Bond Case Briefs

Municipal Finance Law Since 1971

How States Can Make the Most of Their Rainy Day Funds.

They can effectively smooth economic bumps. But it's important to have clear rules for how and when to use the money.

Texas policymakers are grappling with an unusual question: how — and even if — to spend some of the state's ample savings. As of the end of the last fiscal year, the state's rainy day fund had amassed $9.7 billion, the largest fund in the country as measured in dollars.

That may seem like a welcome quandary. After all, some states lack a robust savings account like the Lone Star State's Economic Stabilization Fund. But Texas lawmakers disagree on how to use their fund, and similar arguments are playing out in many other states where rainy day reserves have grown, leaving policymakers to debate whether they should tap them and for what reasons.

State government budgets are greatly affected by fluctuations in the economy. During boom periods, tax revenue can exceed a state's spending needs and produce a surplus. But when the economy slows, tax payments decrease while mandatory costs stay constant or increase. Between 2003 and 2007, state tax revenue grew by a robust 7 percent on average annually. But between 2008 and 2010, when the recession hit, states experienced the worst revenue downturn in decades, forcing many legislatures and budget officials to make painful cuts, raise taxes or both. They had little choice. State policymakers have only limited influence over the business cycle and changes in tax revenue — and no control over factors such as natural disasters that drive revenue volatility and wreak havoc on state budgets.

To minimize the need for uncomfortable choices between raising taxes or cutting spending, 48 states have created budget stabilization funds — rainy day funds — that take advantage of boom times by directing surplus revenue into savings that can offset future shortfalls. However, many of these funds lack rules to effectively smooth the ups and downs in revenue. Designing a robust fund, and knowing how and when to use it, gives state and local officials a critical tool for managing an economic slowdown or natural disaster. A well-managed rainy day fund can also help raise a state's bond rating, which in turn lowers the cost of borrowing and frees budget resources for other uses. But creating clearly defined funds with specific operating instructions is crucial to ensuring that these set-aside reserves are used to effectively safeguard a state's fiscal health.

First, state policymakers need to differentiate between one-time, non-recurring revenue — such as a federal grant for school construction or money from a legal settlement — and ongoing sources of revenue. Without doing so, they risk using a finite financial resource to fund ongoing costs, leading to structural budget problems. In Utah, policymakers recently enacted rule changes that require legislators to treat above- trend revenue — revenue that exceeds a 15-year average growth rate — as one-time revenue. So when lawmakers identified $116 million in above-trend revenue for fiscal 2016, they designated it as a one-time source of money, ensuring that it would not be used to pay for ongoing expenditures.

Moving the funds into a "one-time bucket" had an important effect, says state Rep. Brad Wilson, who proposed the rule change. "It helped all the lawmakers who were paying attention to the budgeting process understand we are, in fact, above trend. We are at a point in the business cycle where we should be preparing for lean times again."

Second, defining a fund's savings rules helps states smooth over bumps in the economic cycle. In Connecticut, state officials track and project radical shifts in the stock market, a wise practice given that nearly 40 percent of the state's tax receipts come from capital gains, dividends and other investment earnings paid to the many Connecticut residents whose income is tied to Wall Street. Beginning in 2020, whenever the state takes in above-average revenue from capital gains or the corporate income tax, those funds will be automatically deposited in the emergency reserve. Connecticut law also outlines conditions for using the fund — essentially clarifying just what "rain" means for a rainy day fund.

Understanding the nature of revenue, clearly designing a rainy day fund's rules for saving, and stipulating just how and when the money can be spent will not only help lawmakers and budget managers offset periods of economic volatility but also make them better and more responsible stewards of the taxpayers' money.

GOVERNING.COM

BY SUSAN K. URAHN | JUNE 21, 2017

Executive vice president and chief program officer for the Pew Charitable Trusts