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Governor Gregoire's Rainy Day Fund Proposal: Potential Benefits and Serious Limitations

States often have two types of fiscal problems — cyclical and structural. Cyclical deficits arise during downturns of the business cycle and typically are temporary. As the economy improves, the budget moves back into balance or surplus.

Structural deficits are indicative of a more deep-seated problem. They occur when the rate of growth of revenues regularly does not adequately fund the rate of growth of expenditures, even in good economic times. Washington periodically experiences significant cyclical deficits *and* suffers from a serious – and worsening – structural deficit.

Implemented correctly, a rainy day fund can be an important budgetary tool that helps to alleviate cyclical deficits. Solving the problem of structural deficits, however, requires more fundamental restructuring of the state's revenue system, a topic that is beyond the scope of this report.

Cyclical deficits and rainy day funds

During economic recessions, state revenues fall. At the same time, the demand for health care and economic security programs rises. The federal government, which is permitted to spend more than it earns, can deal with cyclical deficits by borrowing money. State governments – such as Washington State – do not generally have this option, so they are often forced to cut programs or raise revenues. Either choice during a recession risks deepening the downturn or extending its duration.

For this reason, a robust rainy day fund is an essential component of a fiscally responsible state budgeting policy. The concept is simple—when the state is raising more money than it needs, it should save some of that surplus for a time (such as a recession or natural disaster) when revenues are not sufficient to pay for important public priorities.

In practice, the details of a rainy day fund are crucial to its success or failure:

- Deposits to the fund should be mandatory, and should take priority over new expenditures and tax cuts in the allocation of surplus revenues. However, the requirement for mandatory deposits should be suspended during those periods when the funds are needed to continue to fund current commitments.
- The rainy day fund should be of sufficient size and should not be capped at too low a level.
- The fund needs to be accessible in times of need without undue hurdles.

Deposit rules should be fiscally sound

Decisions about making deposits into the rainy day fund must balance the need to make saving a priority with the need to adequately fund public services within the current budget period.

A sound deposit policy should keep in mind the following:

- Without rules requiring biennial deposits, savings will nearly always take a backseat to new expenditures or tax cuts. This results in decisions about savings decisions being held until the end of the budgeting process when any remaining surplus is deposited.
- Deposit requirements, while necessary, should not be so stringent as to require budget cuts. Rainy day savings should take precedence over new expenditures or tax cuts, but not over continuing to fund current commitments.
- Rainy day funds are designed to be spent during a period of recession or natural disaster. During such a period, it makes little fiscal sense to continue requiring deposits; those requirements should be automatically suspended.
- If the formula for requiring deposits is based on revenue projections, there should be a provision for reevaluating the requirement if economic (not policy) factors substantially change the revenue during the budgeted period.

Rainy day funds are not a bandage for structural problems

A rainy day fund is an important policy to ensure fiscal stability. It can protect from cyclical deficits, which are temporary shortages of revenue due to downturns in the business and labor market. A rainy day fund cannot fix a structural deficit, which is a situation where the revenue structure does not allow the state to raise adequate funding whether in good times or bad.

- Washington State's revenue system is projected to grow at a rate that is slower than the state's economic growth, while the costs of providing the vital structures Washingtonians depend on (education, health care, transportation, and so on) continue to grow along with the state's economy.
 - According to the Office of Financial Management, the state's structural deficit is projected to be \$653 million by 2011 and \$1.9 billion by 2013. However, these numbers include the rainy day fund, which would not be available to close the state's structural deficit. The actual total structural deficit not including the rainy day funds is much higher: \$1.2 billion in 2011 and \$2.8 billion by 2013.
 - The structural deficit will already affect the state during the 2007-09 biennium. The Governor's budget would leave a surplus, but that surplus is due completely to carry-over revenue from previous biennia.
 - Eliminating Washington's structural deficit would require significant changes to its tax and budget structure.
- While deposits to the rainy day fund should be appropriated along with other spending priorities, the actual deposit should be left until the end of the budget period when it is known whether revenue and spending held up to projections.

The best policy would be a deposit requirement designed around a "current services" surplus. A current services surplus exists when projected revenue (as calculated by the Economic and Revenue Forecast Council) is expected to be higher than the cost needed to pay for current commitments (as calculated by the Office of Financial Management). Rainy day fund legislation could require that a certain portion of the

current services surplus would be automatically appropriated to the rainy day fund before the remaining surplus is appropriated to new investment or revenue reductions.¹

Other states

Thirty states including Washington State have requirements that the states deposit all or some of the revenues not appropriated elsewhere into a savings account.² A number of other states have more specific deposit requirements. Five states have special dedicated fund sources such as lottery or tobacco settlement funds. Six states have deposits that are determined based on revenue or personal income growth. Rhode Island requires two percent of revenue to be deposited each year. Maryland requires \$50 million each year and Missouri requires deposits whenever the fund balance is below the required level.³

Governor's proposal

Governor Gregoire proposes substantially expanding upon the state's current deposit requirements to create a full-fledged rainy day fund. She proposes a constitutional amendment that would require that one percent of the state's general revenue be deposited into the rainy day fund without regard to the fiscal balance of the state's budget. This means that cuts in current services could be required in order to make the deposits. A better policy design would be to directly measure the current services surplus and tie the deposit requirement to the size of the surplus.

The fund should be allowed to grow to an adequate size

Decisions about the size of the fund must balance the need for a robust account that will serve its purpose while not allowing the fund to grow too large.

A sound policy about the size of the rainy fund should consider:

- Studies by the Center on Budget and Policy Priorities and recommendations by the Government Finance Officers' Association suggest that an adequate rainy day fund would be equal to 15 percent or more of the state's annual general fund expenditures. This has been determined by looking at the experience of states during the recent recession.⁴
- Caps that do not allow the rainy day fund to grow beyond a certain size are often set too low and prove inadequate during a time of need.

- Once the rainy day fund reaches the target level, policymakers should have flexibility in deciding whether it makes sense to increase the size of the fund or appropriate the money elsewhere.

Other states

While many states (all but 10 of the 45 states plus the District of Columbia that have rainy day funds) cap the size of the fund at 10 percent or less of the state's budget, many of those caps date from a time in which a five percent reserve was considered to be adequate. The last two recessions, however, have made it clear that a larger reserve is necessary. In 2005, 38 states, including Washington, had reserves of less than 10 percent of total spending but a number of states have continued to build reserves as revenue growth has improved in the past couple of years.

Governor's proposal

The Governor proposes to cap the rainy day fund at 10 percent of annual general state revenue. Any required deposits that would exceed 10 percent would be deposited instead to a school construction fund. Recent experience in Washington State suggests that this cap may be too low. When the 2003 legislative session began, it was projected that the cost of continuing current services for the 2003-05 biennium would be \$25.1 billion, but revenues were expected to be \$22.4 billion, a deficit of \$2.7 billion. The governor's rainy fund would have been roughly one billion at most, and would have been depleted in the first year of the biennium.

The fund should be accessible when needed

A useful rainy day fund must be made accessible during times of need, but not depleted for new spending.

A sound fund access policy should consider:

- Supermajorities should not be required to access the fund. Such a rule would create another barrier to effective legislative activity. A minority of legislators could block the sensible use of the rainy day fund in times of fiscal crisis.
- An alternative might be the establishment of some objective standard for determining when the fund could be used. However, it is difficult at best to put into statute a trigger that would consistently allow access to the fund when needed.

There can be a significant lag before economic data is available and projections of economic data are far from perfect.

- Limiting use of the funds to circumstances in which there is a current services deficit – again, where revenues are not sufficient to cover the cost current state services – and the legislature determines that the state is in an economic downturn.
- When the state is facing a current services deficit, the amount of the rainy day fund that can be used at one time should not be limited. The rainy day fund is the quickest and easiest way of solving the fiscal crisis in the first year of a biennium. Other budget balancing measures such as revenue increases or targeted budget cuts require more time to analyze and implement.
- There should not be rules requiring quick replenishment of funds. These rules can exacerbate the problem if the fiscal crisis continues into the period when replenishment is required. Particularly stringent rules also create a disincentive to access the funds.

Other states

In most states, a majority vote of the legislature is sufficient to appropriate monies from the rainy day funds and the legislature may use whatever proportion of the monies in the funds it deems appropriate. Only 10 of the 46 states with rainy day funds have supermajority requirements, and only 13 states have set limits on how much of the fund can be used at one time. Only six states and the District of Columbia have strict replenishment rules, three of which were not able to access their rainy day funds during the recent fiscal crisis despite having significant deficits.

Governor's proposal

The Governor's proposal would set supermajority requirements unless 1) the Governor declares an emergency, or 2) forecasted employment growth is less than one percent. Unless the economic forecasts meet those criteria, the proposal would give a minority in the legislature or the Governor disproportionate influence over use of the rainy day fund.

Conclusion

A rainy day fund would be a welcome addition to Washington State's budget policy in that it could potentially provide a powerful budgetary mechanism for ameliorating the negative impacts of cyclical economic downturns. For a rainy day fund to be effective, however, it must be structured in a way that will allow it to serve its desired purpose. The Governor's proposal could be improved in key ways based upon established criteria for rainy day fund design drawn from the experiences of other states.

Moreover, the creation of a rainy day fund in Washington state, even one predicated on a careful adherence to fiscal policy best practices, will be of full benefit only if paired with a responsible effort in the near-term to cure the growing structural deficit facing the state. Otherwise, policymakers could find themselves in the perverse position of locking away scarce dollars for some potential future calamity while ignoring or exacerbating present-day problems.

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Endnotes

¹ This idea is proposed in Zahradnik, Bob, *Rainy Day Funds: Opportunities for Reform*, March 9, 2005, Center on Budget and Policy Priorities.

² In addition, Washington State has an emergency reserve account that was established by Initiative 601. Approved by the voters in 1993, I-601 created a spending limit and a "rainy day" fund for excess revenues. Revenue above the spending limit is deposited into the Emergency Reserve Fund. If the balance of the Emergency Reserve Fund exceeds five percent of annual revenues, the excess is deposited into the Student Achievement Fund. In reality, there has not been excess revenue to deposit into the fund in many years.

³ All Information in this report about the rainy day fund policies of other states comes from Zahradnik, Bob, *Rainy Day Funds: Opportunities for Reform*, March 9, 2005, Center on Budget and Policy Priorities.

⁴ See, for example, <http://www.gfoa.org/services/rp/budget.shtml#10>.