



A South Carolina Rainy Day Fund Saving Up for Bad Economic Cycles

Introduction

In October 2008, the South Carolina General Assembly met to cut \$488 million from a General Fund Budget of \$6.7 billion. More cuts are coming. Those cuts were entirely avoidable had the state built up sufficient savings in a Rainy Day Fund to carry it through an economic downturn. Some point to recent tax cuts as the cause, while others blame excessive spending. Fixing either would not have avoided cuts in the face of the severe economic downturn if the moneys generated or not spent were not put aside in savings.

Individuals and businesses with irregular income flows know that they have to put money aside during good times in order to cover the rent in slow times. All but three states, including South Carolina, have instituted some kind of a Rainy Day Fund (RDF), sometimes called a Budget Stabilization Fund (BSF). (Thatcher, 2008, p 1)

Rainy Day Funds

“The mechanisms governing how revenues to these funds are provided, the amount of fund balances permitted, and the specific procedures for transfer of moneys from the funds vary considerably among the states.” (Loppnow, 2007, p. 2) Typically, the withdrawal of funds is triggered by revenue downturns or deficit conditions in the state’s General Fund. “The three most common purposes of the BSF are (1) for revenue shortfall, (2) for cash flow, and (3) for emergencies. Among these three, explicit reservation for revenue shortfalls has been the dominant purpose.” (Hou, 2004, p. 40)

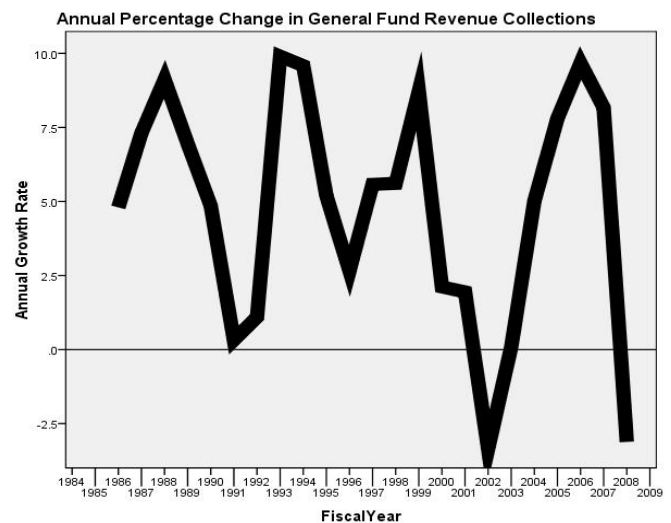
As South Carolina economists Donald Schunk and Douglas Woodward have noted: “The evidence strongly suggests that these [Rainy Day] funds have

real economic and social consequences. States with rainy-day funds have been shown to increase total state savings dollar for dollar. They have also been shown to diminish the volatility of state social sector expenditures, especially for states that have strict deposit and withdrawal rules.” (Schunk & Woodward, 2005, p. 107)

This *Policy Perspective* will look at the need to fix South Carolina’s existing rainy day funds and the considerations in designing such a fund. We will point to a proposal made for the 2008 legislative session by Dr. William Gillespie, the state’s Chief Economist which was captured in proposed legislation (*S. 718*, Constitutional amendment, and *S. 1220*, implementing statute) that failed to pass the Senate as a solid approach to budget stabilization.

Roller Coaster State Revenues

Figure 1



As Figure 1 shows, the annual growth rate for South Carolina General Fund revenue collections is wildly inconsistent and has twice in the in the past decade been negative – not counting the likely further negative growth rate in the current fiscal year. (SCBEA,

South Carolina's General Reserve and Capital Reserve Funds Rainy Day Funds or Flood Funds?

South Carolina's General Reserve Fund and Capital Reserve Fund are counted as Rainy Day Funds. However, they have several features which limit their effectiveness in assisting the state through tough times.

The General Reserve Fund is more like a Flood Fund than a Rainy Day Fund. *S.C. Const. Art. III, Sect. 36(A)*. It can only be used when you are already underwater to cover operating deficits. You have spent more money than you took in. At its Constitutional limit of 3 percent of the General Fund, it is far too small to meaningfully carry South Carolina through as much as one year.

The other flaw with South Carolina's General Reserve Fund is that it has to be paid back too soon—beginning in the year after it is tapped with an appropriation of at least 1 % of General Fund revenue in the most recently completed fiscal year. Down cycles tend to last two to three years. That means that we are forced to refill the Rainy Day Fund while we may still be underwater. Despite the ongoing down-cycle that we will face in 2009, the Constitution requires that we appropriate funds to refill savings. That's like not fixing your roof after a storm because you have to put money in savings. (McNichol & Filipowich, 2007, p.2)

The other South Carolina fund counted as a Rainy Day Fund is the Capital Reserve Fund. *S.C. Const. Art. III, Sect. 36(B)*. The Capital Reserve Fund is not an ongoing reserve. It's really an accounting entry. If revenues look okay for the current fiscal year by March 1, then the General Assembly, with a super-majority vote, draws up a prioritized list of things to fund out of the 2 % of the previous fiscal year's General Fund revenue. If the fiscal year ends with an operating deficit, items are crossed of the list from the bottom up until the deficit is satisfied. If that bucket of money is used up before the operating deficit is met, then the state dips into the General Reserve Fund.

Neither of these funds functions to level out the ups and downs of revenue cycles.

2008; Gordon Shuford, SCBEA, personal correspondence, September 23, 2008)

State government revenues are what economists call "procyclical" – in good economic times they grow, in bad times they slow or shrink. (Sorenson, Wu & Yosha, 2000; Wagner & Elder, 2007)

However, demands on state services are counter-cyclical. When times are bad, there is a greater need for services precisely when revenues to fund those services are shrinking. (See, for example, Economic Policy Institute, 2002) In bad times, more taxpayers become eligible for and need Medicaid, TANF and unemployment, as well as wholly-federally-funded programs like Food Stamps, precisely when revenue to fund those programs is shrinking. (See O'Conner, 2008)

A balanced budget requirement like South Carolina's removes options for dealing with these ups and downs. States can't borrow to make up a budget shortfall. So, they cut budgets or raise taxes.

"Cuts in spending and tax/fee increases are a form of pro-cyclical action when counter-cyclical action is needed, withdrawing government spending and increasing taxes when the economy would benefit from the opposite actions." (Hou & Moynihan, 2007, p. 8; see also McNichol, 2008)

Budget cutting has been the principle tool used to deal with slowing and declining revenues in South Carolina. State and local governments made up almost 12 percent of the state's Gross Domestic Product in 2006. (Bureau of Economic Analysis, 2008) The State of South Carolina is a major economic force. Cutting expenditures makes economic downturns worse. When the state's economy needs more spending, the state has reduced spending.

As the National Governors Association recently noted: "Both these actions [budget cuts and tax increases] are procyclical, which means they will make the downturn more severe." (NGA, 2008, pp. 1-2)

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“Budget cuts are the most widely used—and immediately effective—strategy to deal with budget imbalances, and are easily instituted, both across-the-board and targeted at specific programs.” (NASBO, 2004a)

None of the above reactions to fiscal crises would be identified in a list of best-practice management techniques. Rather, they are characterized by a sense of crisis management, minimization of conflict, or desperation. The crisis nature of unexpected fiscal mismatches leads directly to the advantages of RDFs. Using RDF funds to offset the shortfall in revenue or shore up proposed spending mitigates some of the problems associated with a budget deficit. The availability of RDF resources allows a state to respond to situations in a timely fashion and avoid unwise and shortsighted decisions.
 Cornia & Nelson, 2003, p. 564

How Big Should the Rainy Day Fund Be?

The research is clear: the ability of a Rainy Day Fund to stabilize expenditures is largely a function of its size. (Wagner & Elder, 2005; Gonzales & Paqueo, 2003; Hou & Moynihan, 2007; Navin & Navin, 1994; Cornia & Nelson, 2003; Douglas & Gaddie, 2002) A study by Iris Lav and Alan Berube of the Center on Budget & Policy Priorities found that a level of at least 18 percent was needed to survive economic downturns lasting three years. (1999)

Historically, proponents had targeted 5 % of the General Fund. “The only “standard” that practitioners continue to refer to is a normative “5 percent” rule of thumb provided by a Wall Street executive in the late 1970s and early 1980s.” (Hou, 2004, p. 45) The Government Finance Officers Association (GFOA) “... recommends, *at a minimum*, that general-purpose governments, regardless of size, maintain unreserved fund balance in their general fund of no less than five to 15 percent of regular general fund operating revenues....” (2002)

States as a whole have not usually far exceeded those levels until recent years. *The Fiscal Survey of the States* noted in June 2008: “After reaching a peak in fiscal 2006 at \$69 billion or 11.5 percent of expen-

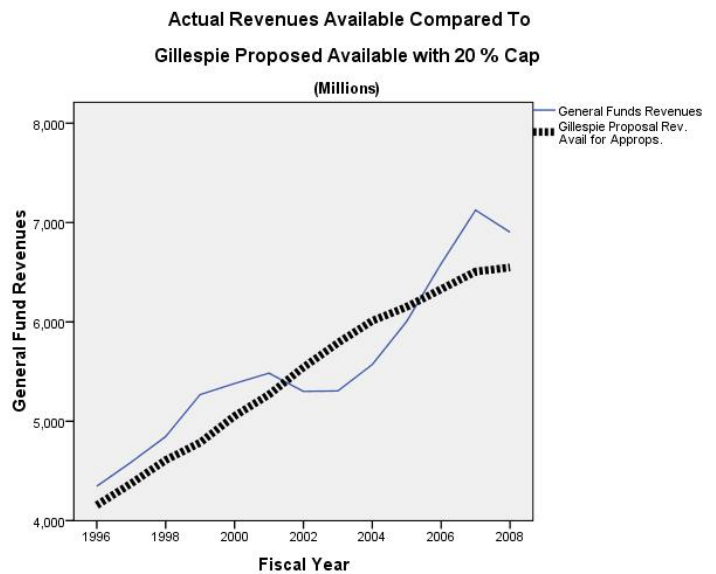
ditures, [combined general fund and Rainy Day Fund] balances have declined. Fiscal 2007 balances, at 10.5 percent of expenditures were still well above historical averages.” The historic average was 5.8 %. (NGA & NASBO, 2008, p. 23)

Studying all states, their budget stabilization funds, fiscal realities and volatility in the late 1990s, Philip G. Joyce concluded: “In the end, then, the answer to the question ‘What’s so magical about five percent?’ is ‘Nothing much.’” (Joyce, 2001, p. 87)

How big a fund you need varies state-by-state. A 1996 study by Sobol and Holcombe suggests that the optimal size of Rainy Day Funds to avoid fiscal stress during the 1989-1992 downturn ranged from 5 % to 50 %. (p.48)

South Carolina would have needed a reserve of at least 15 % to carry the state through the 1990-1991 recession. (Sobel & Holcombe, 1996, p. 41) More recently Wagner and Elder estimated that South Carolina would expect to experience a 14 % to 18 % shortfall of annual state revenues during a typical downturn. (2007, Table 2, p.737)

Figure 2



In 2008, Dr. William Gillespie reported on simulations which his staff at the Board of Economic Advisors had run on a proposed Budget Stabilization

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Fund. According to those simulations for a 10 year period through FY2007¹, a 20 % reserve would have been sufficient in all years except FY2004 and FY2005. Shortfalls of \$214.5 million in those two years "... could be covered by reserve funds or reductions in appropriations." (SCBEA, 2008b)

In testimony before the Senate Finance Committee, Gillespie told the Senators that a fund capped at 20 % would get South Carolina through a recession as severe as the 2001-2002 recession. However, Gillespie described that as a "50 year event" and suggested that a fund capped at 15 % would get the state through a typical downturn.

We are now – six years after the end of the last 50 year event – in the middle of what former Federal Reserve Board Chair Alan Greenspan has described as "once-in-a century credit tsunami." (Greenspan, 2008, p.1) If South Carolina had started with the Gillespie plan in FY1997 with a 20 % cap, South Carolina would have had an \$875.2 million dollar fund balance going into the beginning of the current crisis in FY2008 – \$1.0392 billion with no cap. Rather than axing the budget by more than \$488 million, we'd be okay for a couple years.

If your goal is to stabilize spending and avoid the kinds of budget slashing currently going on in South Carolina, a significant Rainy Day Fund is required. The available evidence suggests that a fund sized at a minimum of 20 % of the previous year's General Fund Revenue is required to avoid tax increases and/or appropriation cuts over a down cycle.

What Are the Arguments Against a Large Fund?

Those who would describe themselves as favoring smaller government look at the accumulation of large sums of money in a reserve fund and argue that those reserves mean that the state has over-collected taxes. They would instead return those dollars to taxpayers as temporary tax cuts.

Many small government advocates push for tax-expenditure limits (TEs) which cap the amount of state spending growth by a rigid formula, typically the growth in population and the consumer price index. (See, for example, Sanford, 2008, p. 1) However, TEs are designed to restrain spending and not to stabilize spending. As Schunk and Woodward note: "Indeed, of varying TEs in place, the chief failure is that they do not build rainy-day and other stabilization funds." (2005, p.107)

Conversely, those who view numerous services provided by the state – such as public safety, health care, public education and infrastructure – as already underfunded look at large reserves as leaving critical resources wasting. Members of the S.C. Senate during the 2008 consideration of a Budget Stabilization Fund indicated to us a significant concern that a high cap – 15 % with excess dollars dedicated to "capital improvement projects, debt retirement, or a tax rebate" – would further contribute to deterioration of funding for Medicaid and public education.

A properly designed Rainy Day Fund with strict contribution and withdrawal rules should result – over time – in the same total dollars expended. The formula advanced by Dr. Gillespie does cap expenditure growth. At the same time, however, it also creates a floor on expenditure growth. Assuming that the fund is fully-funded, General Fund expenditures will grow no more and no less than the average growth in General Fund revenue over the previous ten years adjusted for tax cuts and tax increases.

There are long-term threats to funding for health care and public education. Those threats are erosion of the revenue base through repeated tax cuts and of the tax base through a growing reliance on a sales tax on goods while spending shifts to services. (Fox, 2003) South Carolina faces a structural deficit in which our tax structure cannot keep up with our needs. (Lav, McNichol & Zahradnik, 2005) This has been compounded by \$582 million in annual cuts to General Fund Revenue from FY1996-FY2007 – tax cuts. (SCBEAa, 2008)

¹ Fiscal years for South Carolina, which run from July 1 to June 30 of the following year, are referenced by the second calendar year of the fiscal year. Thus, FY1996 runs from July 1, 1995 through June 30, 1996.

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The growth rate from 1997-2007 was only 4.5 %, compared to 13.11% from 1967-1977, 9.27 % from 1977-1987 and 5.47 % from 1987-1997. (Gillespie, 2008, “SC Personal Income, General Fund, and CPI + Population Growth Rates”)

Revenues available for General Fund expenditures in coming years will be no more than General Fund revenues allow and the future is increasingly bleak. That’s true whether you stabilize budgeting or not.

A fully-funded Rainy Day Fund would stabilize funding for education, public safety and health care and make clearer the effects of other tax policies on those public goods.

No doubt, setting a high cap may be politically risky; thus, it takes political strength to implement a high cap. On one hand, popular support is indispensable if the populace perceives the BSF as idle money that wastes their tax dollars, the high cap will lack support from the grassroots level. On the other hand, support from both parties in the House and the Senate is crucial as well. Therefore, setting a high cap is technically desirable, but politically demanding. To put it into practice takes wisdom and courage.

(Hou, 2004, pp. 61-62)

What Do You Use Funds Above the Cap For?

During the discussion of the Gillespie Proposal in the 2008 South Carolina Senate, as much attention went to use of funds above the cap on the Rainy Day Fund as on any other facet of the plan.

That attention may be misplaced. As Hou notes: “[N]one of the states (except Alaska, with no limit) has reached their cap levels; thus, the so-called caps may not limit the balance but serve as a target not yet reached.” (Hou, 2004, p. 46)

The Senate in 2008 finally decided to limit use of funds above the cap to capital improvement projects, debt retirement, or a tax rebate. If the goal is to stabilize spending, but ensure that over time the same dollars are put to providing for the public good, then an argument could be made that above-cap dollars

should simply be returned to the General Fund. The General Assembly could then apply them to whatever priorities exist at the time.

How Do You Fund a Rainy Day Fund?

The size of a cap is irrelevant if not enough funds are placed in the Rainy Day Fund to carry it through an economic downturn.

“Most states rely on year-end revenue surpluses in filling their rainy day funds—33 to be precise.” (Brome, 2007, p.1. See also Schrock, 2003, p. 4; NCSL, 2004) Funds not put to other budget uses or resulting from better than expected collections go in the kitty. It’s the penny jar approach to building savings.

Some states, like South Carolina, for its General Reserve Fund, and Rhode Island, set a required percent of revenues until the cap is met. Other states, like Indiana, require contributions when certain economic growth rates are achieved. (Brome, 2007, p.1)

The Gillespie proposal requires contributions when revenue growth exceeds the average growth over the preceding 10 years. Other revenue marks – such as growth in personal income or the deeply flawed population plus consumer price index – could have been used. “If you were to use personal income growth as the mark, you would not put away enough funds to smooth out revenues over the full revenue cycle. If you use cpi+population you would put away more than enough funds to smooth out revenues over a recession.” (Gillespie, 2008, p. 16)

Comparing the experiences of Michigan and Indiana to that of Ohio during the 1990-1991 recession, Navin and Navin found: “Both Michigan and Indiana, two states that consistently funded their accounts, endured the 1990-91 recession much better in terms of expenditure reductions and tax increases than Ohio which funded its stabilization account on a more sporadic basis.” (Navin & Navin, 1994, p. 464)

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Former Congressional Budget Office Director Alice M. Rivlin, in the midst of the last state fiscal crisis, urged states to adopt new rules to “save more in their rainy day funds” in hard times. “By the time the economy is growing strongly again, stricter reserve rules will be resisted, because politicians will be under pressure to use the revenues for spending increases and tax cuts.” (Rivlin, 2002, p. 6)

Hou’s comprehensive study of Rainy Day Fund structures across the country concludes: “Funding a BSF by formula is worth considering because it eliminates to the largest extent possible political interference from the governor, the legislature, or both, which is common when BSF relies on general fund surplus or appropriation as its source.” (Hou, 2004, p. 61)

One concern with formulaic approaches is avoiding a ratchet effect. If you base the future on a particularly low year or set of years, you artificially depress the level of allowable funding going forward. You would not want to start the mark at the bottom of the current downturn. Starting from where the mark would have been if we had implemented a cap 10 years ago is a more reasonable approach.

Adjusting the Cap

An important feature of the Gillespie Proposal is that it adjusts the formula base whenever the General Assembly cuts or raises taxes. Without such an adjustment, a ten year moving average of past collections will understate expected future revenues when taxes are raised and overstate them when taxes are cut. A cigarette tax with revenues put in the General Fund, for example, would take ten years to fully show up in allowable appropriations unless the base is adjusted in the first year. An income tax cut would similarly remove revenues in one year, while allowable appropriations would not fully recognize that reduction for ten years.

By requiring an explicit adjustment for the fiscal effects in either direction, the proposal makes explicit the long-term effects of a cut or an increase.

fool’s errand. Regardless of party or approach to government, absent a formulaic approach or a required appropriation to fill up the fund, the fund will be inadequate when needed. Instead, those dollars will have gone to cut taxes, fund new programs or create a legislative slush fund like the Competitive Grants Program, leaving the state in the same pickle it finds itself in late 2008.

Without legally enforced discipline – a Constitutional mandate, the Rainy Day Fund will never have enough in it to stabilize revenues during a downturn. We agree with Sen. Glenn McConnell’s view that a statutory Rainy Day Fund is “eyewash”.

How and When Do You Spend Rainy Day Funds?

Typically, if states have a restriction on withdrawals from their rainy day fund, those withdrawals are limited to economic downturns or operating deficits. In addition to providing for economic downturns and budgetary misestimates, nine states use their funds for cash flow and eight for emergencies. In four states (Alaska, Washington, Maine and Missouri), the funds can be used for practically anything. (Hou, 2004, pp. 40-43; Loppnow, 2007, p. 2; NCSL, 2004)

As proposed by Dr. Gillespie, his Budget Stabilization Fund would only be used for budget stabilization. The General Reserve and Capital Reserve Funds would remain in place to address deficits. Gillespie proposed an adjustment for revenue shocks, such as significant inflation, but not for expenditure shocks. (Gillespie, 2007, p.18)

The legislation considered by the Senate in 2008 would have allowed use of the Budget Stabilization Fund for emergencies – 1) a natural disaster, severe weather event, act of God, or act of terrorism, fire, war, or riot; 2) compliance with a court order; or 3) an unfunded federal mandate. (S. 1220, Sect. 1, Section 11-11-410(4)(b)-(d)) Although making the fund available for emergencies makes sense, that puts its availability for stabilization more at risk during an economic downturn.

Relying on surpluses or, worse, non-required appropriations to fund adequately a Rainy Day Fund is a

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You don't want the Rainy Day Fund to look like a slush fund; you also don't want to make it too difficult to access those funds for budget stabilization purposes. "Thirteen states require a supermajority vote of the legislature in order to transfer money out of the rainy day fund." (Tax Policy Center, 2007, ¶4) That is too restrictive.

Using the Rainy Day Fund in an economic downturn helps maintain consumption and demand. This exerts a countercyclical effect precisely when the broader economy needs the state to keep spending – not to cut back. (McNichol, 2008) You want rules that automatically trigger that countercyclical action when revenues decline. That happens with a self-executing formula.

The Gillespie proposal and the implementing legislation proposed in 2008 contained a self-executing formula. When the BEA certifies that revenues fall below the target appropriation level, funds to bring appropriations up to the mark are transferred from the Budget Stabilization Fund.

Any withdrawal except for budget stabilization, a defined emergency or excess funds above the cap would require an "affirmative vote in each branch of the General Assembly by two-thirds of the members present and voting, but not less than three-fifths of the total membership in each branch." (S. 718, Article X, Section 1, Section 7(c)(1))

Conclusions

The recent \$488 million in budget cuts to South Carolina's General Fund were entirely avoidable if South Carolina had in place a Rainy Day Fund designed to stabilize revenue and expenditures.

South Carolina's current Rainy Day Funds – the General Reserve Fund and the Capital Reserve Fund – are not designed to stabilize budgets. Rather, their role is to provide funds in the event of an operating deficit. They are flood funds rather than rainy day funds. You can only access the General Reserve Fund when you are already under water. They are

also severely flawed in that they require replenishing the funds even in down times.

The success of a Rainy Day Fund in providing budget stability lies in its being large enough to carry the state through an extended (two to three year) economic downturn. The evidence for South Carolina suggests that the fund should probably be at least 20 percent of the General Fund.

To achieve a fund of that size requires real discipline in good times. A formulaic approach, such as that advanced by state economist Dr. Bill Gillespie in 2008, would ensure that sufficient funds could be available in hard times – so long as the size of the fund were not too restricted. The formula offered by Gillespie – setting an annual mark for revenues available for appropriation driven by the annual growth in revenues over the previous ten years – is a reasonable approach that does not over-restrict spending. Over a full revenue cycle, it should produce the same total spending, while leveling out the ups and downs.

Boom and bust funding and expenditure cycles damage the state and the public goods it seeks to deliver. The remedy – a sufficiently Rainy Day Fund with stringent deposit and withdrawal rules – takes discipline. But it's just good common sense to put away money in good times to get you through hard times.

This Policy Perspective was written by Dr. John Ruoff, SC Fair Share Research Director, with research assistance from Carrie Draper, Layne Langston and Jammie Starr.

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