Report to Executive Appropriations Committee

SJR 15 – Master Study Resolution

Item 163 – Rainy Day Fund – To study recommendations for the optimum size of the Rainy Day Fund.

Overview

The Budget Reserve Account (Rainy Day Fund) was established by the legislature July 1, 1986. Currently, up to 25 percent of any General Fund surplus is transferred into the Budget Reserve Account at the end of the fiscal year. The surplus is determined by the Division of Finance after the completion of the annual audit by the state auditor. The amount in the Budget Reserve Account may not exceed 8 percent of the General Fund Appropriation for the fiscal year in which the surplus has occurred. UCA 63-38-2.5(2)(a).

Historically, the Rainy Day fund has been used twice prior to FY 2002. The first time was in 1989, using $20 million to cover an operating deficit. The Second occasion was in 1993, utilizing $30 million to settle a class action lawsuit filed by federal retirees. In 1995, the Legislature appropriated $35 million to replenish the fund. For FY 2002, the Legislature authorized $113.3 million to fund revenue shortfalls, leaving approximately $10 million in the fund.

Purpose of a Rainy Day Fund

There are two main schools of thought comparative to the necessity of having a state rainy day fund.

- In a 1999 report Center on Budget and Policy Priorities (CBPP) noted that rainy day funds should make it possible for states to ride through a recession without having to raise taxes or cut services.

- On the other hand, CBPP stated that a more common view is these reserves were simply a management tool to give states the time to make thoughtful cuts and other resource allocations in a downturn.

During the last general session, the Legislature's use of the Rainy Day fund fell more into the category of providing temporary relief while the economy has a chance to recover and minimizing cuts in essential services. The Analyst believes that the establishment of the Rainy Day fund was intended to be a temporary fix for downturns or other emergencies affecting the state budget.

How much money should be maintained in the Rainy Day Fund?

The question posed for this particular review asks what appropriate fund balance should be maintained in the Rainy Day Fund. Obviously, this question does not have a specific answer because the issues for which funds are being set aside are unknown in terms of magnitude – the correct amount is the amount needed at the time of the emergency.

Phil Joyce, an associate professor of public administration at George Washington University argues that the size of the reserve fund should have some relevancy to the types of revenue streams generated within the various states. For example, Nevada which is highly dependent on tourism and Oregon which depends on sales tax for much of its revenues probably need more than other states that have a more stable and diversified budget environment.

A 5 percent set aside is a common "rule of thumb"

Katherine Barrett and Richard Greene, writing for Governing magazine in September, 1999 states, *"…managers, constantly confronted with complex questions, are well served if they can rely on general guidelines. And we have probably spoken of no rule of thumb more than the one that says good financial management demands that cities and states set aside 5 percent of their general fund revenues in a contingency fund."*

However, some policy organizations have suggested even higher set asides. For example, the Center on Budget and Policy Priorities (CBPP), said in 1999 the vast majority of states are still coming up way short and suggested that 18 percent of general fund expenditures was a more realistic reserve.

However, as previously stated, the size of the fund is dependant on the strategy a particular State wants the fund to support.

5 percent is generally supported by rating agencies

Wall Street analysts recommend maintaining a budget stabilization balance between 3 and 5 percent of general fund budgets. In fact, according to Governing Magazine, Hyman Grossman, a managing director at Standard and Poor's Corp., may well have been the first major advocate of the 5 percent figure. His response to the 18 percent as suggested by the CPBB said it was *"naive and counterproductive. You can get to the point where reserves are obscene."* For Utah, which is experiencing higher than average population growth, diversion of large amounts of money into a contingency fund may be inadvisable if it causes other critical spending needs to go unmet.

Bond rating companies are especially interested in the contingency plans of states during times of economic recession. These companies review state finances to see if there are revenue balances or reserves, which could be called upon in the event of revenue shortfalls. Ratings agencies generally acknowledge that a budget stabilization fund equal to 5 percent of the total Free Revenue (GF/USF in Utah) is a prudent level to put aside for an economic downturn. **Appendix A reflects Rainy Funds in other states as a percent of General Fund as of FY 2000.**

SB 154, 2002 General Session

Passage of SB 154, Debt Service and Rainy Day Fund Amendments, (**Appendix B**) requires the Division of Finance to make additional transfers, up to 25 percent of any surplus, to replace any prior appropriations from the fund. Given the actions of the 2002 Legislature to use $113.3 million from the fund, this legislation will assist in restoring the fund quicker and getting the balances closer to generally accepted guidelines.

However, it is noted the bill does allow for setting aside surplus to cover additional debt service payments on new debt that has been authorized by the Legislature and is issued after the last legislative session. This could reduce the amount of surplus available to replenish the Rainy Day Fund.

What is Utah's current situation?

As previously mentioned, Utah is currently transferring only General Fund surplus into the Rainy Day Fund. With the FY 2002 appropriation from the Rainy Day Fund, the remaining fund balance of $10 million is obviously significantly below the 5 percent rule of thumb. In addition, it is important to remember that Utah, unlike most states, has separated free revenues into the General Fund and Uniform School Fund. Therefore, **in the opinion of the Analyst, any calculation of reserve funds should be done using the combined GF/USF totals.**

When using the revised FY 2002 total of both funds, a 5 percent Rainy Day Fund would equate to $177.8 million.

Consideration of HB 273, Education Protection Funding Program

It is noted that with the passage of HB 273 in the 2001 General Session the **Education Protection Funding Program** was established.

This legislation provided that up to $20 million of any surplus in the Uniform School Fund at the end of FY 2002, be appropriated to the Growth in Student Population Restricted Account. The bill also provides for contributions and other appropriations that can be made to the restricted account. After FY 2002, this act has no requirements for appropriations.

Recommendations

In a June 1999 report to the Executive Appropriations Committee on the *Rainy Day Fund and Other Solutions to Budget Shortfalls*, the Analyst recommended the creation of a new Rainy Day Fund for education which would be funded from 25 percent (or a percent designated by the Legislature) of the Uniform School Fund surplus in any given year. The criteria for transfers in and out of the fund would be the same as with the existing General Fund surplus requirements.

Because the General Fund is projected to grow more slowly than the Uniform School Fund, the State will probably never get to the recommended 5 percent reserve level without the inclusion of the Uniform School Fund in the transfer equation. **Therefore, the Analyst makes the same recommendation for this report.**

APPENDIX A
Budget Stabilization Funds
***(as of % of General Fund)**

	FY 2000
Alaska	83.9
Michigan	11.3
Iowa	9.5
Minnesota	8.6
Washington	8.3
Nevada	8.2
Massachusetts	7.6
Mississippi	7.5
New Mexico	7.3
Arizona	6.8
Maryland	6.6
Nebraska	6.5
Ohio	6.1
Vermont	5.9
Maine	5.7
Indiana	5.6
Delaware	5.1
Pennsylvania	5.1
Virginia	5.1
Connecticut	5.0
South Dakota	4.9
Florida	4.8
North Carolina	4.6
Kentucky	3.6
Colorado	3.4
Rhode Island	3.1
New Jersey	3.1
Georgia	3.0
Oklahoma	3.0
South Carolina	2.7
West Virginia	2.7
Utah	**2.7**
Tennessee	2.5
New Hampshire	2.4
Idaho	2.1
Missouri	2.0
New York	1.4
California	1.4
Louisiana	0.9
Wyoming	0.5
Hawaii	0.5
Texas	0.3
Alabama	0.1
Wisconsin	0.0
Kansas	0.0
North Dakota	0.0
Illinois	none
Arkansas	none
Montana	none
Oregon	none

* Includes Uniform School Fund in Utah

Appendix B