

Budget Stabilization Funds

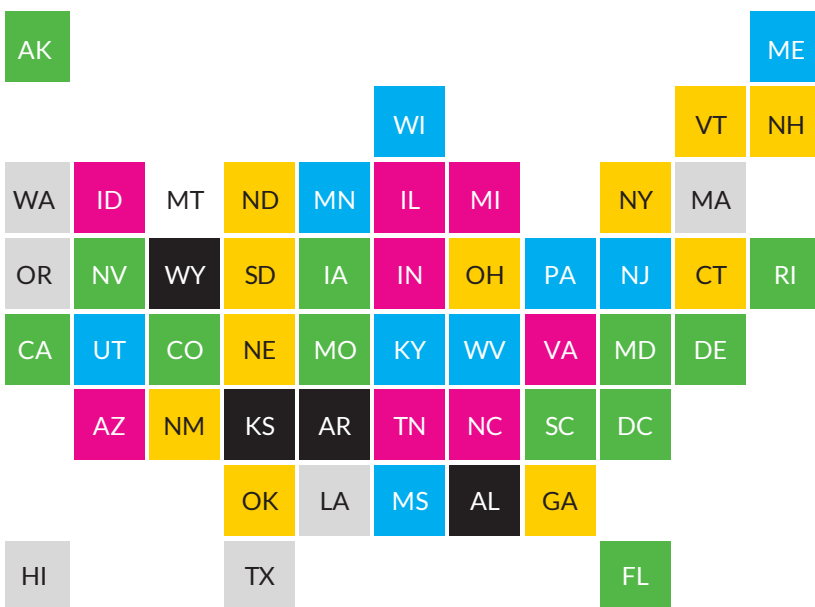
How States Save for a Rainy Day

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Budget stabilization funds (BSFs), also known as rainy day funds, allow states to set aside surplus revenue for times of unexpected revenue shortfall or budget deficit. Although BSFs have been widely adopted as a tool to mitigate revenue volatility, states follow different rules on how much revenue to contribute to their BSF annually, whether the balance should be capped and at what level, and under what conditions the funds can be spent. Research shows that BSFs increase state savings and reduce volatility.¹

Funding Mechanisms for State Budget Stabilization Funds, 2015



Budget Stabilization Deposit Mechanisms

Today, every state but Montana has some type of BSF. States follow different rules about when and how to deposit revenues into their funds, and some states have more than one fund. States can choose to follow one or a combination of the following rules:

- Allow some or all of the year-end surplus to flow to the BSF. For example, Pennsylvania deposits 25 percent of the general fund’s fiscal year-end balance into its Budget Stabilization Reserve Fund.

Source: Review of state statutes and constitutions; National Association of State Budget Officers, *Budget Processes in the States*, (Washington, DC: National Association of State Budget Officers, 2015); and Pew Charitable Trusts, *Building State Rainy Day Funds* (Washington, DC: Pew Charitable Trusts, 2014).

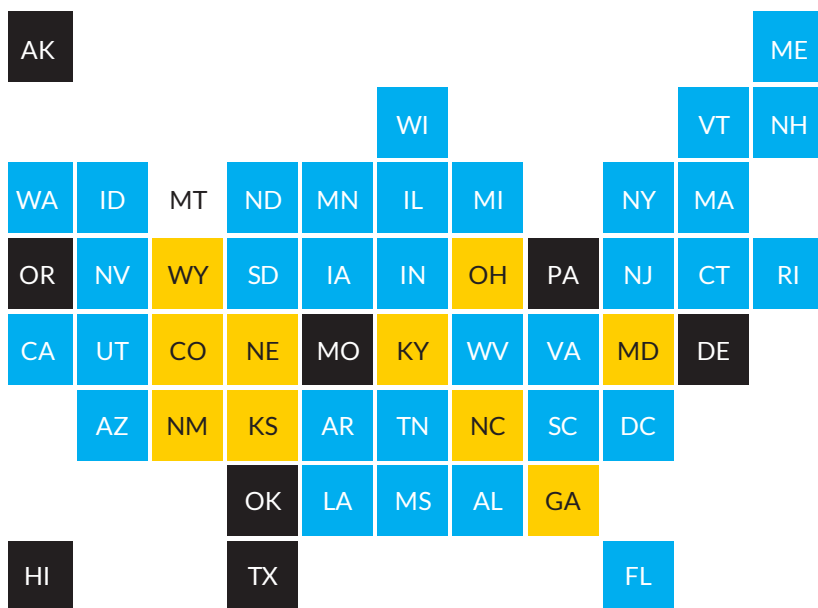
Note: Montana is the only state without a BSF. For more detailed notes on deposit classifications for specific states, see Megan Randall and Kim Rueben, *Sustainable Budgeting in the States: Evidence on State Budget Institutions and Practices* (Washington, DC: Urban Institute, 2017).

- **Require revenue set-asides every year until the fund reaches its cap, or require an automatic deposit based on revenues.** In Florida, the BSF balance must always be at least 5 percent of net revenue collections for the general revenue fund. Some states have earmarked specific revenue streams for their funds, such as capital gains or severance taxes for their BSF based on either actual or projected revenues. Alaska deposits revenues from oil and gas litigation and settlement disputes into its constitutional Budget Reserve Fund.
- **Require a contribution based on revenue or economic growth.** Arizona's BSF receives appropriations based on the annual growth rate in personal income over and above the trend growth rate.
- **Require payments and replenish the funds at the discretion of the legislature or governor as part of the budget process.** Arkansas, for example, has a Long Term Reserve Fund that is funded entirely at the discretion of the legislature through the annual appropriation process.

Some states have combinations of the above rules. Hawaii, for example, funds its Emergency and Budget Reserve Fund in part through tobacco settlement revenues and in part through deposits triggered by revenue growth.

Procedures for Spending State Budget Stabilization Funds, 2015

- At the discretion of the legislature or the governor, with no conditions
- Requires specific circumstances (shortfall, emergency, deficit, etc.)
- Requires supermajority vote
- No BSF



Twenty-five states cap the balances of their funds. The cap is either a percentage of revenue or expenditures. Most states that fund BSFs with operating surpluses stop transfers once the cap has been reached, but a few redirect surpluses to other funds for special projects or they remit funds back to taxpayers.

How Do States Use Their Funds?

In most states, the BSF is dedicated to closing fiscal gaps or maintaining government spending when revenues are projected to decline. States can access funds using one of the following rules:

- At the discretion of the legislature or governor, by regular vote during the appropriation process.
- A declaration of economic emergency, or other specific circumstances such as slow economic growth or a natural disaster.
- A supermajority (three-fifths or two-thirds) vote of the legislature to make a transfer.

Several states also allow the BSF 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 year.

> **Source:** National Association of State Budget Officers, *Budget Processes in the States*, (Washington, DC: National Association of State Budget Officers, Spring 2015); and Pew Charitable Trusts, *When to Use State Rainy Day Funds* (Washington, DC: Pew Charitable Trusts, 2017).

BEYOND THE RAINY DAY FUND

In addition to BSFs, many states have separate reserve funds designed to cover shortfalls in vital funds such as education or Medicaid spending. Forty-three states and the District of Columbia also maintain a separate emergency fund for natural or man-made disasters. Unspent disaster fund dollars carry forward to the next year in most cases, and 23 states allow the executive branch to transfer unspent appropriations from other budget areas into the fund if a disaster occurs.

BSFs Increase Savings and Reduce Volatility

BSFs have the following beneficial fiscal effects:

- **Mitigate fiscal volatility** and are considered a best practice across much of the literature.
- **Buoy state spending** when revenues decline during an economic recession.

One 2006 study found that the larger a state's stabilization fund, the smaller its budget gap during recession years. This is because states use stabilization funds to plug budget holes during recessions.

- **Produce a net increase** in state savings over and above what would otherwise be collected as surplus in the general fund without a savings account.

Some recent studies have found a substitution effect is at least partially at play (that is, states shift general surplus into a BSF rather than generating new savings), but the net effect remains supplemental, increasing savings over what states would have saved without the fund.

One frequently cited study from 1999, noted for its methodological rigor and strong econometric techniques, found that each dollar states invested in a rainy day fund produced a dollar increase in total state savings (that is, rainy day fund plus general funds).

Designing a BSF

Clear deposit and withdrawal rules ensure that states use their fund to increase savings, because some research shows that not all states use their funds to offset economic downturns.

Some states use BSFs to circumvent tax and expenditure limits or to fund pension debt and other obligations.

One 1994 study, for example, found that several Midwestern states used their stabilization funds for property tax relief or to offset pension liability. New Jersey can use its fund any time its revenue comes in under what was projected because of poor forecasting or fiscal mismanagement.

A 1996 study found that BSFs stabilize spending only if contributions to the fund are mandatory. And a 2005 study found that strict deposit and withdrawal rules help mitigate economic volatility caused by the business cycle.

Some rules of thumb for designing a BSF include the following:

- Setting formal deposit rules, especially requiring contributions during good times.
- Not capping the fund or capping at an adequate level. Many states cap their BSF balance at 5 to 15 percent of spending. At the end of fiscal year 2015, 26 states had BSF balances below 5 percent. These caps and target levels should be based on a state's fiscal characteristics.
- Setting formal withdrawal rules that stipulate conditions for repayment.

¹For more information, see Megan Randall and Kim Rueben, *Sustainable Budgeting in the States: Evidence on State Budget Institutions and Practices* (Washington, DC: Urban Institute, 2017).