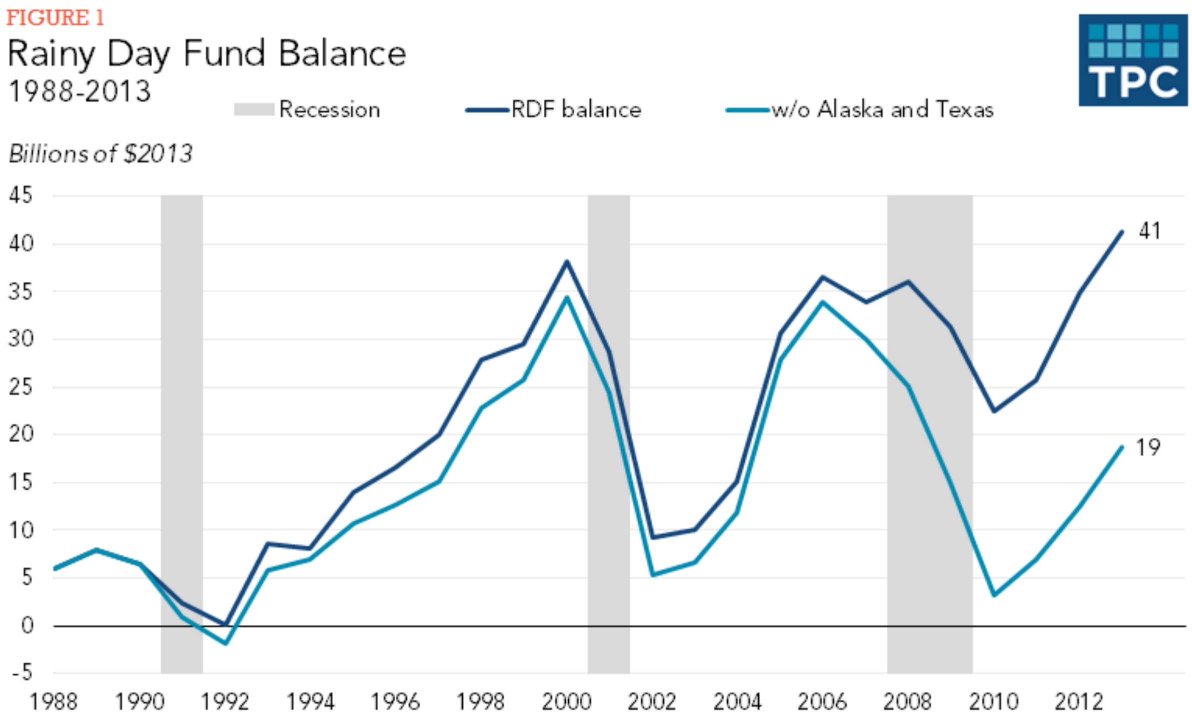
**What are state rainy day funds, and how do they work?**

Budget stabilization funds allow states to set aside surplus revenue for times of unexpected revenue shortfall or budget deficit (figure 1). Every state but Arkansas, Kansas, and Montana has some type of rainy day fund.




**Sources:** National Association of State Budget Officers; Bureau of Labor Statistics for CPI.

## SOURCES OF FUNDING

How rainy day funds (RDFs) are funded varies state to state (table 1). Most allow some or all year-end surplus to flow to the RDF. Other states require specified set-asides every year until the fund reaches its cap. A few states replenish with specific appropriations as part of the budget process. Finally, some RDFs have dedicated sources of revenue. Natural resource–rich states dedicate a portion of revenue from extraction to various reserve funds. Recently, California and Massachusetts dedicated a portion of capital gains tax revenue to RDFs.

TABLE 1

## Rainy Day Fund Funding Mechanisms

| Funding mechanism | States |
|---|---|
| Year end surplus deposited in RDF | Alaska, Delaware, Georgia, Iowa, Kentucky, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma |
| Portion of year end surplus deposited in RDF | Louisiana, Maine, Minnesota, Nevada, New Jersey, Pennsylvania, Texas, Utah, West Virginia, Wisconsin |
| Automatic deposit - certain percentage of revenues or appropriations | Alabama, California, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Missouri, Rhode Island, South Carolina, Tennessee, Vermont, Washington |
| Deposit triggered by revenue growth | Arizona, Idaho, Indiana, Nebraska |
| Other | Illinois, Michigan, Oregon, South Dakota, Virginia, Wyoming |
| No RDF | Arkansas, Kansas, Montana |

**Source:** National Association of State Budget Officers.

## USE OF FUNDS

In most states, the RDF is dedicated to closing fiscal gaps in the current year or maintaining government spending when revenues are projected to decline. However, some states use funds only for specific purposes. For example, Colorado's fund can only be used to cover shortfalls caused by natural disasters.

The means of access varies; some states allow transfers from the RDF to be included in normal appropriations bills, while others require an emergency declaration or a supermajority (three-fifths or two-thirds) of the legislature to make a transfer. Several states also allow the RDF to be used to cover short-term cash flow gaps. Funds are transferred to the general fund and must be paid back by the end of the fiscal year.

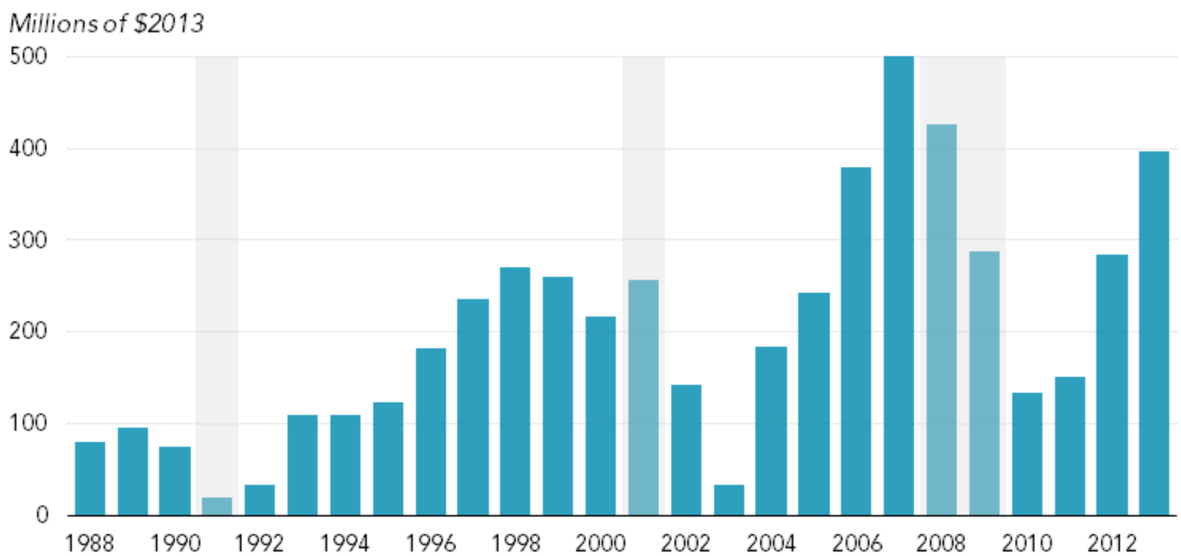
## CAPS

Twenty-five states cap the balances of their funds. The cap is either a percentage of revenue or expenditure. Most states that fund RDFs with operating surpluses stop transfers once the cap has been reached. But a few redirect surpluses to other funds for special projects or taxpayer relief. New Mexico, for example, has a "cascading" fund balance. The operating reserve is capped at 8 percent, and any excess goes to the tax stabilization reserve. This reserve is also capped, and its excess flows to the taxpayer dividend fund. Other states have separate reserve funds for education or Medicaid spending designed to cover shortfalls in these vital programs.

## MITIGATING FISCAL CRISIS

An economic downturn can cause significant fiscal stress for states because without changes in policy, revenues decline even as demands on programs such as unemployment insurance and Medicaid increase. Savings in rainy day funds help them weather a fiscal downturn with fewer expenditure cuts. The median balance of state RDFs declined significantly after the last three recessions and then built back up (figure 3).

FIGURE 3
Median Balance of Rainy Day Funds
1988-2013




**Source:** NASBO Survey of State Finances, various years.

Capping the amount in the RDF is a sensible approach to preventing the unnecessary build-up of restricted funds, but the cap has to be set appropriately. The rule of thumb had been 5 percent of expenditures, but the Great Recession has made states reconsider. Only 5 of the 25 states with caps top out at 5 percent or less. The Government Finance Officers Association recommends two months of expenditures, or about 16 percent, though only four states had RDF balances above 16 percent at the end of 2013, and all were natural resource–rich states (Alaska, North Dakota, West Virginia, and Wyoming).

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