



# How to Effectively Use State Rainy Day Funds

Best practices for spending, replenishing reserves

## Overview

Rainy day funds can be a powerful tool to help policymakers weather economic downturns and establish a strong fiscal foundation for states. But the details of how the funds are set up and how they are managed make all the difference. When state policies governing rainy day funds are clear and consistently practiced, they mitigate the impact of recessions, lessening the need for tax increases or disruptive spending cuts. They are also looked upon favorably by the major credit rating agencies. Through research and technical assistance to states, The Pew Charitable Trusts' state fiscal health project has identified best practices for rainy day funds:

1. Maintain at least one reserve account specifically for budget stabilization.
2. Deposit extraordinary revenue, including above-average tax revenue and one-time collections, into the rainy day fund.
3. Define clear withdrawal conditions.
4. Calculate a risk-based cap or savings target.

## Maintain at least one reserve account for budget stabilization

The primary purpose of a rainy day fund is to offset the impact of revenue declines and stabilize a state's fiscal position through economic ups and downs, natural disasters, and declared states of emergency. By establishing a separate savings account for this purpose, states can ensure that resources are available during times of fiscal distress.

Some states have other types of reserve funds, including capital funds that provide short-term resources for infrastructure projects, tax relief funds that can be used to support one-time tax rebates, and revolving cash accounts to offset month-to-month imbalances in revenue collections. Although these accounts may serve important fiscal policy roles, they do not provide comprehensive protection from a downturn.

## Deposit extraordinary revenue into the rainy day fund

One of the ways to build up rainy day funds is to establish deposit rules that encourage a steady accumulation of reserves during periods of economic and revenue growth.

States can do that by tying deposits into the rainy day fund to above-normal revenue growth or one-time influxes of revenue (such as from legal settlements in excess of \$10 million or one-time transfers from the federal government). This requires policymakers to determine what "above-normal" is and to establish what qualifies as "one-time collections." For example:

- **VIRGINIA** sets aside at least 50 percent of revenue that exceeds the previous six-year average.<sup>1</sup>
- **TENNESSEE** sets aside 10 percent of year-over-year additional revenue.<sup>2</sup>
- **MARYLAND** dedicates all or a portion of its nonwithholding income tax revenue that exceeds the 10-year average to its rainy day fund.<sup>3</sup>

Other states have connected rainy day fund deposits to extraordinary revenue growth in one or more particularly volatile revenue streams. For example:

- **TEXAS** sets aside 37.5 percent of all oil and gas severance tax revenue in excess of 1987 levels for the state's Economic Stabilization Fund.<sup>4</sup>
- **MASSACHUSETTS** transfers capital gains tax revenue that exceeds a threshold that adjusts with the economy. The state also sets aside all awards from major legal settlements into the rainy day fund.<sup>5</sup>

Depositing at least a portion of extraordinary revenue or one-time revenues into the rainy day fund can help expand or replenish a state's reserves while discouraging lawmakers from applying extraordinary revenue toward recurring expenditures—something that can cause a longer-term budget imbalance. Analysts from S&P Global Ratings and Fitch Ratings have said such rule-based deposits are generally viewed favorably when assessing state debt issuances.<sup>6</sup>

## Define clear withdrawal conditions

To ensure that rainy day funds are used as intended, policymakers should create clear withdrawal rules and establish them in law. These rules should make it difficult to use reserves when economic and revenue growth are strong but should not bar access when the money is needed. For example:

- **MINNESOTA** permits withdrawals when "a negative budgetary balance is projected and when objective measures, such as reduced growth in total wages, retail sales, or employment, reflect downturns in the state's economy."<sup>7</sup>

- **OREGON**'s Legislature can draw from the rainy day fund only after one of the following three conditions has been met:
  1. The latest quarterly economic and revenue forecast for the biennium projects that next year's revenue will be at least 3 percent less than current biennium general fund appropriations.
  2. There has been a decline for two or more consecutive quarters in the last 12 months in seasonally adjusted nonfarm payroll employment.
  3. A quarterly forecast indicates that revenue for the current biennium will be at least 2 percent below the forecast on which the current budget was based.<sup>8</sup>
- **WASHINGTON**'s Legislature requires a simple majority vote to appropriate rainy day fund balances during declared states of emergency or times of economic slowdown, using employment growth as a trigger. However, during any other time, the members of each house must obtain a three-fifths supermajority.<sup>9</sup>

Although credit rating agencies may downgrade a state's creditworthiness when reserves are drawn down during periods of economic or revenue growth, they do not penalize proper rainy day fund use. In fact, analysts have suggested that they view states that draw on reserves during a recession favorably, provided that they take other measures—such as cutting spending and increasing taxes—and replenish reserves when possible.<sup>10</sup>

## Calculate a risk-based savings target

Policymakers should tailor reserve caps and targets to their state's economy, tax structure, revenue volatility, and financial flexibility.<sup>11</sup> A state that experiences greater economic and revenue volatility should aim for larger reserves than a state with a comparatively stable tax base.

Regular volatility studies and budget stress tests can provide guidance on how frequent and deep revenue downturns have been. From there, policymakers should address the following questions:

1. How much of a potential shortfall—all of it, or just a portion—should reserves cover?
2. How long should the state expect to rely on reserves?
3. How severe a downturn should the state guard against?

Addressing these questions can help lawmakers settle on an appropriate savings target, which can be applied toward a budget stabilization fund or cash reserves more broadly.

- **MINNESOTA**, for example, has required its budget office since 2014 to annually recommend a savings target. The office performs a risk analysis based on the state's revenue performance and recommends a figure that is projected to offset nine out of 10 potential recession-driven shortfalls for up to two years. Fitch Ratings praised the technique when it upgraded the state to "AAA" in July 2016.<sup>12</sup> By the end of 2019, the state had reached its target.<sup>13</sup>

## Conclusion

Rainy day funds help states prepare for downturns or other unexpected emergencies. They reduce the need to cut spending or raise taxes, actions that are counterproductive during a recession. By establishing clear policies that guide deposits, withdrawals, and savings targets, states can ensure that reserves are regularly collected, properly used, and well-managed.

## Endnotes

- 1 Constitution of Virginia, Limit of Tax or Revenue; Revenue Stabilization Fund (2016), <https://law.lis.virginia.gov/constitutionexpand/article10/>.
- 2 The Pew Charitable Trusts, “Building State Rainy Day Funds” (2014), <https://www.pewtrusts.org/en/research-and-analysis/reports/2014/07/15/building-state-rainy-day-funds-policies-to-harness-revenue>.
- 3 Maryland limits the amount of estimated and final payments (nonwithholding income tax collections can include income from interest, dividends, partnerships, self-employment taxes, and—critically—capital gains) that can be built into its budget. Appropriations are limited to the 10-year average for estimated and final payments, though the restriction is lifted if projected nonwithholding revenue is set to exceed 2 percent of total revenue. See The Pew Charitable Trusts, “State Budget Strategies: States Pioneer Ways to Mitigate Swings in Personal Income Tax Revenue” (2018), <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/03/states-pioneer-ways-to-mitigate-swings-in-personal-income-tax-revenue>.
- 4 Texas Transportation Funding Amendment, Proposition 1 (2014), [https://ballotpedia.org/Texas\\_Transportation\\_Funding\\_Amendment,\\_Proposition\\_1\\_\(2014\)](https://ballotpedia.org/Texas_Transportation_Funding_Amendment,_Proposition_1_(2014)). Before 2015, Texas dedicated three-quarters of all oil and gas severance tax revenue above 1987 levels to its Economic Stabilization Fund. A constitutional amendment approved by voters in 2014 dedicated half of this amount toward highway funding.
- 5 The Pew Charitable Trusts, “Building State Rainy Day Funds.”
- 6 The Pew Charitable Trusts, “Rainy Day Funds and State Credit Ratings” (2017), <https://www.pewtrusts.org/en/research-and-analysis/reports/2017/05/rainy-day-funds-and-state-credit-ratings>.
- 7 Minnesota Stat. § 16a.152 (2019), <https://www.revisor.mn.gov/statutes/cite/16A.152>.
- 8 Oregon Rainy Day Fund 293.144 (2017), <https://www.oregonlaws.org/ors/293.144>.
- 9 Washington Constitution, Article VII, Revenue and Taxation, Section 12, Budget Stabilization Account (2007), <http://leg.wa.gov/CodeReviser/Pages/WAConstitution.aspx>.
- 10 The Pew Charitable Trusts, “Rainy Day Funds and State Credit Ratings.”
- 11 Ibid.
- 12 Fitch Ratings, “Fitch Rates Minnesota’s \$878MM GOs ‘AAA’; Upgrades Outstanding Debt,” news release, July 28, 2016, <https://www.fitchratings.com/site/pr/1009660#solicitation>.
- 13 Minnesota Management and Budget, “State of Minnesota Releases Budget and Economic Forecast,” news release, Dec. 5, 2019, <https://mn.gov/mmb/mmbhome/#/detail/appld/1/id/412276>.

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