

## Use of Rainy Day Funds in Third District States\*

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*Rainy day fund* is the popular name for special reserve funds employed by all but three states (Arkansas, Kansas, and Montana) to provide a more flexible response to emergencies and/or cyclical fiscal extremes.<sup>1</sup> This is the primary policy tool designed specifically to help states address fiscal stresses generated by recessions. By transferring a portion of budget surpluses to their rainy day funds during years of strong economic growth and rising revenues, states can reduce the need to raise taxes and cut services during years of weak growth and declining revenues. (For a discussion of Third District state budget gaps, see my Research Rap Special Report, “Budget Gaps and Balanced-Budget Proposals in Third District States,” June 2010.<sup>2</sup>)

Deploying a rainy day fund to provide a significant fiscal policy response assumes that a state has sufficient reserves, regulations on use that are not overly binding, and the political will to use the fund. As a recession’s fiscal impact tends to stretch beyond a recession’s end and into the initial recovery, we will look at the experiences of Delaware, New Jersey, and Pennsylvania in funding their rainy day funds and using them in the Great Recession and its aftermath.

### Rainy Day Funds Nationwide

Total U.S. rainy day funds, aggregating across all the states, peaked at 5.1 percent of general fund expenditures at the end of fiscal year (FY) 2008 and fell to 4.5 percent (estimated) at the end of FY 2010. (If we exclude Alaska and Texas, states with atypical funds because they are flush with energy revenues, rainy day funds peaked at 3.9 percent in FY 2007 and fell to an estimated 1.6 percent in FY 2010.) Rainy day

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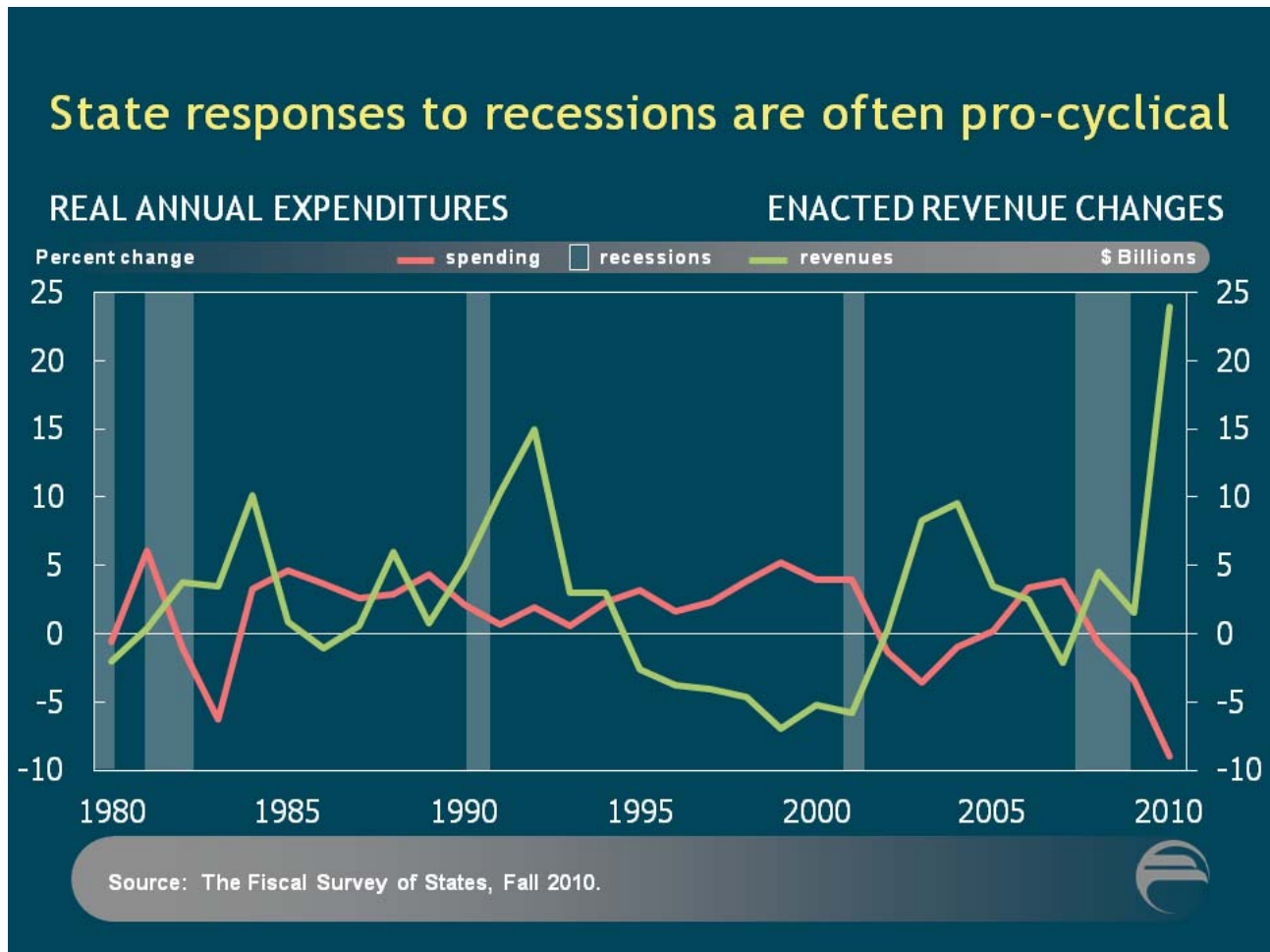
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<sup>1</sup> Some states use their rainy day funds for yet other purposes, such as managing annual cash flow problems. See the National Conference of State Legislatures (2008). The rainy day fund is called the *Budget Reserve Account* in Delaware, the *Surplus Revenue Fund* in New Jersey, and the *Budget Stabilization Reserve Fund* in Pennsylvania.

<sup>2</sup> Available for free at <http://www.philadelphiafed.org/research-and-data/publications/research-rap/2010/budget-gaps-and-balanced-budget-proposals.pdf>.

funds are not the only funds that are potentially available to help states fight the effects of recessions. States also have unencumbered general fund balances (that portion of the fund balance that is not designated and not reserved) that can also be used if necessary. End-of-year surpluses (which include both unencumbered general fund balances and rainy day funds) as a percent of total state expenditures for all states combined peaked at 10.9 percent at the end of FY 2006 but fell to 4.6 percent by FY 2009.

Without sufficient rainy day funds, states continue to rely on a mix of pro-cyclical budget policies to address their fiscal imbalances. Each of the past four recessions have spurred states to enact revenue increases and/or cut services (and sometimes wages or jobs). These policies tend to amplify the impact of the recession on their states — for example, tax increases reduce the ability of households to spend and thus increase the stress on state businesses, further reducing state revenues.

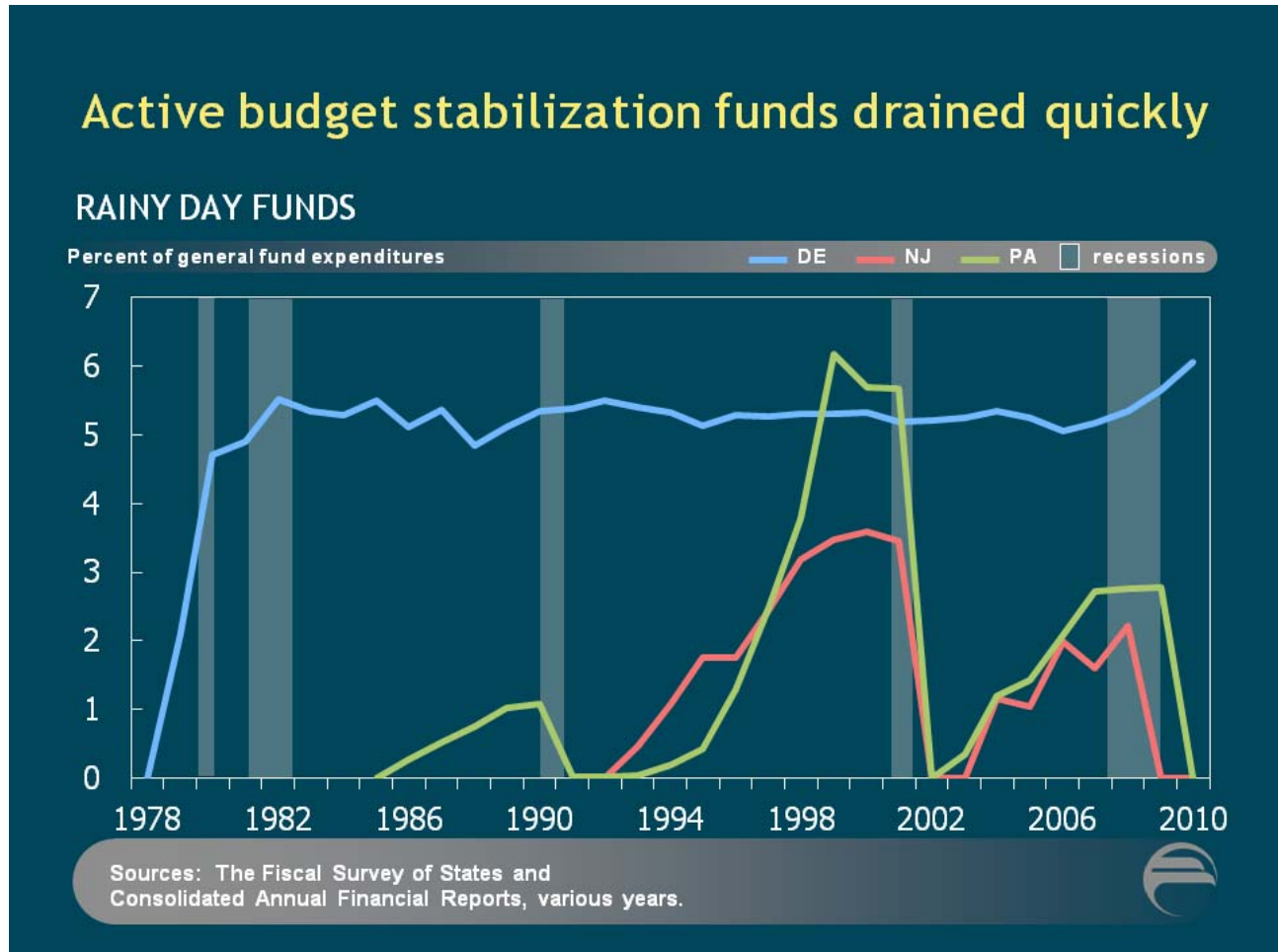


While convention has held that reserve funds amounting to 5 percent of annual general fund expenditures may be appropriate, actual experience and ongoing research suggest that a higher percentage specific to individual state circumstances may be desirable.<sup>3</sup> In fact, Oklahoma and Virginia voters approved referenda this fall that raised their fund cap from 10 percent to 15 percent.

<sup>3</sup> In particular, see Joyce (2001) and Navin and Navin (1997).

## Delaware

In 1977, Delaware became the first Third District state to adopt a rainy day fund. The state's "Budget Reserve Account" began accumulating balances in 1979, quickly reached its legal limit (a cap of 5 percent of estimated general fund revenues), and has maintained that proportionate level every year for at least the past 25 years. Delaware's constitution spells out the funding formula and allowable uses.<sup>4</sup>



An automatic funding formula stipulates that "within forty-five (45) days after the end of any fiscal year, the excess of any unencumbered funds remaining from the said fiscal year shall be paid into the Budget Reserve Account." Using its Budget Reserve Account requires a three-fifths super majority of the Delaware General Assembly. There is no formula for its use, but a requirement that any withdrawal "be necessary to fund any unanticipated deficit in any given fiscal year or to provide funds required as a result of any revenue reduction enacted by the General Assembly." The broad requirement for withdrawal provides flexibility, and the requirement of a super majority will tend to reduce the likelihood of abuse.

Although the state was tempted to supplement revenues for the current 2011 fiscal year with \$10.8 million from the Budget Reserve Account, its revenue expectations improved somewhat prior to final budget adoption. As a consequence, Delaware did not tap its rainy day fund. Indeed, Delaware has never tapped its

<sup>4</sup> Delaware Constitution, Article VIII, Section 6.

rainy day fund. By preserving the Budget Reserve Account's principal, it retains value as a source of funds for disaster response or other one-time emergencies, and to some degree, it bolsters confidence of bond rating agencies — the state has enjoyed a triple-A bond rating since 2000. However, its value as a budget stabilizer through economic business cycles is limited by the state's unwillingness to tap it and by its limited size.

Even if the state had been willing to use its rainy day fund for the conventional purpose of addressing recession-induced revenue declines, its \$186.4 million of reserves would not have gone far. For FY 2010 alone, Delaware relied on over \$300 million from tax and fee increases and about \$200 million from expenditure cuts, and it received \$234 million in federal stimulus aid. Delaware's four-year cumulative budget gap from FY 2009 through FY 2012 will surpass 40 percent of its average annual general fund budget — eight times greater than its 5 percent reserve cap.<sup>5</sup>

In FY 2004, following the milder 2001 recession, Delaware faced a 12.2 percent budget gap. Once again, the state resorted to tax increases in FY 2004, after deploying expenditure cuts in FY 2003. Had Delaware tapped its Budget Reserve Account, it would not have had to repay the funds; the state doesn't have a repayment rule (as some states have) that requires the money be quickly replaced, which curtails the value of the fund to address cyclical revenue declines.

To its credit, Delaware is not running large structural deficits like New Jersey, and it adheres to other sound fiscal practices. At the same time that Delaware's constitution was amended to establish the Budget Reserve Account, the requirement for a 2 percent "cushion" was also adopted.<sup>6</sup> In addition, Delaware's end-of-year general fund balances (exclusive of rainy day funds) have averaged more than 14 percent over the past 30 years, although not all of these balances are necessarily available.

## **New Jersey**

New Jersey was last among the Third District states to adopt (in 1990) and fund (in 1993) a rainy day fund — its Surplus Revenue Fund. While New Jersey has readily used this fund in both subsequent recessions, the reserves have been inadequate. The Surplus Revenue Fund grew to just 3.5 percent of expenditures as of 2001. New Jersey faced a 19 percent budget gap in FY 2004, but the funds had been tapped by the end of FY 2002.

New Jersey's four-year cumulative budget gap from FY 2009 through FY 2012 will surpass 130 percent of its average annual general fund budget. Allowing that as much as half of that deficit may be structural, not cyclical, the state's 2.2 percent of reserves as of the end of FY 2008 still provided virtually no

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<sup>5</sup> For recent estimates of budget gaps for FY 2009 through FY 2011, see McNichol (2010).

<sup>6</sup> "No appropriation, supplemental appropriation or budget act shall cause the aggregate State General Fund appropriations enacted for any given fiscal year to exceed 98 percent of the estimated State General Fund revenue for such fiscal year from all sources, including estimated unencumbered funds remaining at the end of the previous fiscal year." From Article VIII, Section 6(b) of Delaware's Constitution.

protection from severe expenditure cuts and tax increases. The state tapped the entire \$742 million to help meet the FY 2009 budget.

The automatic funding formula for New Jersey requires that prior to the end of each calendar year the State Treasurer shall credit the Surplus Revenue Fund with an amount equal to 50 percent of the excess, if any, between the actual revenues less the anticipated revenues from the prior fiscal year. The actual revenues shall be adjusted for any enacted revenue increases.<sup>7</sup>

Balances in the Surplus Revenue Fund may be appropriated by the legislature in specific circumstances of declining revenue or by the governor for a declared emergency. There is no formula limiting the amount to be used.<sup>8</sup>

New Jersey's Surplus Revenue Fund was statutorily enacted, which means it can be more easily circumvented by the legislature. Without the constitutional basis as in Delaware, legislators can suspend the funding formula and appropriation rules. Like Delaware, New Jersey limits its fund to "5% of the amount certified by the Governor as total anticipated revenues in the General Fund and the Property Tax Relief Fund upon approval of the annual appropriation act."<sup>9</sup> Unfortunately, New Jersey's fund has averaged 1.6 percent of expenditures since its inception and reached a high of only 3.6 percent in 2000.

Furthermore, New Jersey has not maintained high general fund end-of-year balances as a secondary reserve. Compared with Delaware's 14 percent, New Jersey's general fund balances have averaged just over 3 percent over the past 30 years. This estimate excludes the balances in the rainy day fund and in the property tax relief fund.

## **Pennsylvania**

Pennsylvania enacted a Tax Stabilization Reserve Fund in 1985, which was replaced by its current Budget Stabilization Reserve Fund with passage of the FY 2003 budget. Pennsylvania's fund has endured three cyclical downturns. Relatively little cushion was afforded in the 1990-91 recession with a fund equal to only 1.1 percent of expenditures, nor in the late Great Recession with a fund equal to 2.8 percent of expenditures. Pennsylvania's four-year cumulative budget gap from FY 2009 through FY 2012 will surpass 60 percent of its average annual general fund budget.

With a fund of almost 6.0 percent of expenditures in 2001, it was of partial help in meeting the first year of revenue declines, but by FY 2004 when the budget gap estimates ranged from 2.4 percent to 9.6 percent of expenditures, the fund was largely tapped out.

The automatic funding formula for Pennsylvania requires that 25 percent of any year-end general fund surplus be deposited in the Budget Stabilization Reserve Fund by the end of the succeeding quarter. The

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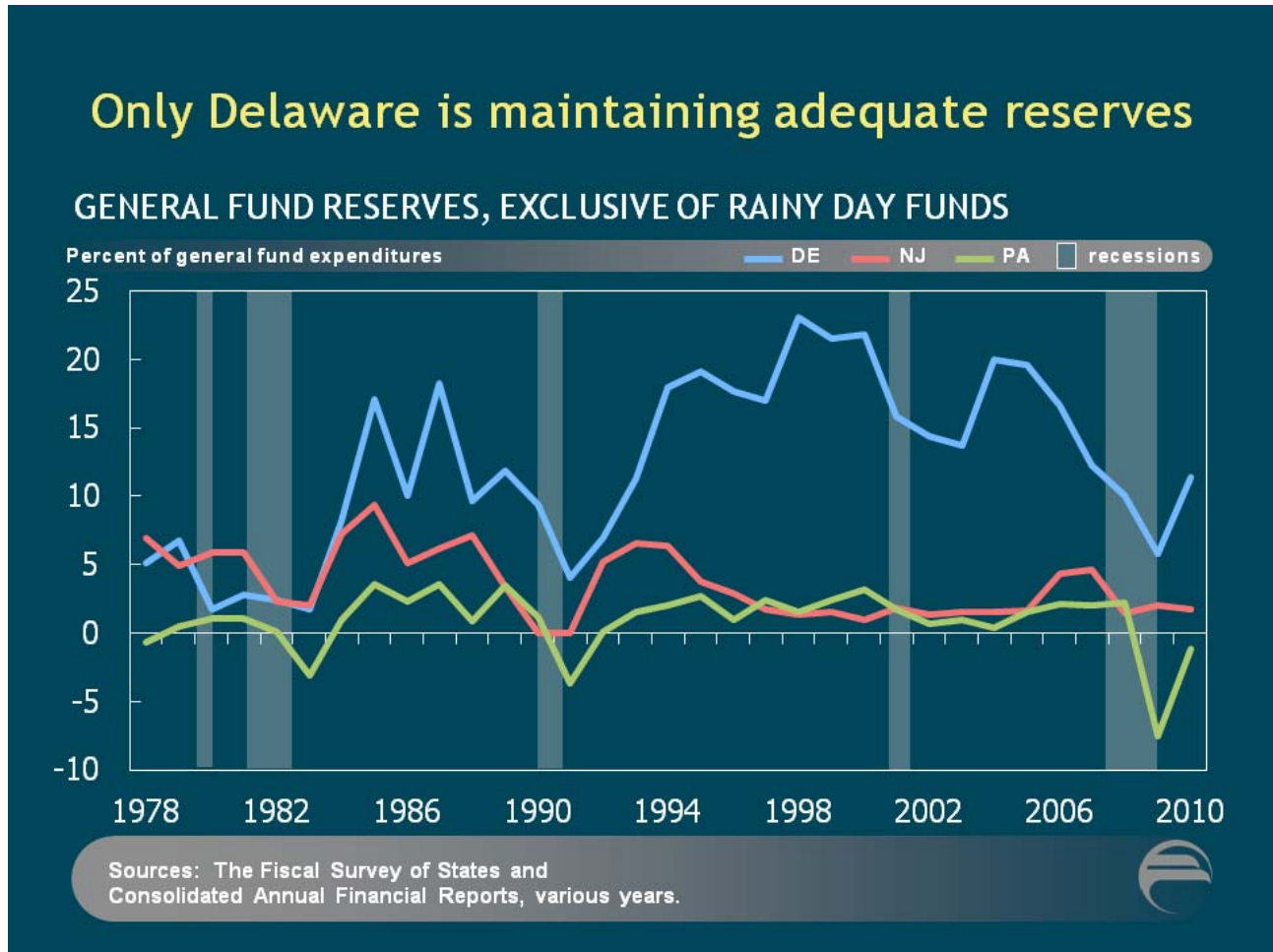
<sup>7</sup> New Jersey Statutes, 52:9H-14 through 52:9H-16.

<sup>8</sup> New Jersey Statutes, 52:9H-18 and 52:9H-19.

<sup>9</sup> New Jersey Statutes, 52:9H-21. Appropriation of excess.

funding formula falls to 10 percent of the surplus when the fund equals or exceeds 6 percent of actual general fund revenues.<sup>10</sup>

Since the formula relies on the year-end surplus, legislators have great flexibility prior to the calculation to restrict the size of the surplus, as well as the resulting reserve fund deposit. In addition, Pennsylvania’s Budget Stabilization Reserve Fund was statutorily enacted, which means it can be, and has been, circumvented to achieve other ends. Pennsylvania’s fund has averaged 1.6 percent of expenditures since its inception and reached a high of only 3.6 percent in 2000.



Pennsylvania cannot rely on its general fund balances, either. Not only have Pennsylvania’s general fund balances (excluding rainy day fund balances) averaged just 1.0 percent over the past 30 years, but four out of 30 years have ended with negative balances.

Balances in the Budget Stabilization Reserve Fund may be appropriated by a two-thirds vote of the legislature following the governor’s recommendation to address significant unanticipated revenue shortfalls or a declared emergency. There is no formula limiting the amount to be used.

<sup>10</sup> Pennsylvania Statutes and Consolidated Statutes Title 72 P.S. Taxation and Fiscal Affairs Chapter 1. The Fiscal Code Article XVII-A. Special Funds Subarticle A. Budget Stabilization Reserve Fund.

## **An Alternative Approach from Hong Kong**

Before concluding, it may be instructive to consider a best-practices alternative from the city-state of Hong Kong, as it responds to its own fiscal fallout from the global recession. While functioning much like a U.S. city-state combination, albeit with significant differences in its cultural, economic, and governmental history, Hong Kong wields a far more robust policy kit in the face of its ongoing recession. Its fiscal reserves were an estimated 21 months of government expenditure (or 172 percent) by the end of March 2010. This enables Hong Kong to run large operating and capital budget deficits to reduce tax and revenue burdens on households and businesses, to maintain current service levels, to meet rising social welfare needs, and to heavily boost capital infrastructure spending. Hong Kong's countercyclical fiscal stimulus is expected to reduce its reserves to 15 months (or 125 percent) of expenditures by March 2015.<sup>11</sup>

## **Summary**

Overall, all three states' rainy day funds did little to buffer the 2001 recession, much less the recent recession. The states either quickly ran out of funds, as have New Jersey and Pennsylvania, or decided against using the fund, as in the case of Delaware. There is also a countercyclical stabilizing function of which governments are capable, as Hong Kong exemplifies, but these state rainy day funds are too small to achieve that objective.

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<sup>11</sup> From a speech by the Financial Secretary, the Hon. John C. Tsang, presenting Hong Kong's 2010-11 Budget on February 24, 2010, especially Appendix A. pp. 7-9.

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