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Saving for a Rainy Day?

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States are facing the most severe budget crises in the post-World War II era. Recent data suggest, however, that the budget crises may be abating, despite some dire predictions last year. Back in April 2003, the National Conference of State Legislatures (NCSL) reported that aggregate state budget deficits would be in the range of $20 to $30 billion for fiscal year (FY) 2003, and possibly as large as $78 billion in FY 2004. More than half of the states were projecting a budget deficit in excess of 5 percent of general fund revenue for FY 2004, and one in four states was forecasting a deficit greater than 10 percent.

Reports seven months later, in November 2003, contrasted with the April 2003 figures: The NCSL reported that state budget deficits totaled $17.5 billion for FY 2003, and ten states projected an aggregate deficit of $2.8 billion for FY 2004. This improvement was due in part to stronger than expected growth of gross domestic product in the second half of 2003.

In an effort to be less reliant on expenditure reductions and/or tax increases to mitigate periods of fiscal stress, states typically save surplus revenue during good years for use during lean years when revenue growth is below average. While such surplus funds have historically been maintained as a general fund surplus, nearly all states have supplemented this practice with the use of a rainy day fund. This fund is nothing more than a separate account in state budgets where surplus monies are retained.

Of the 46 states that currently have a rainy day fund, only eight were in place before 1980. States with rainy day funds generally deposit some fraction of a general fund surplus into the rainy day fund (short-term savings) and retain the remainder in the general fund (long-term savings). Both general fund and rainy day fund balances typically earn interest according to a state's investment policies regarding surplus funds. The total funds available to correct unexpected shortfalls at any given time equal the sum of the state's general fund and rainy day fund balance.

According to the NCSL, states' rainy day fund balances have dropped significantly in the past two years as states attempted to mitigate their budget crises. In January 2002, total rainy day fund balances topped $17 billion. Aggregate balances dropped to $11.4 billion at the end of FY 2002 and fell further to $8.5 billion at the end of FY 2003. In FY 2004, 13 states are expected to tap their rainy day funds to minimize budget shortfalls. However, many states are reluctant to reduce rainy day fund balances further, and many states (Arizona, Idaho, and Oklahoma, for example) have depleted their balances altogether.

Of course, rainy day funds can assist states in easing recessionary pressures only to the extent that these funds supplement the general fund. If monies saved in rainy day funds are simply replacing monies saved in the general fund, then there is little benefit. Since rainy day funds are nothing more than separate accounts in state budgets, policymakers may decide simply to reduce the size of the general fund surplus by $1 for every $1 deposited in the rainy day fund. In fact, for every dollar that a state does deposit into its rainy day fund, total savings (the sum of the state's rainy day fund plus general fund balance) increases by only $0.44 to $0.49.[1] This suggests that the average state's use of rainy day funds has not significantly improved its fiscal health.

Apart from the issue of substitutability with the general fund, the most important point regarding rainy day funds and savings is not how the funds are saved, but whether sufficient funds are saved. Research finds that states having strict rules that force policymakers to save and limit how rainy day funds may be spent will improve a state's ability to weather downturns.[2] The same research reveals, however, that the typical state's rainy day fund is grossly insufficient to mitigate a severe . crisis and substantially lessen the need for expenditure reductions and/or tax increases. This is evident from the massive budget shortfalls faced by most states in the past three years. ■

[1] Wagner, Gary A. "Are State Budget Stabilization Funds Only the Illusion of Savings? Evidence from Stationary Panel Data." *Quarterly Review of Economics and Finance*, Summer 2003, *43*(2), pp. 213-38.

[2] Holcombe, Randall G. and Sobel, Russell S. *Growth and Variability in State Tax Revenue: An Anatomy of State Fiscal Crises*. Westport, CT: Greenwood Press, 1997.