BTC Brief

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SAVING FOR A RAINY DAY WHEN NC NEEDS AN UMBRELLA TODAY

Balancing the Goal of Stability in Public Investments with an Adequate Response to Community Needs

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Lawmakers have introduced companion bills – House Bill 7 (HB7) and Senate Bill 14 (SB14) – that would make changes to the state's existing Savings Reserve Account, commonly referred to as the Rainy Day Fund. The proposed changes would alter existing state law in two deliberate ways:

1. **Mandating how deposits are made into the Savings Reserve Account**
2. **Placing restrictions on the ability of policymakers to access the Savings Reserve Account**

The Rainy Day Fund is a critical tool to ensuring the stability of public investments through economic downturns and ensuring that the state can respond adequately to unexpected disasters. However, in the current context, reforms to the state's Rainy Day Fund must balance the immediate needs in communities with setting aside dollars for as yet unidentified and unanticipated future needs. Today, in particular, the Rainy Day Fund is a critical source of funding for the immediate needs in Eastern North Carolina as the region rebuilds from Hurricane Matthew.

The current Savings Reserve Account balance is **approximately $1.475 billion** after accounting for relief funding provided for the hurricane disaster and wildfire relief appropriated in December. Existing state law does not stipulate an exact balance that the Rainy Day Fund must meet; rather, there is a goal of 8 percent of prior year appropriations. North Carolina's Rainy Day Fund balance is approximately 6.6 percent of total state appropriations in the past year, significant progress from 3.7 percent in 2006.1

Nearly $674 million in General Fund revenue has been placed into the state's Rainy Day Fund in the past two fiscal years alone.[2] Setting aside these dollars has meant North Carolina has not done what it needs to meet the needs of communities and to ensure that the economic expansion reaches every North Carolinian. The result is that the state continues to reduce its investment as a share of the economy, and in the past year it held spending to the arbitrary formula of growth in population plus inflation.[3]

Adapting the Rainy Day Fund reforms to ensure dollars are accessible, savings don't squeeze out immediate needs

North Carolina already has many of the recognized measures of an effective Rainy Day Fund. North Carolina does not cap the size of its Rainy Day Fund, does not have onerous replenishment rules[4], does not have limits on the use of funds nor require supermajority votes to access the funds.[5] Lawmakers are not prohibited from depositing additional dollars into the Rainy Day Fund – the amount of dollars that can go into the Rainy Day Fund is uncapped.

The proposed changes would actually move North Carolina away from many of these best practices while also putting in place stronger deposit rules that prioritize savings over addressing immediate needs. As lawmakers pursue the proposed changes under HB7 and SB14, ensuring that the state can fund immediate needs and that the Rainy Day Fund is set up to allow for stability in public investments over time is important. Here are three ways to improve the proposed changes to the Rainy Day Fund.

- **A portion of annual revenue over what is anticipated based on projections and historical performance should be deposited into Rainy Day Fund rather than requiring 15 percent of total annual revenue growth be deposited into the fund.** This would allow the state to take advantage of unanticipated revenue growth while also allowing the state to target revenues collected to immediate needs, particularly in recovering from periods of cuts. This is particularly important since revenue growth is necessary to keep up with the growth in the cost and reach of public services over time.

- **There should be no limit to withdrawals from the Rainy Day Fund, which in the proposals is set at 7.5 percent of the prior year's General Fund net appropriations.** The Rainy Day Fund is intended to be available to meet urgent needs and limits to the purposes could put at risk priorities. For example, because one of the purposes is to "cover the difference between that fiscal year's base budget needs and projected revenue," the result could be in times of low revenue growth that the state could not fully fund enrollment growth in K-12 schools, which is no longer part of the base budget, because of deposit requirements.

- **The proposed supermajority requirement should be eliminated so that access to the Rainy Day Fund can't be blocked by a few legislators in times of fiscal crisis.**

HB7 and SB14 Propose Changes to North Carolina's Savings

Major changes to the state's existing Rainy Day Fund, even as the state should be drawing down those funds for the significant recovery effort in Eastern North Carolina, should be carefully considered before being adopted. Here are the proposed changes in the two bills:

- Aggregate use of funds each fiscal year cannot exceed 7.5 percent of prior year's General Fund net appropriations and requires majority approval by House and Senate.
- Supermajority approval is required by House and Senate for any use of Savings Reserve Account dollars that exceeds the newly established spending threshold.
- 15 percent of estimated overall tax revenue growth from year to year must be deposited into Rainy Day Fund. Governor's recommended budget must also include this automatic revenue deposit.
- New target balance for the Savings Reserve Account to be determined jointly by Office of State Management and Budget and Fiscal Research Division and will be based on unspecified scenario tests.

Proposed Changes to Rainy Day Fund Could Limit the Usefulness of Savings in Fiscal Crisis, Natural Disasters

The requirement that 15 percent of annual revenue growth be transferred to the Rainy Day Fund at the outset of the budget process fails to allow future policymakers to budget based on community needs. Generally, best practices say that contributions should be made based on "windfall" or one-time revenue (such as capital gains tax increases), or on revenue coming in that is above projections and therefore beyond what is needed to meet community needs.

To put this figure in perspective, 15 percent of the annual growth rate varies considerably year to year from $188 million in the 2014-15 fiscal year, to $84 million in the 2015-16 fiscal year. Given the continued changes being made to the state tax code and potential changes to the federal tax code, the ability of taxes collected to meet the costs of basic public services is constrained and would be further limited by this rule.

Overall revenue growth over the past three years was $2.4 billion, which would have meant around $364 million in required General Fund revenue deposits into the Rainy Day Fund under the proposals. These dollars could have made significant investments in ensuring access to affordable housing and child care, would have made greater progress toward getting teacher pay to the national level, and could have supported rural economic development initiatives.

The proposed spending limit could potentially limit the state's ability to effectively respond to major economic crises, such as another Great Recession. The state faced a budget shortfall in 2009 of $3.2 billion, well above the proposed threshold that would require a supermajority vote to access these savings.[6] The proposed supermajority approval requirement to access Rainy Day Funds beyond the spending threshold could mean that just a few policymakers could prevent use of the Rainy Day Fund to respond to an immediate crisis in a timely manner. Just 10 states have limited access to Rainy Day Funds through supermajority vote requirements. Two of them, Louisiana and Missouri, made deeper cuts and raised revenue due to restricted access to their savings during the recession.[7]

North Carolina policymakers have prioritized savings in recent years but have also neglected investments in the infrastructure and services that can help the state better weather downturns and natural disasters. Reforms to the Rainy Day Fund may be warranted to ensure that savings remains a priority, but rules should be designed to ensure that dollars can be put to use when needed as they are today in North Carolina.

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1. http://www.cbpp.org/research/why-and-how-states-should-strengthen-their-rainy-day-funds
2. NCGA approved budgets for FY16 and FY17. http://www.ncleg.net/Applications/BillLookUp/LoadBillDocument.aspx?SessionCode=2015&DocNum=6294&SeqNum=2
3. Tazra Mitchell and Cedric D. Johnson, "2017 Fiscal Year Budget Falls Short of Being a Visionary Plan for North Carolina's Economic Future," BTC Report, NC Budget & Tax Center, Raleigh, NC, July 2016. http://www.ncjustice.org/?q=budget-and-tax/btc-reports-2017-fiscal-year-budget-falls-short-being-visionary-plan-north-carolina%E2%80%99s
4. Of note is the requirement in the House Bill 2 related to Hurricane Matthew recovery that requires the Governor to immediately replace $100 million in dollars used for the recovery back in the Rainy Day Fund at the front end of the budget process.
5. http://www.cbpp.org/research/why-and-how-states-should-strengthen-their-rainy-day-funds
6. http://www.cbpp.org/research/states-continue-to-feel-recessions-impact?fa=view&id=711
7. http://www.cbpp.org/research/why-and-how-states-should-strengthen-their-rainy-day-funds