

Fiscal Fact

Trend #8: Insufficient Rainy Day Funds

Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012

By
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Most states have created budget stabilization, or “rainy day,” funds to draw upon when economic conditions create a severe or sudden drop in tax revenues.¹ However, these cash reserves were for the most part inadequate in coping with the recent economic downturn. For all intents and purposes, only Alaska and Texas have sizable rainy day fund amounts remaining, although many states have begun to rebuild their balances.²

Generally, U.S. states are required by their constitutions or by statute to contribute to their rainy day funds according to a formula or rule up to a preset limit or cap. At a minimum, most are required to deposit some portion of year-end surpluses into their rainy day funds during good years. Some examples:

- **Idaho** must deposit any revenue in excess of 4 percent growth over the previous year’s revenues, up to 1 percent of revenues.
- **Louisiana** must deposit 25 percent of any non-recurring revenue, plus all surpluses in excess of \$750 million.
- **Utah** must dedicate 25 percent of year-end surpluses to the fund.
- **Virginia**’s deposits are based on a formula related to the growth in tax revenues over several years.
- **Washington** must contribute 1 percent of state general fund revenues to the fund each year, irrespective of economic conditions, until the fund reaches a level of 10 percent of general revenues.

The size of rainy day funds is typically benchmarked against annual appropriations or general revenues. There is no uniformity as to how much states are required to keep in their funds. The smallest funds are capped at 2 percent while the highest pre-set cap is 15 percent; seven states have no cap on their funds (see Table 1).

¹ Arkansas, Kansas, and Montana have not created such funds. See Daniel G. Thatcher, “State Budget Stabilization Funds,” National Conference of State Legislatures Report (Sep. 26, 2008), <http://ncsl.org/default.aspx?tabid=12630>.

² See National Conference of State Legislatures, *State Budget Update: Spring 2012*, http://www.ncsl.org/portals/1/documents/fiscal/sbu_spring2012_freeversion.pdf.

Table 1: State Caps on Rainy Day Funds, as a Percent of Spending or Revenues

Cap	Cap on Spending	Cap on Revenue
2.0%	New York, District of Columbia	South Carolina
2.5%		Iowa
3.0%	New York	Rhode Island, South Carolina
4.0%	Colorado, District of Columbia	Louisiana
5.0%	North Dakota, Tennessee, Vermont, Wisconsin, U.S. Virgin Islands	California, Delaware, Idaho, Illinois, Kentucky, New York, Ohio, Oregon
6.0%	Utah, Puerto Rico	Pennsylvania
7.0%		Arizona, Indiana
7.5%	Mississippi	Iowa, Maryland, Missouri, Oregon
10.0%	Alabama, Connecticut, South Dakota, South Dakota, Virginia, West Virginia	Florida, Georgia, Michigan, New Hampshire, Oklahoma, Texas, Washington
12.0%		Maine
15.0%	Nevada	Massachusetts
No Cap	Alaska, California, Hawaii, Nebraska, New Mexico, North Carolina, Wyoming	
Other	Minnesota (set dollar amount)	

Source: National Conference of State Legislatures.

Note: A state may appear more than once because of variations between the state's multiple funds.

To prevent the politicization and misuse of rainy day funds, many states have established tough legislative rules to authorize use of the funds or economic triggers that must be met before lawmakers can access the funds. According to the National Conference of State Legislatures (NCSL), 16 states require a legislative supermajority (three-fourths, two-thirds, or three-fifths) to withdraw from their funds.³ Other states permit drawing on the fund only after an economic trigger, such as a drop in personal income or an increase in unemployment.

While there is currently no consensus on how large a state rainy day fund should aim to be, bonding agencies and state budget officials generally target 5 percent as the appropriate amount. If the fund is too large, there are opportunity costs with the funds being tied up in reserve, as well as a worry that it would reduce incentives for careful expenditure planning.⁴

Recent scholarly research has studied past recessions to develop rainy day fund rules of thumb based on the average revenue shortfalls during an economic downturn. Wagner & Elder, for example, found that “the typical state can expect a revenue shortfall equal to 13 to 18 percent of revenue during a normal downturn.”⁵

³ See Thatcher, *supra* note 1.

⁴ See, e.g., Gary C. Cornia & Ray D. Nelson, *Rainy Day Funds and Value at Risk*, 29 STATE TAX NOTES 563 (Aug. 25, 2003).

⁵ Gary A. Wagner & Erick M. Elder, *Revenue Cycles and the Distribution of Shortfalls in U.S. States: Implications for an ‘Optimal’ Rainy Day Fund*, 60 NAT’L TAX JOURNAL 740 (Dec. 2007).

To achieve this during a typical period of economic expansion, states would need to save between 2.4 percent and 2.8 percent of each year's revenues during good economic times.

In 2006, the peak year for state rainy day funds between 2001 and 2012, only Alaska and Wyoming had accumulated at least 13 percent of their annual general fund spending level in reserve funds (see Table 2). Aside from those two states, North Dakota, and Oklahoma, all states had accumulated less than 10 percent of their annual general fund spending amount in a reserve fund.

Table 2: State Budget Stabilization Funds Fell Far Short of 13-18 Percent Level in FY 2006

State	Percent of General Fund Appropriations in Reserve Fund	Rank
All States (average)	4.9%	-
Alabama	No Fund	42
Alaska	76.5%	1
Arizona	7.1%	13
Arkansas	No Fund	42
California	9.7%	5
Colorado	No Fund	42
Connecticut	7.4%	12
Delaware	5.1%	20
Florida	4.0%	23
Georgia	4.1%	22
Hawaii	1.2%	38
Idaho	4.9%	21
Illinois	1.1%	39
Indiana	2.7%	31
Iowa	7.8%	9
Kansas	No Fund	42
Kentucky	1.4%	36
Louisiana	8.8%	8
Maine	1.7%	34
Maryland	6.0%	17
Massachusetts	7.6%	10
Michigan	0.0%	42
Minnesota	6.3%	16
Mississippi	0.5%	41
Missouri	6.9%	15
Montana	No Fund	42
Nebraska	9.2%	6
Nevada	7.5%	11
New Hampshire	5.2%	18
New Jersey	1.6%	35
New Mexico	8.9%	7
New York	2.2%	33

North Carolina	3.7%	26
North Dakota	10.2%	3
Ohio	3.2%	29
Oklahoma	10.0%	4
Oregon	No Fund	42
Pennsylvania	1.4%	36
Rhode Island	3.1%	30
South Carolina	2.7%	31
South Dakota	4.0%	23
Tennessee	3.3%	28
Texas	0.6%	40
Utah	4.0%	23
Vermont	5.2%	18
Virginia	7.0%	14
Washington	0.0%	42
West Virginia	3.5%	27
Wisconsin	0.0%	42
Wyoming	43.8%	2

Source: National Conference of State Legislatures, *State Budget Actions FY 2006 and FY 2007*.

Admittedly, developing a rule of thumb is difficult, as state revenue systems vary in reliance on different types of taxes. States with highly progressive income-based tax systems tend to experience more volatility and should therefore have larger reserves to weather economic downturns. States that rely more on consumption taxes, which tend to be more stable, need not have as much in reserves to smooth over revenue declines.

Having a well-funded rainy day fund may not obviate the need for making difficult programmatic cuts during an economic downturn but it can cushion the fiscal system in the short-term. Well-designed rainy day funds should have set rules for filling and withdrawing the funds, a targeted amount to save that takes into account the state's historical revenue volatility, and good transparency to ensure that citizens are informed about how the fund operates and is used.

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