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## No Shelter from the Storm: DC's Rainy Fund Is Inaccessible in the Midst of a Severe Fiscal Crisis

By Ed Lazere

The District of Columbia has a substantial amount set aside in “rainy day” reserves, but restrictive federal rules make it hard for the city to access these funds when needed. While 26 states have tapped their rainy day funds to close budget gaps during the current economic downturn — including Maryland and Virginia — the District has not used its \$284 million in reserves to address the recession. This forced the city to adopt both substantial budget cuts and tax and fee increases.

As the District begins preparing the budget for fiscal year 2011 with a projected budget gap of \$500 million or more, the Mayor and Council should start working now with Congress to modify the federal rules that make DC's reserves more restricted than the rainy day fund in nearly every state. Fixing DC's rainy day fund rules now — so that DC leaders can consider using the fund to address the ongoing budget crisis — makes sense for several reasons.

- **Rainy day funds are a fiscally responsible tool.** States set aside funds in rainy day reserves when fiscal conditions are strong — rather than spending all of their growing revenues. During the early 2000s, states collectively set aside more than \$30 billion in rainy day reserves. States then use those funds when fiscal conditions weaken. Rainy day funds thus promote long-term fiscal stability.
- **Rainy day reserves limit the need to cut services or raise revenues during an economic downturn.** Cities and states use rainy day funds to preserve services without tax increases during a budget crisis, helping ease budget problems until the economy recovers. Spending rainy day reserves also provides an important stimulus to the local economy during a recession.
- **DC's rainy day fund is more restricted than any state rainy day fund.** The U.S. Congress adopted legislation in 2000 requiring the District to set up a rainy day fund — with local funds — but it included rules that make it hard for DC to use the fund. These rules — which apply to DC but not to any state — require the District to start repaying any withdrawals within one year and to complete repayment within two years. When Mayor Fenty proposed tapping DC's rainy day fund for fiscal year 2009, the DC Council rejected it largely because it would require funds to be replenished in fiscal year 2010 and 2011. By contrast, most states rainy day fund rules require replenishment when the economy recovers and the budget returns to surplus.

Some have suggested that the District should not modify its rainy day fund rules now because it might appear irresponsible to alter the rules so that the funds can be used. In particular, some have expressed the concern that the city's bond rating may be adversely affected. There is little reason,

however, to suggest that changing DC’s rules to be more in line with other states would be viewed as fiscally irresponsible. Seven of the 11 states with AAA bond ratings from Standard and Poors have used their rainy day fund in recent in recent years with no reduction in their bond rating. Of all 26 states that have used rainy day funds, only one — Illinois — has seen its S&P rating decline, and this appears to reflect factors unrelated to using its rainy day fund. These findings are consistent with statements from bond rating agencies that using rainy day funds prudently during a fiscal crisis is expected and will not imperil a state’s bond rating.

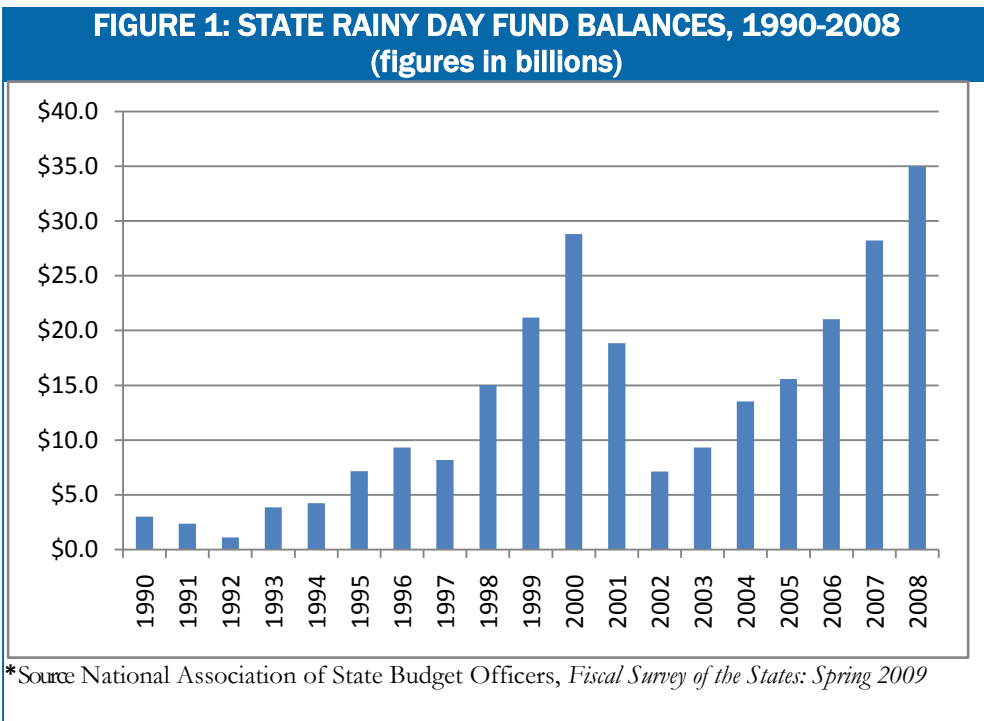
Moreover, any revision to DC’s rainy day fund rules could be designed to maintain important fiscal safeguards, such as limiting the amount of the funds that can be used in one year. Without a change in rules, the District may never be able to utilize its rainy day reserve in an economic downturn, defeating its primary purpose.

### Why Having — and Using — a Rainy Day Fund Makes Sense

States and cities establish rainy day reserves as a savings account that can be used when an unforeseen crisis threatens to unbalance the budget. Just as households are encouraged to save enough to get them through a crisis, cities and states are encouraged to develop reserves. Bond rating agencies suggest reserves should equal at least 5 percent of the budget, though others suggest that much larger reserves are needed to weather a long-term budget crisis.<sup>1</sup>

Setting up a rainy day fund — and using it when needed — makes sense for several reasons.

- Forcing States to Save When Times Are Good.**  
 Under every state’s rainy day fund law, funds must be set aside when economic conditions are good — typically when the state runs a budget surplus — until the fund reaches a specified level. Without such forced savings, it is likely that states would spend all of their annual surpluses — either through increased program funding or tax cuts. Rainy day funds this prevent states from entering into spending or tax cut commitments that may not be sustainable.



<sup>1</sup> The Center on Budget and Policy Priorities recommends state rainy day funds equal to 15 percent of a state’s budget to provide sufficient reserves to weather an economic downturn. See [Rainy Day Funds: Opportunities for Reform](#), 2007.

- **Helping States through Economic Downturns:** Having access to savings when economic conditions decline allows states to maintain services without raising taxes, preserving financial stability until the economy and finances recover. Spending down savings also provides an economic stimulus, which can be important in an economic downturn. Without a reserve, states would have to cut services or raise taxes during a recession, both of which further dampen the economy.

A review of state rainy fund use over the past two decades suggests that states use their rainy day funds as intended. States build up their rainy day funds when economic conditions are strong, and they then use them when budget conditions deteriorate. State rainy day fund balances grew during the economic boom of the 1990s, reaching \$29 billion collectively in 2000. During the economic downturn that started in 2001, the reserves were tapped in many states and fell to \$7 billion. But states replenished the reserves as the economy recovered, with fund balances reaching \$35 billion in 2008. (See Figure 1.)

States started using their rainy day funds again in 2009, as the economy slipped into a severe recession. Some 26 states have tapped their rainy day funds for 2009 or 2010, or both.<sup>2</sup> These findings suggest that states use rainy day funds as intended.

### **Federal Restrictions Make DC's Rainy Day Funds Hard to Use**

In 2000, the District established two new fiscal reserves, an "emergency reserve" and a "contingency reserve," as required by Congress in that year's federal appropriations legislation. The two funds together are similar to the rainy day funds that 45 states have established. The two components of DC's reserve have separate rules governing their use.

- The "emergency reserve" equals 2 percent of the budget, or roughly \$95 million. Its use is limited to "unanticipated and non-recurring extraordinary needs of an emergency nature, such as natural disaster or calamity..." or "in the event of a State of Emergency as declared by the Mayor."<sup>3</sup>
- The "contingency reserve" equals 4 percent of the budget, or roughly \$190 million. It can be used to address either a natural disaster or a shortfall in revenues in an economic downturn.

Although the requirement to establish a rainy day fund made sense, federal rules governing the emergency and contingency reserves are far stricter than the rules most states place on their rainy day reserves, in two key ways. First, the District is required to start repaying rainy day fund withdrawals while economic conditions remain weak. Second, DC can access its rainy day fund only under limited circumstances, while most states have flexible access to theirs.

These are discussed in more detail below.

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<sup>2</sup> National Association of State Budget Officers, *Fiscal Survey of the States: Spring 2009*, tables A-5a and A-5b (<http://www.nasbo.org/publications.php#fss2007>)

<sup>3</sup>Home Rule Act, Section 450A(a)(4).

## **DC is Required Start Repaying Rainy Day Fund Withdrawals While It Is Still Raining**

Under federal rules, DC must repay half of any amount withdrawn rainy day fund withdrawal within one year and the remaining half within two years. This means that the District would be forced to repay a withdrawal before the recession is over and its finances have recovered. When Mayor Fenty proposed using \$125 million from DC's rainy day fund for fiscal year 2009, the DC Council rejected this in part because repayment would have to occur in FY 2010 and FY 2011, when budget conditions were expected to be weak.

This repayment requirement is far more restrictive than the rules in most states. Some 39 of 46 states with a rainy day fund have no time-specific replenishment rule. Instead, most states (31) wait to re-build their rainy day funds until their budgets return to surplus; others wait until revenues start growing faster than a specified rate. (See Table 1 at the end of this report.) As noted above, this process seems to work. State rainy day fund balances fell during the recession of the early 2000s, in the midst of the last recession, and then state rainy day fund balances grew through 2008 as states replenished their reserves.

Among DC and the six states that require repayment in a certain time frame, only DC and Rhode Island require repayment within two years.<sup>4</sup>

## **DC Can Access its Rainy Day Fund Only Under Limited Circumstances**

As noted, DC's rainy day reserves are split into two parts: The \$190 million "contingency reserve" can be used when revenue collections drop by a specified amount. The remaining \$95 million "emergency reserve" is restricted to use in a natural disaster or a declared state of emergency. The structure of the reserves restricts access in two key ways.

- The full rainy day fund is not available in an economic downturn. Since nearly \$100 million is restricted to responding to a natural disaster or a state of emergency, this amount cannot be used during the economic downturn. No other state restricts a portion of their rainy day fund for natural disasters. Instead, most states have full access to their reserves for *either* a natural disaster or economic downturn.<sup>5</sup>
- Even the portion of DC's rainy day fund set aside for use in an economic downturn can be accessed only under certain circumstances. The \$190 million contingency fund can be used only if DC experiences a revenue shortfall after a budget is adopted that is greater than five percent of the budget, or about \$250 million. This is a difficult threshold to meet. For example, the District has not met the threshold for FY 2010, even though projected revenues for FY 2010 fell by \$170 million less than a month after the budget was approved.

This is not how other states treat their rainy day funds. In 39 states, the rainy day fund can be used whenever revenue collections drop below expected levels by any amount.<sup>6</sup>

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<sup>4</sup> Center on Budget and Policy Priorities, [Rainy Day Funds: Opportunities for Reform](#), April 2007, op cit.

<sup>5</sup> DC Fiscal Policy Institute, [Fixing DC's Rainy Day Fund](#), April 2003, page 6

<sup>6</sup> *ibid*, page 6.

## Recommendations for Improving DC's Rainy Day Fund Rules

The rules governing DC's rainy day reserves can be modified to address each of the restrictions noted above. Because the rules were established in federal law, the District's leaders must work with Congress to modify them. The changes proposed below would make DC's rainy day reserves more accessible while ensuring that the reserves are replenished in a responsible fashion when economic conditions improve. Those kinds of protections are important to address the concern that the District should not be changing its rainy day fund rules.

There are three changes that would make DC's rainy day fund more accessible.

- **Replace the Rule that Requires DC to Repay its Rainy Day Fund Within Two Years.** In the vast majority of states, the law governing the rainy day funds requires the fund to be replenished when the state runs a budget surplus. This ensures that states are not required to set aside funds in their reserves when economic conditions remain weak. The District's rainy day fund should be modified to requiring it to devote some or all of any year-end surplus to the rainy day reserves. This replenishment would occur until the fund reaches the required level.
- **Merge the Two Reserves and Allow Funds to be Used Flexibly to Meet Emerging Needs.** Since no state restricts a portion of its rainy day fund for use in natural disaster, the District shouldn't restrict any of its reserve in this way, either. This could be accomplished by merging the contingency reserve and emergency reserve into a single fund that could be tapped for *either* a natural disaster or an economic downturn.
- **Allow DC's Rainy Day Fund to be Used Whenever Falling Revenues Push the Budget Out of Balance.** As noted, most state rainy day fund laws allow funds to be withdrawn whenever the budget is out of balance or when revenue collections drop below expected levels by any amount. In the District, however, funds can be tapped only if projected revenues drop by at least five percent after a budget is adopted. These rules should be modified to allow the rainy day fund to be tapped when expected revenues fall below the budgeted level by any amount.

### Ensuring Fiscal Responsibility While Making the Rainy Day Fund Easier to Use

These changes would align DC's rainy day fund rules with those in other states. Nevertheless, because the proposed changes to DC's rainy day fund would give the Mayor and Council greater access to the rainy day fund, it may raise concerns that the rainy day fund would be relied upon too readily to address budget shortfalls.

The fact that states tend to replenish their rainy day funds when conditions are strong suggests that states can manage their rainy day funds responsibly even with flexible rules. Nevertheless, there are steps DC can take to ensure that its reserves are used and managed responsibly.

- **Limit the amount that can be used in any year.** The new rules could limit how much of the rainy day fund can be used in a given year, as some states do. The District could for example, limit use to half of the full fund in any year.

- **Require that a large share of surplus funds be devoted to the rainy day fund.** The new replenishment rules could require, for example, that half of unrestricted surpluses in a given year be used to replenish the fund.
- **Tie use of the rainy day fund to a drop in revenues.** Some states allow their rainy day fund to be used when the budget falls out of balance for any reason. While this flexible policy has merit, it would allow use of rainy day fund when a budget falls out of balance due to overspending. A more conservative approach would be to allow the rainy day fund to be used only when revenue collections fall short of expectations — that is, when the budget is out of balance due to a weak economy.
- **Increase the size of the rainy day fund.** Some organizations recommend rainy day funds that equal 15 percent or more of a state’s budget. At 6 percent, DC’s rainy day fund may be below the level needed to weather a multi-year fiscal crisis. Expanding the size of DC’s fund should be considered for this reason. This step only makes sense, however, if the District’s leaders actually plan to use the funds when economic conditions deteriorate.

### Is Now an OK Time to Change the Rules?

Some argue that the District should not change rules now, in the midst of an economic crisis, because it might look fiscally irresponsible to loosen rules so that the funds can be used. Some have argued that the city’s bond rating could be adversely affected.

There is no reason to suggest, however, that modifying DC’s rainy day fund rules would have negative consequences for the District.

- States are using rainy day funds and maintaining bond ratings. Of 11 states with AAA bond ratings from Standard and Poors, seven have use their rainy day fund in 2009 or 2010 (or both) — Florida, Georgia, Maryland, Minnesota, North Carolina, Utah, and Virginia. None of these states has had its bond rating reduced. Moreover, of all 26 states that have accessed rainy day funds, only one — Illinois — has seen its bond rating reduced since 2007, and this did not reflect use of its rainy day fund.<sup>7</sup> These are signs that accessing a rainy day fund can be part of responsible fiscal management.
- Bond rating agencies have indicated that using a rainy day fund should not by itself affect bond ratings. Robin Prunty of Standard and Poor’s recently noted that “We are frequently asked if the use of the reserve leads to a downgrade. Our feeling is that the reserves are established exactly to manage volatility, and I think the expectation is that they are utilized during difficult economic periods.”<sup>8</sup>
- The proposed changes would align DC’s rainy day fund rules with those in the majority of states, most of whom have used their rainy day fund in recent years.
- The rules that are in place were set by the federal government, at a time when DC was under a

<sup>7</sup> See [“S&P Downgrades Illinois’ GO Bond Ratings.”](#) March 10, 2009.

<sup>8</sup> Pamela M. Prah, [“Is it ‘Raining’ Enough.”](#) stateline.org, February 22, 2010.

financial control board and trust in managing its finances was limited. The District has shown since then that it can manage its finances responsibly.

In the end, a rainy day fund is a key tool for maintaining fiscal stability during economic downturns. To use this tool effectively, cities and states need to have both flexible rules that allow the funds to be used when need, as well as rigorous rules to require replenishment when fiscal conditions improve. Without both of these, a rainy day fund will not serve its intended purpose.

**TABLE 1**  
**Summary of State Rainy Day Fund Rules**

State	Replenishment Required in Specific Time Frame?	Restrictions on Withdrawal	How/When Deposits to Fund Are Made
Alabama	Within 5 years	Requires super-majority vote	One-time funds
Alaska	No	Requires super-majority vote	Mineral litigation settlements
Arizona	No	Limits amount of funds that can be used at one time	When personal income growth exceeds specified level
Arkansas	<i>no rainy day fund</i>		
California (2 accounts serve as rainy day funds)	No	50% of funds in one of the accounts are for retiring deficit recovery bonds	Year-end surplus; percent of estimated general fund revenues
Colorado	<i>no rainy day fund</i>		
Connecticut	No	None	Year-end surplus
Delaware	No	Requires super-majority vote	Year-end surplus
District of Columbia (emergency & contingency reserve)	Within 2 years	Only contingency reserve can be used for revenue shortfall, and it can only be used if revenues fall more than 5% below projections	Local funds (requires fund balance to be 7% of local budget)
Florida (has 2 funds)	Within 5 years	None	Year-end surplus
Georgia	No	None	Year-end surplus
Hawaii	No	Requires super-majority vote	Tobacco funds
Idaho	No	Limits amount of funds that can be used at one time	When revenue growth exceeds 4%
Illinois	<i>no rainy day fund</i>		
Indiana	No	Limits amount of funds that can be used at one time	When personal income growth exceeds specified level
Iowa	No	Requires super-majority vote	Year-end surplus
Kansas	<i>no rainy day fund</i>		
Kentucky	No	None	Year-end surplus
Louisiana	No	Requires super-majority vote; limits amount of funds that can be used at one time	Year-end surplus; oil and gas revenue above a certain amount
Maine	No	None	Year-end surplus
Maryland	No	None	Year-end surplus
Massachusetts	No	None	Year-end surplus; 0.5% of

			tax revenue from preceding year
Michigan	No	Limits amount of funds that can be used at one time	When personal income growth exceeds specified level
Minnesota	No	None	Year-end surplus
Mississippi	No	None	Year-end surplus
Missouri	Within 3 years	Requires super-majority vote; limits amount that can be used at one time	When fund falls below required balance
Montana	<i>no rainy day fund</i>		
Nebraska	No	None	Year-end surplus
Nevada	No	None	Year-end surplus
New Hampshire	No	Requires super-majority vote; limits amount of funds that can be used at one time	Year-end surplus
New Jersey	No	None	Year-end surplus
New Mexico	No	None	Year-end surplus
New York (	Within 3 years	None	Year-end surplus
North Carolina	No	None	Year-end surplus
North Dakota	No	None	Year-end surplus
Ohio	No	None	Year-end surplus
Oklahoma	No	Requires super-majority vote; limits amount of funds that can be used at one time	Year-end surplus
Oregon (has 2 funds)	No	Requires super-majority vote; limits amount of funds that can be used at one time	Lottery revenue; 1% of year-end surplus
Pennsylvania	No	Requires super-majority vote to use fund	Year-end surplus
Rhode Island	Within 2 years	None	3% of revenue each year
South Carolina	Within 3 years	None	Year-end surplus
South Dakota	No	None	Year-end surplus
Tennessee	No	Limits amount of funds that can be used at one time	When revenue growth exceeds 10%
Texas	No	Requires super-majority vote	Year-end surplus
Utah	No	None	Year-end surplus
Vermont	No	None	Year-end surplus
Virginia	No	Limits amount of funds that can be used at one time	Based on formula using prior 6 years of revenue growth
Washington	No	Requires super-majority vote	Year-end surplus
West Virginia	No	“Part B” cannot be tapped until original fund is depleted	Year-end surplus
Wisconsin	No	None	Year-end surplus
Wyoming	No	None	Year-end surplus
Source: Elizabeth McNichol and Brian Filipowich, “Rainy Day Funds: Opportunities for Reform,” Center on Budget and Policy Priorities, Revised April 17, 2007, <a href="http://www.cbpp.org/files/4-16-07sfp.pdf">http://www.cbpp.org/files/4-16-07sfp.pdf</a> .			