Rich Huddleston, Executive Director
Nona French, Research and Fiscal Policy Director

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Saving for Arkansas' Future: Establishing a State Rainy Day Fund

By Nona French

Summary

What is a rainy day fund? A rainy day or budget stabilization fund is similar to a savings account for a family. You put aside a little extra cash each month so that in an emergency you don't have to use money that you need for basic expenses such as food or rent. This philosophy goes for state budgets as well. If you want to ensure that we can fund programs that are essential to Arkansas, even in rough economic times, you set aside money during the good times into a rainy day fund.

Why have a rainy day fund? When the economy slows down, unemployment grows, family incomes slow and tax revenues fall. To balance the budget, states have to cut spending (most of which goes to education, health and human services) or increase taxes. These actions can undermine the long-term stability of a state's tax and budget system and hurt the economy, not to mention families who depend on essential services. A rainy day fund can help us ride out the lows of a business cycle until incomes and tax revenues start to rise.

Why now? In Arkansas the $700-$900 million forecast surplus is not a permanent shift in income, but rather generated by economic growth, previous tax increases and spending cuts. This is an unprecedented opportunity to lay the foundation for better fiscal management in the future.

Introduction

As the Arkansas General Assembly holds budget hearings prior to the 2007 legislative session, it will be in the unique position of having an $800 - $900 million surplus at its disposal. As a result of the surplus, the legislature will face intense pressure to cut both taxes and increase spending in numerous program areas. At the same time, it must meet its obligation to pass a balanced budget that also meets the needs of the state. The surplus; however, presents another unique opportunity – to establish a rainy day fund in order to save for the future when the money is needed during bad economic times.

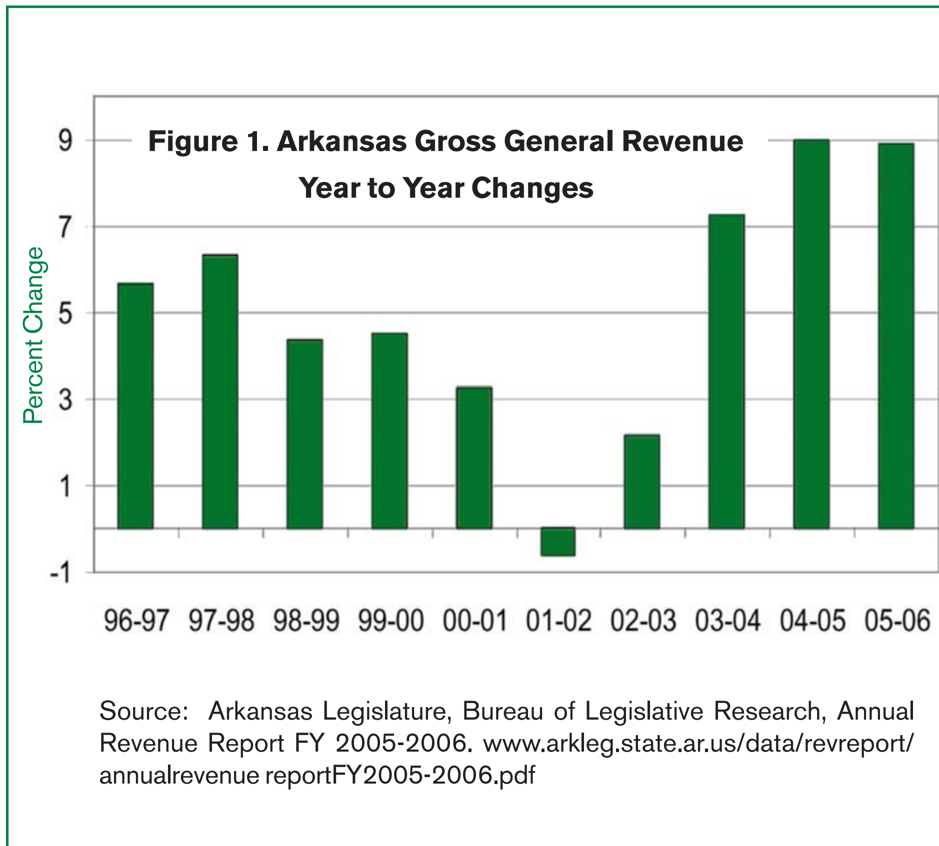
This issue brief explores how business cycles impact the state's budget, how states typically respond to budget shortfalls, how to create a rainy day fund and why a rainy day fund would be helpful to Arkansas' future.

The Impacts of a Business Cycle

Like most states, Arkansas is legally required to adopt a balanced budget for each fiscal year. Unlike most states, Arkansas is one of five states (Arkansas, Colorado, Illinois, Kansas and Montana) that don't have a state savings account when anticipated expenditures exceed projected revenues. Without a rainy day fund, our ability to appropriately respond to economic fluctuations is severely limited. As a result, our state, like many of our families, lives paycheck to paycheck – unable to achieve long-term goals because of the focus on short-term contingencies.

This fact is made even worse by the impacts that business cycles – upturns and downturns in the economy – can have on state budgets. State employment and incomes grow when the economy grows. As this occurs, the need for state services tends to grow at a slower rate while the ability of states to generate tax revenues increases, which can produce a surplus. When the economy cools, employment and income growth slow (or decrease), and state tax revenues fall as a result. At the same time, our need for state services increases when employment and family incomes decline.

Revenue growth can vary dramatically from year to year because of changes in the economy and subsequent changes in employment and incomes. Since 1993, the year to year change in gross general revenues ranged from -0.59% to 8.96%. However, the need for education, healthcare, transportation and other state services doesn't go away just because revenues fall. From 2002 to 2006, states experienced $250 billion in deficits. States responded to these shortfalls in three ways: cutting expenditures, increasing taxes and using reserves in rainy day



Source: Arkansas Legislature, Bureau of Legislative Research, Annual Revenue Report FY 2005-2006. www.arkleg.state.ar.us/data/revreport/annualrevenue reportFY2005-2006.pdf

funds. Since 2001, states with rainy day funds used $30 billion in reserves to meet budget shortfalls.[1]

The budgetary problems that states experience due to the business cycle may be worsened by the tendency of decision makers to overreact. Short-term fixes through changes in spending or tax policies can worsen a state's long-term fiscal outlook in future years. Changing tax and spending policies during one biennium, in the case of Arkansas, may create additional budget stresses in the future years when the changes will have their full effect.[2]

In addition to fiscal uncertainty due to business cycles, states also encounter uncertainty due to the following factors:

- Revenue estimation uncertainty.
- Expenditure estimation uncertainty.
- Unpredictable federal tax policy.
- Unpredictable court decisions.
- Unpredictable voter decisions.
- New state mandates such as the State Supreme Court Rulings in the Lakeview School funding case.
- New federal mandates such as the new expenditure requirements imposed by the federal No Child Left Behind legislation.
- Other contingencies such as responses to major events: 9/11, hurricanes, etc.[3]

Responses to Budget Shortfalls

A common response to decreasing state revenues is cutting expenditures. There are a number of problems associated with reducing expenditures below the current level, not the least of which include declines in service levels, quality and a reduced ability to meet the needs of families and taxpayers. Much of the state budget consists of "untouchables" such as education and Medicaid. The result is that a five percent shortfall in general revenues (below what was budgeted) could require cuts in other programs greater than five percent to generate the required level of savings. Spending cuts also have negative economic consequences for a state economy "because they reduce state spending on goods and services on a dollar for dollar basis in our local economies." [4]

Further, when the economy is growing and state revenues are increasing there is widespread support for cutting taxes. However, there is usually less support for raising taxes to make up the shortfall when revenues decline. In the Arkansas General Assembly, supermajority votes (3/4s vote) are required to increase many taxes (most notably personal and corporate income taxes), while local votes of the people are required to increase property taxes. At the state level, the sales tax is the easiest to increase (simple majority vote), but it's a regressive tax that puts an added burden on the most vulnerable families in the state.

But the best option is using reserves in rainy day funds. States can use the reserves in their rainy day funds to reduce the size of required spending cuts or tax increases. The Center for Budget and Policy Priorities recommends using rainy day funds as the first response to fiscal stress. The use of these funds allows time for longer-term financial planning, which may allow policy makers to identify cuts that are less economically damaging and that fall less heavily on low-income residents. States can "minimize the damaging effects of spending cuts and tax increases" by using rainy day funds as a first response to fiscal stress.[5] States with rainy day funds vary in the amount they keep in these funds. Recent expected year-end balances for states – unspent funds available for state rainy day funds – are presented in Figure 2 below.

Characteristics of a Rainy Day Fund

What are the characteristics of a rainy day fund? How big should the fund be? When should the funds be spent? When and how should the fund be replenished? Recent research suggests some of the answers. Researchers at UALR have estimated that the typical states' expected revenue cycle is just over six years, with approximately 4.25 years of revenue

Arkansas Budget Process:

In Arkansas the budget process is governed by Act 750 of 1973, known as the State Revenue Stabilization Act. This act establishes three levels of budgetary priority for general revenue spending, the "A","B", and "C" budgets. The budget process begins when state agencies submit biennial budget requests to the Department of Finance and Administration (DFA). DFA prepares the Executive Budget based on estimates of general revenues for the coming two fiscal years. The Executive Budget contains the budget amount recommended by the Governor. The General Assembly then appropriates money after consideration of the Executive Budget and revenue estimates. When there aren't enough projected revenues available to fund all needs, programs in category "A" are funded first and then items in categories "B" and "C" are funded if revenues grow faster than projected. Any revenues in excess of the approved budgets go into the General Improvement Fund, which is used to fund various projects proposed by legislators and the governor.

expansion followed by 1.7 years of revenue contraction. On average the expected revenue shortfall during the economic downturn is 13 to 16 percent, an amount that could be offset by saving 3 to 3.5 percent of the level of revenue each year of the expansion.[6]

The Center for Budget and Policy Priorities recommends the following steps to establishing an effective rainy day fund[7]:

- Instead of restricting the size of rainy day funds to an inadequate standard of five percent of the budget, states should set a target level for the size of the fund that is at least 10 to 15 percent of the budget. Once that target is met, policymakers should give serious consideration to making additional deposits into the fund above the 15 percent level.
- State policymakers could ensure that saving for a rainy day is a policy priority by including rainy day fund appropriations in the budget. Once the budget covers necessary (*i.e.* baseline or current service) spending needs, a specific percentage of the spending could be budgeted for the rainy day fund. The rainy day fund could be appropriated, for example, before new tax cuts or spending programs are approved. In addition, it would also make sense to deposit a portion of any year-end budget surplus into the rainy day fund.
- States should have flexibility in using the funds once there is an economic downturn. The most straightforward method for accessing rainy day funds is through the normal appropriation process. State legislatures typically address shortfalls in the current budget when they are developing the budget for the upcoming fiscal year. Placing a super-majority requirement on accessing the funds does not make sense because it creates an unnecessary political hurdle to making a withdrawal from the fund. Super-

Figure 2. Rainy Day Fund Ending Balance as a Percentage of General Fund Revenue, 2006 Projected

0.0%	0.01%-1.9%	2.0%-2.9%	3.0%-3.9%	4.0%-4.9%	5.0%-9.9%	10.0% or Greater
(No RDF Balance)	Arizona	Alabama	Missouri	Florida	Connecticut	Alaska
Hawaii	Georgia	Indiana	Rhode Island	Utah	Delaware	South Dakota
Nevada	Idaho	New Hampshire	Tennessee	Vermont	Iowa	Wyoming
Wisconsin	Kentucky	New York	West Virginia		Louisiana	
California	Maine	Ohio			Maryland	
	Michigan	South Carolina			Massachusetts	
	Mississippi	Washington			Minnesota	
	New Jersey				Nebraska	
	North Carolina				New Mexico	
	Pennsylvania				North Dakota	
	Texas				Oklahoma	
					Virginia	

Source: National Association of State Budget Officers, The Fiscal Survey of States, Dec. 2005. Data for Oregon are unavailable. Arkansas, Colorado, Illinois, Kansas and Montana do not have rainy day funds.

majority requirements also give additional leverage to a minority of legislators that can distort priority-setting and policymaking.

- State rainy day fund policies should not include a replenishment rule. These rules create a disincentive for using the fund and may lead to rainy day fund deposits competing with other programs for scarce resources. Instead, the funding targets and process described above should be utilized to ensure that once a state fiscal crisis ends, a state begins to plan for the next one.

The Importance of a Rainy Day Fund

Why do most states have some form of a rainy day fund as part of their fiscal policies? According to the Institute on Taxation and Economic policy the reason is simple – "taxes and public spending operate on different cycles". Having a rainy day fund helps states smooth out the boom and bust cycles in their budgets. This makes good sense for Arkansas for several reasons:

- It's good for business. Uncertainty about the quality of public services and changes in the tax system make the state a less attractive place to live, work and invest.
- It's good for long-term capital investments. States with well designed rainy day funds have better bond credit ratings, which translate into lower costs for capital improvements.
- It's good management. It allows for better public management in state agencies, allowing the focus to shift from crisis management to meeting the long-term needs of Arkansas families.
- It's good government. A rainy day fund of adequate size, with appropriate withdrawal and replenishment rules leaves more time to focus on good government.

National experts such as those with the National Association of State Budget Officers recommend that states focus more on ways to deal with the cyclical nature of the economy and future drops in state revenues. State officials should debate and examine structural reforms, such as rainy day funds, that may be appropriate for their particular situations.[8]

Most importantly, rainy day funds are good for working families. These families are at significant risk during an economic downturn. When revenues fall, the state has only two choices for balancing the budget, both of which can have a large impact for working families: reducing expenditures and increasing taxes. Education, health and human services account for over 85% of general revenue expenditures, leaving very little of the budget which can be cut without impacting families. In an economic slowdown, the need for services by working families increases. On the other hand, increasing certain regressive taxes, such as sales taxes, places too much of the burden on those same families. They are doubly at risk when budgets are cut and taxes are increased.

The best time to begin planning for the next economic downturn is when times are good —before the next budget crisis – and when establishing a rainy day fund won't jeopardize funding for critical programs serving children and families. A budget surplus is usually only temporary, but it can provide a unique opportunity for a state to begin saving for a better future.

Endnotes

[1] Zahradnik, Robert, "Rainy Day Funds: Opportunities for Reform", CBPP, March 9, 2005

[2] Johnson, Nicholas and Sarah Farkas, "Tax Cuts on Layaway: The Short- and Long-term Fiscal Implications of 2006 State Tax Actions", CBPP, October 10, 2006

[3] National Association of State Budget Officers (NASBO), Budgeting Amid Fiscal Uncertainty: Ensuring Budget Stability by Focusing on the Long Term, 2004

[4] Zahradnik, Robert and Nick Johnson, "State Rainy Day Funds: What to Do When it Rains?", CBPP, January 31, 2002

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[8] National Association of State Budget Officers (NASBO),Budgeting Amid Fiscal Uncertainty: Ensuring Budget Stability by Focusing on the Long Term, 2004

For More Information:
Rich Huddleston, Executive Director
rhuddleston@aradvocates.org
www.aradvocates.org

Arkansas Advocates for Children & Families
Union Station, Suite 306
1400 W. Markham
Little Rock, AR 72201
(501) 371-9678

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