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How to Build a Rainy Day Fund.

A new report shows how states could have weathered the recession better.

Just before the Great Recession, Florida set aside $1.4 billion in its rainy day fund. It was an amount that all but disappeared two years later when lawmakers in 2009 had to find a whopping $4 billion in cuts due to declining tax revenue.

But it didn’t have to be that way, according to an analysis by the Pew Charitable Trusts. In fact, if Florida’s rainy day fund deposit rules had been similar to Virginia’s, Florida could have had more than four times the amount in its rainy day fund going into the recession. Certainly, a savings stash of $6 billion wouldn’t have entirely saved the state from cuts. Florida’s budget gaps continued until 2013 and totaled $20 billion over the years, according to Pew. But it’s hard to argue it wouldn’t have lessened the pain.

Pew’s simulation is featured in a new report called Building State Rainy Day Funds, the second in a series of studies aimed at helping policymakers better prepare their state’s finances in times of increasing revenue volatility. An article in the August issue of Governing also explores revenue volatility; in fact, it’s the newest feature in our Finance 101 series. The story notes that policies like those in Virginia, which ties deposits in its rainy day fund to revenue volatility, and Utah, which actually studies and reports on its revenue volatility, are rare.

The goal of both the Pew and Governing series is to get more policymakers to think about best practices before it’s too late. “A lot of states had been budgeting in perpetual crisis mode during the recession and some of that has continued into the recovery and beyond,” says Brenna Erford, who manages Pew’s work on state budget policy. The report notes that while states’ collective budget reserves totaled $60 billion in 2008, budget gaps in 2009 totaled nearly twice as much. “Our interest,” says Erford, “is to get states to think longer-term about their overall fiscal health.”

Florida isn’t the only state highlighted in Pew’s report. Pennsylvania would have had nearly three times the savings — as much as $2.1 billion — and South Carolina would have saved five time more or $835 million had deposit rules been tied to volatility. Pew focused on Florida, Pennsylvania and South Carolina because they are large states; have different economies and tax systems; and grew during the mid-2000s while not drawing on their emergency funds.

The first report in Pew’s series evaluates revenue volatility across the 50 states. Using data from 1994 to 2012, the report examines the factors that drive revenue swings, including state-specific patterns of economic growth and contraction, and recommends ways to respond to these conditions. The new report seeks to guide policymakers’ thinking on how to best fuel rainy day funds. The overall recommendation is that the funding be tied to revenue volatility, something that just one-quarter of the states currently do. Linking savings to volatility also doesn’t require that a state make a contribution during lean years, as some states’ deposit rules ask. There’s no one-size-fits-all approach for connecting savings to volatility, but one of three methods are common: tying funding to overall revenue volatility, tying funding to particularly volatile revenue streams or tying funding to economic conditions.

Going forward, Erford says the research project will study the growing difficulties in revenue forecasting and look at the optimal size of and withdrawal rules for rainy day funds. “Budget officials are very aware of the challenges they face,” says Erford. “In terms of the longer-term questions of how that volatility and the general economic conditions are impacting budgeting, or how management responses have varied with other states, our research is intended to inform that in more a systematic way.”

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