“The Determinants of the Structure of Rainy Day Funds” by Isabel Rodríguez-Tejedo is an insightful article pointing out that rainy day funds have been a popular tool for states in recent times, but that the rules governing their structure are quite varied. As a result, Rodríguez-Tejedo found that state rainy day funds have varied in their size and use, sometimes quite significantly, and thus in their impact. In fact,
there are many fiscal, economic, and political factors influencing rainy day fund structures—the article outlines these, including even the intriguing finding that larger upper houses are correlated with more lax requirements for rainy day fund withdrawals and deposits. With the worst of the downturn for the states over, this time period is an opportunity for state officials to reevaluate the structure and rules governing their rainy day funds. The goal should be ensuring significant funds for the next downturn and appropriate replenishment, as well as rules allowing their use at the most optimal time.

Since the recession of the early 1990s, states fortunately have made a strong effort to ameliorate the effects of downturns. Rainy day funds are a crucial part of that effort. Not surprisingly, the different rules for state rainy day funds have an impact on their effectiveness. Of course, as the article shows, there may still be things that many states can do to improve the effectiveness of rainy day funds to even further avoid the painful actions that have to take place when a downturn occurs. In the most recent National Association of State Budget Officers fiscal survey, for example, we found that 20 states had very little or no money in their rainy day funds, whereas some states had large reserves. The specific fiscal, economic, and political circumstances in a state can impact how strict or weak the requirements are; also, states are presumably reacting to their circumstances.

Interestingly, in some states, a low reserve in the rainy day fund may indeed be a good thing—indicating that when the storm came, the fund reserved for a rainy day was used as presumed. Therefore, the challenge for states as they evaluate their rainy day funds is how to make changes and reform so that rainy day funds are built up to appropriate levels and flexible enough to be used when needed. A crucial question for states is, was the amount in their rainy day fund enough, and if not, can they devise ways to ensure higher rainy day funds in the future? As the article says, states with higher debt might have more strict requirements regarding rainy day funds precisely because they have higher debt. Dr. Rodríguez-Tejedo says, “In the tax structure, higher reliance on volatile tax sources seems to increase the odds that a state will choose a strict deposit requirement.”

A significant underlying challenge is also determining what may truly be objectively “unknowable,” that is, the political threshold at which the rainy day fund can actually be too high. Depending on the politics of a particular state, citizens at some point may see the large reserves and want the rainy day fund reserves either spent on programs or returned to citizens in the form of tax cuts. The “political” threshold is one of the factors that needs to be evaluated. The outcome of the evaluation may differ by state and depends on the degree to which citizens want a large rainy day fund, or either money spent on programs or tax cuts or both.

Therefore, states should use this postrecession period as an opportunity to reevaluate their rainy day funds. They also need to consider how to interact with citizens and inform them about rainy day funds. As the article points out, “Given the importance of these rules, states that are reconsidering the nature of their funds may benefit from rethinking the reasons that led to the actual configuration and include them in their discussions of the possibility of reform.” State officials should take the factors that are unique to their state and use the types of correlations found in the article to begin their reevaluation process. The article outlines the situations that might apply to a state’s rainy day fund based on certain characteristics, such as reliance on volatile tax sources.

Observers of state budgets have seen, as the article finds, that “states that spend a higher proportion of their budgets on volatile spending are more likely to establish weak funds.” Perhaps the time has come for these states to determine exactly why and whether state officials would like to consider reforms.

Another question that state officials may want to ask is whether they should consider establishing more than one rainy day fund. States could consider establishing two funds, for example, one with strict rules governing use for more dire situations and one more easily accessed. This would get around the problem of having high reserves in one place that become politically difficult to defend when citizens want more spending or tax cuts or both. For example, Colorado has a stricter fund for natural disasters.

Now that states are coming out of the worst of the downturn, the next few years may be the ideal time to ask just these sorts of questions. States should consider beginning a process of analyzing their deposit and withdrawal rules for their rainy day funds based on what has occurred in the past. States will benefit from looking into the factors that affect their ability to build rainy day funds. While some factors certainly are unlikely to be changed—such as the size of the upper house—the examination and the questions raised will still be valuable. State rainy day funds have proven to be extremely helpful financial management tools when states face difficult fiscal times. Serious examination of their structure and use in each state is an important prospect for further improvement of rainy day funds.