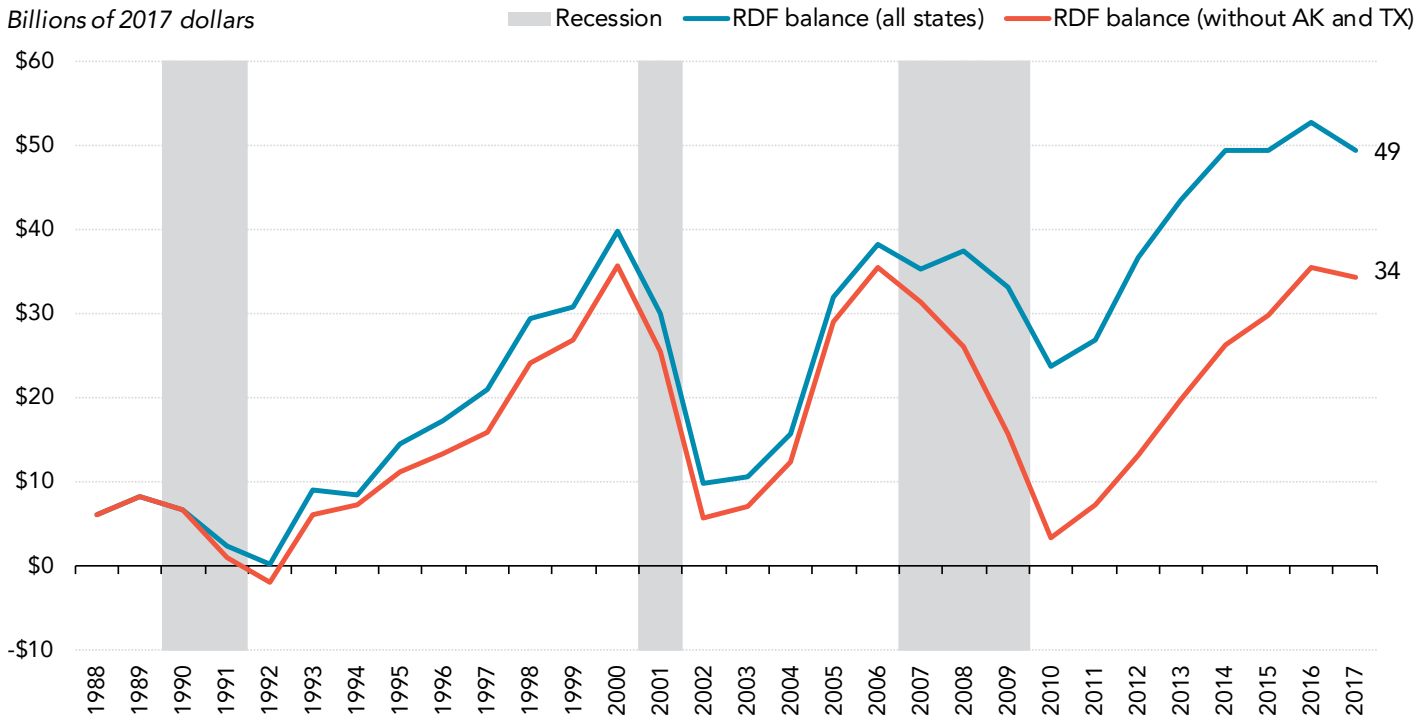
Q. What are state rainy day funds, and how do they work?

A. Rainy day funds, also known as budget stabilization funds, allow states to set aside surplus revenue for use during unexpected deficits. Every state has some type of rainy day fund, though deposit and withdrawal rules vary considerably.

FIGURE 1

Total Rainy Day Fund Balance

All states, 1988–2017



Source: National Association of State Budget Officers, Fiscal Survey of the States, various years, https://www.nasbo.org/reports-data/fiscal-survey-of-states; and National Bureau of Economic Research, "US Business Cycle Expansions and Contractions," http://www.nber.org/cycles.html.

Note: Data are reported in state fiscal years.

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SOURCES OF FUNDING

States finance their reserve funds differently (table 1). Most allow some or all of their year-end surplus to flow to the rainy day fund (RDF). Other states require a flat contribution out of total or special revenue sources. California, for example, dedicates a portion of its capital gains tax revenue to its budget stabilization account. Similarly, natural resource–rich states like Texas and Louisiana dedicate a portion of oil extraction revenues to various reserve funds, in combination with other deposit mechanisms.

A handful of states tie their reserve accounts to either revenue or economic growth. Arizona, for example, ties its deposits to a personal income growth formula, although the legislature must authorize the transfer. Other states require specified set-asides until the fund reaches its minimum required balance. A few states replenish their funds with discretionary appropriations as part of the budget process, but regular contributions are not automatic or required in these states. Except for the few states (such as Colorado) required to remit surplus revenues to voters, most states can also carry additional general fund surpluses into the following fiscal year once any RDF funding requirements are met.

TABLE 1

Rainy Day Fund Deposit Mechanisms

August 2018

Deposit mechanism	States
All or portion of year-end surplus	Connecticut, Georgia, Kentucky, Maine, Minnesota, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Utah, Vermont, West Virginia, Wisconsin
Portion of total or special revenues	Alaska, California, Nevada, Rhode Island
Tied to revenue or economic growth	Arizona, Idaho, Illinois, Indiana, Michigan, New Mexico, North Carolina, Tennessee, Virginia
Required minimum balance	Colorado, Florida, Iowa, Missouri, South Carolina
Combination	Delaware, District of Columbia, Hawaii, Louisiana, Maryland, Massachusetts, Texas, Washington
No required payments	Alabama, Arkansas, Kansas, Wyoming

Sources: National Association of State Budget Officers, *Budget Processes in the States*, 2015, https://www.nasbo.org/reports-data/budget-processes-in-the-states; the Pew Charitable Trusts, "Building State Rainy Day Funds," July 15, 2014, http://www.pewtrusts.org/en/research-and-analysis/reports/2014/07/15/building-state-rainy-day-funds-policies-to-harness-revenue; the Pew Charitable Trusts, "State Rainy Day Funds in 2017, July 18, 2017, http://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2017/07/state-rainy-day-funds-in-2017; and Tax Policy Center staff review of state constitutions and statutes.

Notes: Connecticut currently funds its rainy day fund (RDF) out of year-end surplus, but in 2015 it adopted new rules that will tie deposits to revenue growth. Illinois' RDF has loose deposit and withdrawal rules, and thus does not meet the definition of a rainy day fund for some researchers and state budget analysts. The state has not contributed to the fund since the deposit rules were established in 2004. Kansas established an RDF in 2016 and enacted a funding mechanism that will go into effect in 2019, dedicating 10 percent of unappropriated general fund surplus to its RDF. Currently, it is funded via discretionary legislative appropriation. Montana established its reserve fund in 2017 and currently funds it via end-of-year surpluses, but in 2021 will switch to a deposit mechanism based on revenue growth.

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USE OF FUNDS

In most states, the RDF is dedicated to closing deficit gaps in the current year or maintaining government spending when revenues are projected to decline. However, withdrawal rules vary. Some states include transfers from the rainy day fund to the general fund in normal appropriations bills, while others require an emergency declaration or a supermajority (e.g., three-fifths or two-thirds) of the legislature to make a transfer. Several states can use the RDF to cover short-term cash flow gaps. Money is transferred to the general fund and must be paid back by the end of the fiscal year.

In addition to an RDF that can be used for general purposes during a fiscal crisis, some states have reserve funds available only for specific uses. For example, 36 states have a reserve account dedicated to natural disaster recovery. Other states have separate reserve funds for education or Medicaid spending, designed to cover shortfalls in these vital programs. Deposit and withdrawal rules for these supplemental reserve accounts may vary considerably from the rules governing the state's primary RDF.

CAPS ON FUND BALANCES

Thirty-one states cap the balances of their funds. The cap is typically a percentage of either revenues or expenditures, although some states have more complex formulas for determining maximum fund size. Most states that finance their RDF with operating surpluses stop transfers once the cap has been reached, allowing the surplus to remain in the general fund. A few redirect those operating surpluses to other funds for special projects or taxpayer relief. Maine, for example, after transferring the required fixed amounts to several other reserve funds, directs 80 percent of the remaining surplus to its budget stabilization fund and the remaining 20 percent to its tax relief fund for residents. If the RDF is at its cap, excess surplus flows to the tax relief fund.

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 states weather a fiscal downturn with fewer expenditure cuts. The median balance of state RDFs declined significantly after each of the last three recessions, but states have gradually built them back up each time (figures 1 and 2).

Capping the amount in the RDF is a sensible approach to preventing the unnecessary build-up of restricted funds, but the cap must be set appropriately. Before the Great Recession, a typical rule of thumb was to maintain at least 5 percent of total expenditures or revenues in reserves. States that cap out at 5 percent or less, therefore, may find reserves inadequate to close fiscal gaps. Currently, 7 of the 31 states with caps top out at 5 percent or less.

Many states have reconsidered the 5 percent rule since the Great Recession, as even states with robust prerecession RDFs exhausted much of their reserves. The Government Finance Officers Association now recommends states set aside at minimum two months of operating expenditures (i.e., roughly 16 percent of total general fund spending). Only four states had RDF balances at or above 16 percent at the end of 2017, and all were natural resource–rich states (i.e., Alaska, North Dakota, Texas, and Wyoming). In another approach, also recommended by the Government Finance Officers Association and others, some states have begun to tie and tailor their caps and deposit mechanisms to their own revenue volatility.

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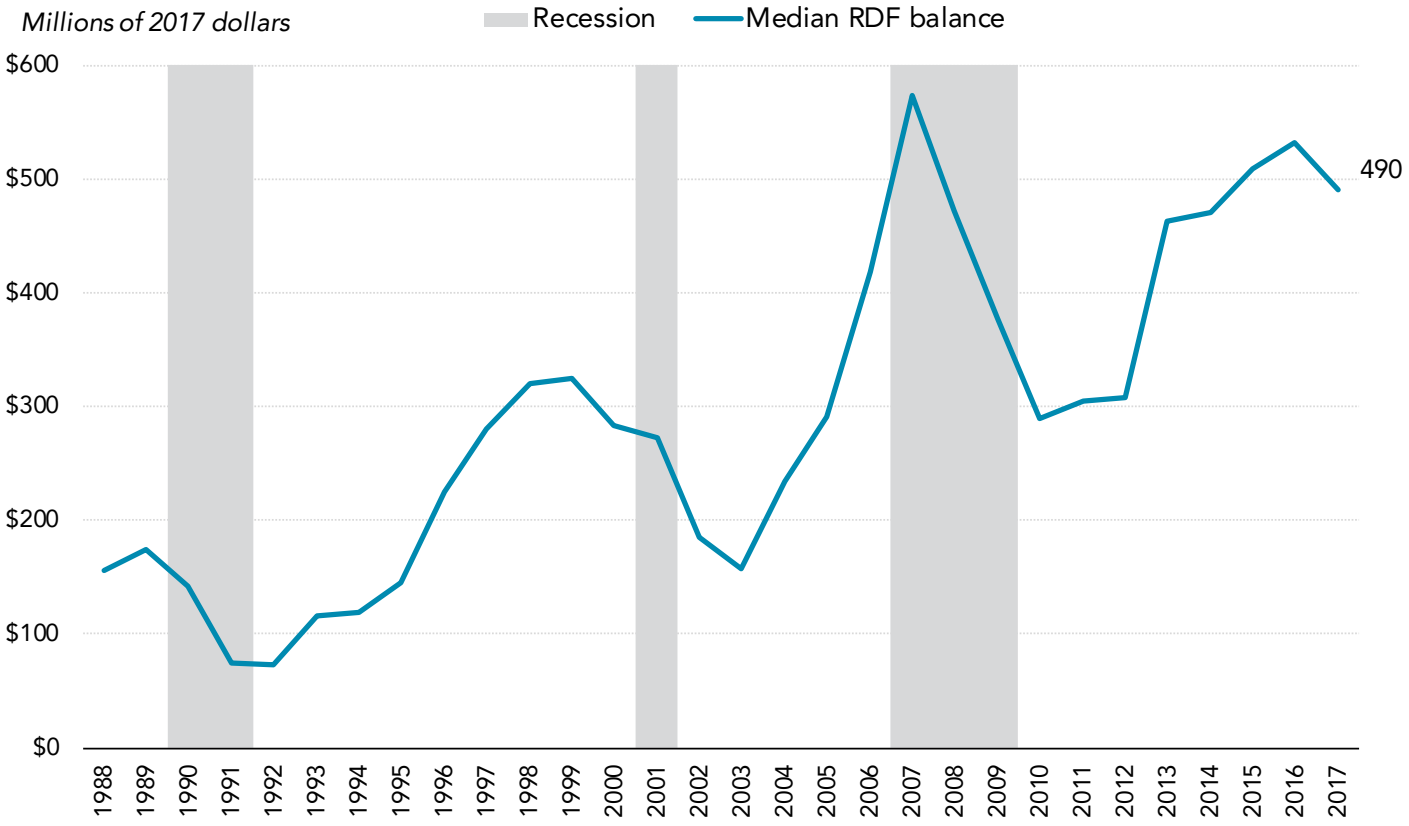
What are state rainy day funds, and how do they work?

RDFs are an important tool for states to avoid sharp cuts in spending or tax increases when they are hurting economically. In 2017, Randall and Rueben synthesized literature on rainy day funds (and other budget rules) from the past thirty years, recommending that states reduce fiscal and economic volatility by pairing strong balanced budget requirements with robust RDFs. Moreover, states should design their RDF deposit mechanisms and limits with an understanding of their own revenue volatility.

FIGURE 2

Median Rainy Day Fund Balance

All states, 1988–2017



Source: National Association of State Budget Officers, Fiscal Survey of the States, various years, https://www.nasbo.org/reports-data/fiscal-survey-of-states; and National Bureau of Economic Research "US Business Cycle Expansions and Contractions," http://www.nber.org/cycles.html.
Note: Data are reported in state fiscal years.

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