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MEMORANDUM

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NEW ENGLAND PUBLIC POLICY CENTER

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To: Representative Susan Almy, Chairperson, Committee on Revenue, New Hampshire House of Representatives
From: Heather Brome, Policy Analyst
Re: Rainy Day Funds
Date: September 18, 2007

You requested research on how other states have ensured saving when the economy is growing and using rainy day funds only when necessary, particularly in light of relying on more variable revenue sources. Rainy day funds are meant to fill in revenue shortfalls during an economic downturn or unexpected expenditure demands, such as a natural disaster. Tax increases or budget cuts, the two options available to most states facing a revenue shortfall, both cause economic strain. This memo summarizes our research into state strategies to address the two concerns you raised with rainy day funds.

How rainy day funds are filled

Most states rely on year-end revenue surpluses in filling their rainy day funds—33 to be precise. One disadvantage of this kind of contribution is that the rainy day fund is then last in line for receiving revenues. Other states use formulas or the discretion of the legislature to determine the yearly contribution. Several states have developed strategies to address your two concerns about Maine's rainy day fund. Some states have required a standard contribution each fiscal year. For instance, Rhode Island contributes 2 percent of revenues each year to its rainy day fund until the rainy day fund reaches a capped limit. A few states have made contributions to their rainy day funds a requirement when either economic growth or revenue growth exceeds a certain threshold.
For instance, in Indiana appropriations to the state rainy day fund are mandated if real state personal income grows at a rate above 2 percent in the prior year and appropriations from the rainy day fund are made when real state personal income shrinks by more than 2 percent. They have a formula for how much should be appropriated in both circumstances.

How states protect rainy day funds

The formula in Indiana address your second concern—that the fund only be used during an economic downturn. Other states have placed limits on the use of their rainy day funds. Some states require a super-majority vote of the legislature in order to access funds. However, if the constraints on using rainy day funds are too rigorous legislators may be less likely to use the fund for its intended purpose

and therefore miss out on the benefits of having rainy day fund. Oklahoma addressed this concern by having no supermajority requirement when revenues decline from one year to the next, but requiring a 2/3rd vote of the legislature to tap into the rainy day fund otherwise. Other states limit the amount or share of the rainy day fund that can be used in any given year.

Adequacy of rainy day funds

However, another consideration with more volatile revenue sources is the appropriate size of a rainy day fund. More than ensuring savings and appropriate spending, states need to understand how much should be saved to ensure the rainy day fund are sufficient to weather a downturn in the business cycle. Simulations run by researchers in Tennessee show that the state would need to have a rainy day fund equal to at least 11 percent of current revenues in order to withstand a modest recession.

In order to address chronic under-funding of rainy day funds, an economist at the Federal Reserve Bank of Chicago proposed creating a national rainy day fund for states to use. The author argues that constructing a national fund would save states from local pressure to spend reserve balances when they reach significant levels. This would allow budget reserve accounts to grow to adequate levels to weather modest recessions. He also argues that a central fund could improve state credit ratings and reduce financing costs for states.

Sources:

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Mattoon, Richard. "Creating a National State Rainy Day Fund: A Modest Proposal to Improve State Fiscal Performance." Federal Reserve Bank of Chicago. WP 2003-20