tobacco settlement as a kind of additional emergency reserve. Similarly, Alabama, which now lacks a substantial rainy day fund, will ask voters in June to authorize the state to withdraw money from a reserve fund generated by offshore drilling leases if such funds are needed to avoid education funding cuts.

A final issue is how states should be preparing for the next recession. It should be obvious that for all the same reasons that states should be spending their rainy day funds down now, states should *not* begin replenishing their rainy day funds until the fiscal crisis is resolved. But states can begin designing rainy day funds so that they can do a better job in a future fiscal crisis of heading off damaging budget cuts and less-than-desirable tax increases. 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 for rainy day funds, with the goal that in a future economic downturn, those funds can be even more useful as a buffer against painful and economically-damaging tax and spending decisions.