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Strengthening Washington's Rainy Day Fund

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Introduction

Washington's Budget Stabilization Account or "Rainy Day Fund" (RDF) was created to secure our essential public structures during recessions, natural disasters, and other state emergencies. Due to several design flaws, our current state RDF does not adequately support education, health care, and other important public priorities in times of need. This year, Washingtonians have an opportunity to make sensible, long-term reforms that would make our state rainy day fund more adequate and accessible during future state crises.

These reforms should include:

- ***Improving the adequacy of the RDF by increasing annual deposits:*** Under current law, one percent of general fund tax revenues are devoted to the RDF each year. At this rate, however, the fund cannot accumulate enough savings to act as an effective backstop during deep recessions. To increase the adequacy of the fund, the deposit rate should be increased to 3.5 percent of general fund revenues.
- ***Fostering improved access and accountability by eliminating the supermajority requirement and applying strict limitations:*** It is imperative that RDF funds only be used to maintain core public services during recessions and other state emergencies; they should not be used to fund new spending programs (including tax expenditure programs) or general tax cuts. To ensure the funds are accessible during emergencies – but used responsibly – Washingtonians should: 1) repeal the onerous supermajority (three-fifths legislative vote) requirement; and 2) stipulate that RDF funds are only to be used when tax revenues are projected to fall short of the amount needed to maintain current levels of services.
- ***Ensuring the rainy day fund does not hinder recovery efforts by modifying deposit requirements:*** Under current law, policymakers must deposit funds into the RDF every year, regardless of economic conditions. As a result, lawmakers could be required to make economically-damaging deposits to the RDF in the midst of (or immediately following) deep recessions, when all available resources are needed to maintain essential public services. A more sensible approach would be to suspend contributions to the RDF

during economic downturns and require that they resume when conditions improve. This could be accomplished by establishing an economic "trigger" – such as when total personal income is projected to grow by more than 11 percent in the coming fiscal year.

It is important to note that Washington's inadequate revenue system prevents our state from having an ideal RDF – one that is replenished only during good economic times when the state faces budget surpluses (see box 2). Even so, by strengthening the RDF, policymakers – and voters via a Constitutional referendum – have an opportunity to stabilize funding for our vital public structures in the long run. The reforms listed above would greatly improve the adequacy, accessibility, and accountability of this important tool. Without these reforms, our limited RDF could prove to be inadequate and ineffective during future recessions.

Rainy day funds bolster public services during emergencies

Rainy day funds are essential budget tools that can help states maintain important investments in education, health care, community safety, and other public systems during recessions and other state emergencies. Ideally, an RDF should allow policymakers to accumulate savings during good economic times. In turn, these built-up savings can later be used to maintain fundamental services when recessions or other fiscal crises occur.

Though Washington has had several emergency reserve accounts since 1981, the state didn't adopt a bona fide RDF until 2007.[1.] Formally known as the Budget Stabilization Account (BSA), the basic elements of Washington's current RDF include:

- *Mandatory annual contributions:* Each year the legislature must deposit an amount equal to at least one percent of general fund revenues into the rainy day fund. There is no ability to suspend deposits (though annual RDF contributions can be reappropriated to help fund services under the conditions listed below).
- *A supermajority vote is required to access RDF funds:* Funds can only be accessed by a simple majority (51 percent) vote in the legislature if: 1) the Governor declares an emergency; or 2) employment is projected to grow by less than one percent in the current or coming fiscal year. Otherwise, the rainy day fund can only be accessed via a supermajority (three-fifths) vote in the legislature.[2.]

Between 2007 and 2009, Washington was able to accumulate savings of $165 million in the RDF.[3.] These savings, along with other reserve funds, were appropriately drawn down in 2009 and 2010 to aid our economic recovery by protecting critical services from unacceptably deep budget cuts. Together, the RDF and other reserve funds closed only about 6.5 percent of the $13.8 billion in recession-induced budget shortfalls encountered during the current 2009-11 budget cycle.

Washington's current rainy day fund is inadequate

The rainy day fund adopted in Washington state in 2007 represents a major step toward improving the overall stability and adequacy of public services in our state. Yet, the effectiveness of our RDF is undermined by several structural flaws, which are detailed below.

The current deposit rate is insufficient

At the current deposit rate (one percent of general fund revenues per year), it is unlikely that Washington's RDF would be adequate to deal with future recessions. Public finance experts – including the Center on Budget and Policy Priorities and the Government Finance Officers Association (GFOA) – recommend that state rainy day funds reach a balance equivalent to at least 15 percent of general state budgets (general fund expenditures).[4.] In Washington, this

means our rainy day fund ideally would have achieved a balance of about $4.5 billion prior to the current recession.

Since it was created in 2007, it would have been unreasonable to expect Washington's current RDF to have reached such a high level prior to the current recession. However, under the current one percent deposit rate, our RDF would still have fallen far short of a $4.5 billion balance – even if it had been enacted 12 years earlier. In fact, had our current RDF been enacted during the 1995-97 biennium, the fund would only have achieved a maximum balance of $472 million, only two percent of the general fund expenditures.[5.]

The current recession has led to budget shortfalls totaling about $13.8 billion over the last three years. At the current one percent deposit rate, it is highly unlikely that our current rainy day fund would effectively mitigate the damage caused by another deep recession.

The supermajority requirement is onerous and excessive

Under current law, it can be overly difficult for lawmakers to access the RDF during periods of emergency. The supermajority requirement, which stipulates that the RDF can only be accessed via a three-fifths vote of the legislature unless the Governor declares an emergency, grants a small minority of lawmakers the ability to block use of rainy day funds. This barrier means the Governor, or a mere handful of legislators, could impose unnecessarily deep cuts on core public services in times of great need.

Current law does allow the legislature to access the RDF by a simple majority when growth in employment is projected to fall below one percent. While this provision generally gives the legislature adequate access to RDF funds during recessions, a natural disaster – such as an earthquake, flood, or tidal wave – could easily strike during periods of rapid employment growth. In such a scenario, the supermajority requirement could prohibit the legislature from accessing RDF funds needed to maintain services for impacted families and businesses.

Mandatory deposits could hinder recovery efforts

Under our current RDF structure, policymakers must make annual deposits to the fund by the end of every fiscal year, irrespective of the state of our economy. While contributions to the RDF should be mandatory during good economic times, it makes little sense to require deposits in the midst of (or immediately following) a recession. In future economic crises, this mandatory deposit rule could force lawmakers to counterproductively divert resources to the RDF – resources needed to preserve essential health care, education, and other public priorities.

Box 1: Legislature may ask voters to amend the rainy day fund

Introduced this year, Senate Bill 8206 would require that revenues resulting from "extraordinary growth" be deposited in the rainy day fund. Under the measure, revenues from growth that exceeds the average growth in the previous five fiscal biennia (10 years) by one-third would automatically be diverted to the RDF. In the event of a recession, the measure appropriately includes a provision that would allow the state to use extraordinary revenues to maintain essential services. Because the RDF was a constitutional amendment, SB 8206 is a resolution and would have to be approved by voters in the next general election.

As of February 28, 2011, SB 8206 has been approved by the Senate Ways and Means Committee; it awaits a full vote on the Senate floor.

Sensible reforms

More than any other event in recent history, the Great Recession has shown that Washington is in need of a robust rainy day fund that is readily accessible in times of need. The problems described above show that our current rainy day fund is inadequate, inaccessible, and could even be counterproductive during recessions and other state emergencies.

The three reforms described below would greatly improve our rainy day fund, making it a more adequate, accountable, and flexible tool for sustaining important public priorities – such as supports for foster children, assistance for people with disabilities, and effective worker retraining programs. (Box 1 describes a current reform proposal in the state Legislature.)

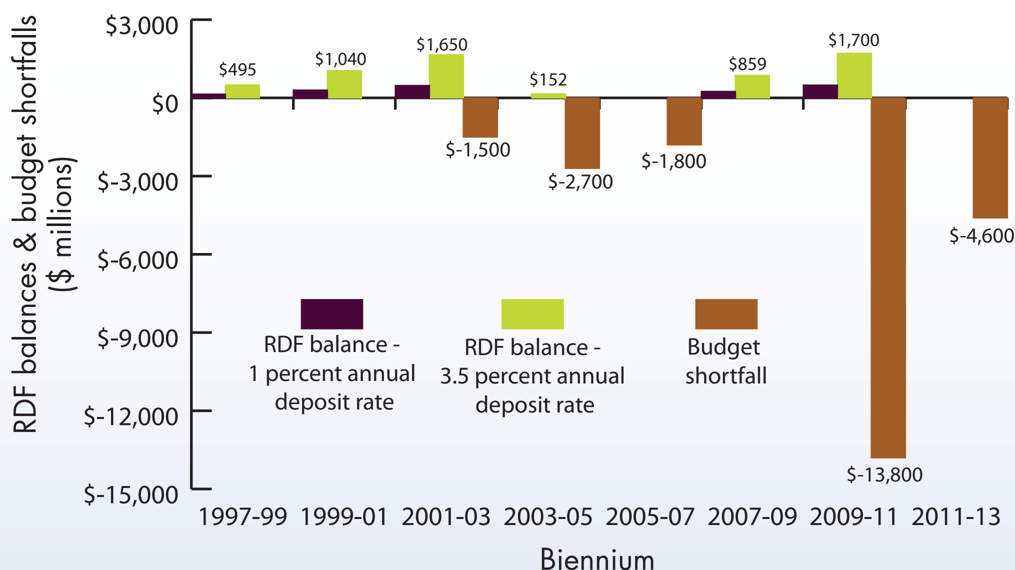
Increase deposits to 3.5 percent of revenues

Increasing the annual deposit rate to 3.5 percent from one percent of general fund revenues would allow our state to build up adequate reserves more quickly between recessions or natural disasters. Figure 1 shows how the RDF would have grown over the past 15 years under two different deposit rates: the current one percent rate and a higher, 3.5 percent annual rate. (Per the recommendation below, the graph assumes deposits only would have occurred in years in which total state personal income grew in excess of 11 percent.) Had the RDF been enacted in the 1995-97 biennium:

- At the higher, 3.5 percent deposit rate it would have generated savings sufficient to fully offset the budget shortfalls that occurred in the 2001-03 biennium as a result of the "dot com bust" recession. The higher rate would also have helped close about six percent of the recession-induced shortfalls encountered in the following 2005-07 budget cycle.
- At the current, one percent deposit rate it would have offset about 32 percent of budget shortfalls experienced during the 2001-03 biennium, with no

Figure 1: Building a better rainy day fund by increasing the deposit rate.

Budget shortfalls and rainy day fund (RDF) balances -- under annual deposit rates of 1 percent and 3.5 percent of general fund revenues -- from1995-97 to 2011-13.



Source: Budget & Policy Center calculations; data from LEAP, EFRC, and the US Census Bureau

Box 2: Washington's inadequate revenue system prevents an ideal rainy day fund

An ideal RDF is only replenished when budget surpluses occur during periods of economic growth. Due to our inadequate revenue system, which fails to keep pace with costs of maintaining basic public services, Washington will not likely experience signficant budget surpluses in the coming years. In order to build a robust RDF, this means our state must contribute to the fund even when revenues are not sufficient to maintain current levels of services. Without reforms to our revenue system, Washington will not be able to create an ideal RDF.

States with an income tax have the most effective RDFs

States with the most effective RDFs typically have an income tax. The reason is that incomes, and consequently revenues from the income tax, rise proportionally with economic growth, creating higher budget surpluses in prosperous times. When flexible replenishment rules and higher contribution requirements are also in place, states that experience budget surpluses are able to build strong RDFs.

Massachusetts provides the most striking example of the efficacy of a strong RDF. Prior to the 2001 recession, that state built up their fund to 10.4 percent of expenditures through a combination of deposits from revenue surpluses and capital gains taxes. The relatively strong revenue structure in Massachusetts, combined with no strict replenishment or access rules and a high cap (15 percent of the general fund budget), allowed the state to weather the 2001 recession better than most states.[a.]

Modernizing the Sales Tax Can Help Strengthen Washington's RDF

In lieu of enacting a state income tax, Washington has one promising way to build a stronger RDF – modernize the sales tax by extending it to consumer services. Our state sales tax has failed to keep pace with dramatic changes in the economy over the last 80 years. When the sales tax was initially enacted in 1935, consumers spent the majority of their incomes on tangible goods. Today, consumers spend most of their incomes on services, which are largely excluded from the sales tax. Updating the sales tax to include services would improve the long run adequacy of our revenue system. And with a revenue structure that is more likely to generate surpluses during times of economic growth, Washington could take advantage of better options to build a robust RDF.

[a.] Elizabeth McNichol and Kwame Boadi, "Why and How State Should Strengthen Their Rainy Day Funds," Center on Budget and Policy Priorities, February 3, 2011, http://www.cbpp.org/files/2-3-11sfp.pdf.

reserves left to help address needs in following biennium.

- Even at the higher deposit rate, it would have been woefully insufficient to offset the damage caused by the current recession. At the 3.5 percent deposit rate, the RDF would have accumulated a balance of about $1.7 billion prior to the fall of 2008, when the Great Recession deepened dramatically. As a matter of perspective, savings of $1.7 billion would have been equivalent to about 6.1 percent of the general state budget (less than half the amount recommended by public finance experts) or 12 percent of the $13.8 billion in shortfalls that occurred over the last three years. (Box 2 explains why Washington's current revenue structure prevents a more adequate RDF.)

Eliminate the supermajority requirement and limit use of funds

The rainy day fund should only be used to maintain core public services during times of crisis. These funds should not be used to fund new programs (including tax expenditure programs) or general tax cuts. While the supermajority requirement bars inappropriate use of RDF funds, it could also be used to block access to these funds when they are sorely needed. Repealing the supermajority requirement would allow legislators to appropriately access rainy day fund reserves during state emergencies.

To ensure RDF funds are not used inappropriately, the law should be changed to stipulate that they can only be used when the state faces a budget shortfall. More specifically, RDF funds should only be accessible when the Economic and Revenue Forecast Council (EFRC) projects that state tax revenues will fall short of the amount needed to maintain current levels of services in the current or coming fiscal year(s). Restricting the use of RDF funds in this way would ensure they are appropriately used only to preserve core state services during recessions, severe natural disasters, or other state emergencies.

Make deposits contingent upon economic conditions

In the aftermath of a major crisis – such as a severe recession, a natural disaster, or an epidemic of disease – policymakers should not be required to divert badly-needed funds to the rainy day fund. (Indeed, policymakers should draw upon RDF funds in these difficult times.) Accordingly, policymakers and the public (via a Constitutional referendum) should eliminate the automatic deposit requirement. Deposits should instead be required only when certain economic conditions or "triggers" are met. For example, deposits could be required when the EFRC projects total personal income in Washington to grow by more than 10 percent in the current fiscal year. (Total state personal income is a common measure of the size of state economies.) Replacing the automatic deposit requirement with deposits based on an economic trigger (or triggers) would allow the RDF to grow during prosperous times while preventing economically damaging deposits when the economy is weak.

Conclusion

The enactment of Washington's rainy day fund in 2007 was a major step toward securing our long-term investments in essential public services. Policymakers and voters in our state now have an opportunity to greatly improve this important tool. The reforms detailed above would create a more robust, accessible, and accountable RDF that is able to bolster important priorities – such as higher education, providing essential services for seniors, and maintaining basic supports for lower income working families – during recessions, natural disasters, and other state emergencies.

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Endnotes

1. Washington established a Budget Stabilization Account in 1981, which was later replaced by an Emergency Reserve Fund. These funds were of limited effectiveness due to a number of budgetary restrictions enacted under Initiative 601.

2. The Legislature can also transfer all funds in the RDF that exceed 10 percent of the general fund budget to the education construction fund.

3. An additional $302 million was transferred from the previous Emergency Reserve Fund (ERF) to the rainy day fund in 2007.

4. Elizabeth McNichol and Kwame Boadi, "Why and How State Should Strengthen Their Rainy Day Funds," Center on Budget and Policy Priorities, February 3, 2011, http://www.cbpp.org/files/2-3-11sfp.pdf.

5. Budget & Policy Center calculations; data from EFRC and LEAP.