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# BTC Brief

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## SAVING FOR A RAINY DAY: Implementing Rainy Day Fund Reforms Now Could Protect Public Investments in Future Recessions

*Timely,  
accessible,  
and credible  
analysis of  
state and local  
budget and tax  
issues*

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### KEY FINDINGS:

- The North Carolina Rainy Day Fund (RDF) works to minimize the negative effect of economic downturns through responsible savings deposits during years of economic growth.
- The failure to save adequately during times of growth has limited the ability of the RDF to help address budget shortfalls during economic downturns, leading to painful cuts to public investments and services that hurt the state's economy and cause hardship for struggling families.
- Changes to North Carolina's rules for RDF contributions could create a more robust RDF that would be better able to protect the state's economy and critical public structures from the negative effects of the next recession.
- Reforms that raise the RDF target to 16 percent, integrate proactive savings decisions into the budget process, and implement an economy-based formula to mandate contributions only during periods of robust growth can ensure adequate public savings without hindering economic activity or displacing resources needed to fund key programs and services.
- Moving savings decisions to the front of the budget cycle would institutionalize a commitment to savings, increase the likelihood of contributions, and grant legislators the flexibility to vary the size of contributions depending on overall economic conditions.

### North Carolina's RDF Inadequate to Protect Key Public Structures

OFFICIALLY KNOWN as the Savings Reserve Account, North Carolina's Rainy Day Fund (RDF) works to minimize the negative effect of economic downturns through responsible savings deposits during years of economic growth. However, inadequate RDF contributions during growth years left North Carolina without the resources needed to protect public investments during and after the 2001 recession and the Great Recession.

The current target for total savings in North Carolina's RDF is 8 percent of the previous year's operating budget. State law directs the State Controller to allocate one-quarter of the unreserved balance at the end of each fiscal year to the RDF.<sup>1</sup> But because these rules leave contributions until the end of the budget process and only include "left-over" funds, North Carolina has hit its savings target only one time in the 20 years since the RDF's establishment (see Appendix for NC Rainy Day Fund Timeline), and at the time the target was only 5 percent.<sup>2</sup>

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The failure to save adequately during times of growth has limited the ability of the RDF to help address budget shortfalls during economic downturns, leading to painful cuts to public investments and services, which hurts the state’s economy and causes hardship for families struggling during times of economic distress. The 2001 recession led to mid-year budget reductions of \$605 million in FY2000-01, including \$121 million in cuts to K-12 education and \$79 million to health and human services.<sup>3</sup> In FY2001-02, there were further mid-year reductions totaling \$789 million, including budget reversions of approximately \$104.8 million for K-12 education and \$132.5 million for health and human services.<sup>4</sup> Smart Start alone was cut by a total of \$140 million in the years following the 2001 recession.<sup>5</sup>

Historically, North Carolina’s leaders have closed budget gaps due to recessions through a balanced approach that both cuts spending and increases revenue. Thus, inadequate RDF balances have led to more substantial tax increases to close shortfalls than would have been necessary with larger RDF balances. In all three recent recessions, sales tax increases accounted for the majority of additional revenue raised to close budget shortfalls.<sup>6</sup> Although economists recommend protecting public investments through temporary taxes over cutting public investments during economic downturns,<sup>7</sup> addressing revenue shortfalls using savings is likely to have the least negative effect on the economy.

While recent proposals from Governor Beverly Perdue and the General Assembly to make one-time deposits this year from an expected FY2011 year-end balance into the RDF show a commendable concern for savings contributions, current best practice suggests that now is not the time to be making deposits. A February 2011 report from the Center on Budget and Policy Priorities examining how states can strengthen their rainy day funds determined that, “given the depth of the current state fiscal crisis and the expected slow return to normal revenue levels, it is not yet time for many states to make deposits to these funds.”<sup>8</sup>

Rather, changing how the state approaches the RDF by establishing a consistent and institutionalized commitment to responsible savings during economic expansions would better position North Carolina to deal with the challenges of the next recession.

### Higher RDF Target Would Lessen Impact of Recession-Driven Shortfalls

If North Carolina’s RDF balance had been equal to 8 percent of prior-year expenditures (the state’s current savings target) at beginning of the 2001 recession, it would have been of sufficient size to substantially minimize the mid-year revenue shortfall of \$702 million.<sup>9</sup> But importantly, relying entirely on the RDF to close that shortfall would have fully depleted the RDF and left it unable to address the multi-year revenue shortfalls that have been typical of the last three recessions. A depleted RDF also leaves North Carolina unprepared for emergency spending, such as disaster relief, and with a steeper climb to reestablish the RDF as a resource for future economic downturns.

Based on the typical 8-year time period between recessions, annual RDF deposits of 1.5 percent of revenues would have allowed the state to meet its 8-percent target.

However, North Carolina could better position itself to deal with the challenges of economic recessions and emergency expenses by establishing a higher RDF target. If the state had had an RDF balance equal to 16 percent of prior-year expenditures in 2001, it could have fully closed the one-year revenue shortfall and left the RDF balance at \$696 million, enough to reduce the following year’s \$1.55 billion revenue shortfall by 43.5 percent.<sup>10</sup> Attaining a higher target thus ensures an RDF balance of sufficient size to more adequately address typical multi-year revenue shortfalls. (See Table 1).

| Biennium | Two-Year Revenue Shortfall | RDF Target | Pre-Recession RDF Balance | RDF % of Revenue Shortfall |
|----------|----------------------------|------------|---------------------------|----------------------------|
| 2001-03  | \$2,302                    | 5%         | \$247                     | 10.7%                      |
|          |                            | 8%         | \$557                     | 24.2%                      |
|          |                            | 16%        | \$1,398                   | 60.7%                      |

SOURCE: Authors' calculations based on data from NC Fiscal Research Division Highlights: Fiscal And Budgetary Actions 2009 Regular Session

Such a level of public savings would protect the state’s ability to invest in education and health services while avoiding the need for significant tax increases, thereby leaving the state in a strong position to rebuild the RDF in order to counteract further downturns. Annual contributions of 2.7 percent of total revenue, over an 8-year period, would have been sufficient to meet a 16-percent target.

### Converting to Proactive RDF Contributions Would Make Savings Target Achievable

Currently, year-end RDF contributions are essentially last in line in the appropriations process: state budget requirements direct the Office of the State Controller to reserve one-quarter of the unreserved balance at the end of each fiscal year for the RDF.<sup>11</sup>

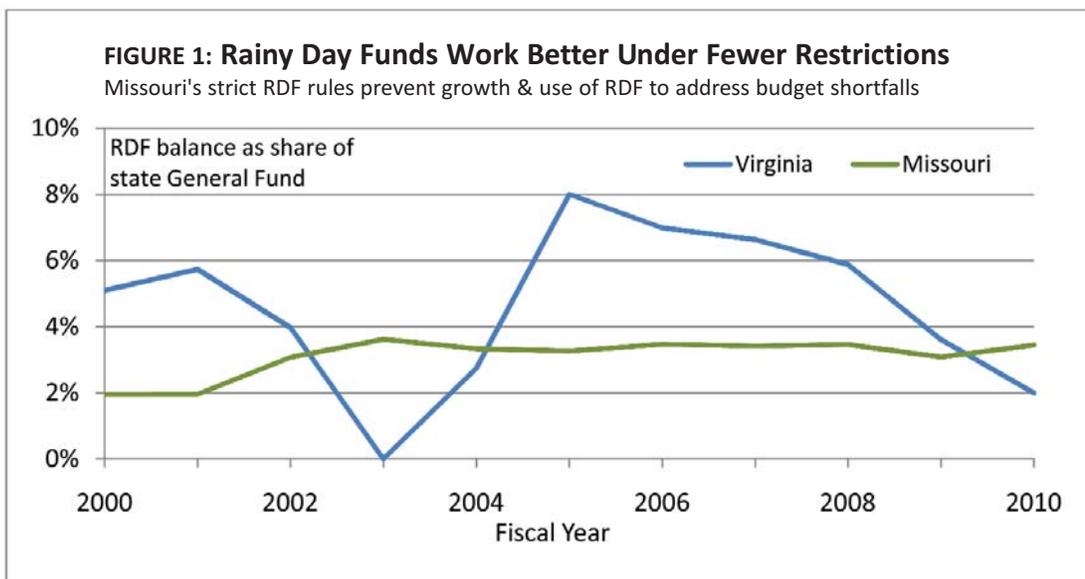
Moving deposit commitments to the front end of the budget-approval process would make savings proactive instead of reactive, increase the likelihood that deposits would be made on a more consistent basis, and allow the General Assembly to tailor the size of the contribution based on the status of the state economy. In short, regular budgeting for RDF deposits would help to ensure that saving is a priority for the state, which is particularly important given the volatility of North Carolina’s revenue streams.

### Mandating Savings During Times of Robust Growth

While moving RDF commitments to the front end of the budget cycle and raising the RDF target to 16 percent of prior-year expenditures would strengthen public savings, it would not guarantee it. Legislators could still choose to only contribute token amounts to the RDF, even when the economy is growing at a rapid rate. Three states in the Southeast (FL, TN, VA) promote adequate savings by mandating contributions based on formulas that act as markers of economic growth. All three states had larger RDF balances than North Carolina in fiscal year 2010, leaving them with more resources available to address continued revenue shortfalls.<sup>12</sup>

Such a formula would mandate RDF contributions only during times of robust growth in the state’s economy and state revenues. Virginia, for example, requires deposits only when the growth in corporate, individual, and sales tax revenues is greater than the previous six years’ average growth rate.<sup>13</sup> During years when growth is slower, lawmakers determine savings deposits through the normal budgeting process. If North Carolina set a trigger to mandate contributions at a high enough level, legislators would maintain the flexibility to vary deposit amounts during years of less robust economic growth.

Currently, North Carolina has few restrictions to either the growth or use of the RDF. States that have implemented restrictions on RDF growth and use, such as establishing a minimum balance for the RDF or requiring a supermajority to withdraw funds, have constrained state policymakers’ ability to effectively manage their budgets in times of fiscal crisis (See Figure 1).



The budget cuts caused by the current recession have made savings during periods of economic growth a higher priority for people throughout the United States. Voters in states across the country have recognized the need for stronger RDF policies: voters in five states passed referenda to strengthen their RDFs in the 2010 election.<sup>14</sup>

SOURCE: NASBO Fall Fiscal Survey of the States, 2000-2010, Spring 2011

## Conclusion

In each of the past three recessions, inadequate savings has forced state policymakers to rely primarily on harmful budget cuts and broad tax increases to close recession-driven shortfalls in state revenues. Doubling the savings target of the Rainy Day Fund to 16 percent of the state’s budget, integrating decisions about contributions to the RDF into the budget process, and mandating RDF deposits during times of robust economic and revenue growth will enable the RDF to better fulfill its purpose of addressing recession- and emergency-driven budget shortfalls.

The Great Recession has not only highlighted the need for such reforms, but as demonstrated by voter-approved RDF reforms in other states, it has increased the public support needed to enact them. In response, state policymakers should take steps to improve the RDF rules while support for such changes remains high to ensure that North Carolina is better prepared to address future revenue shortfalls in a manner that supports economic recovery and protects public services and programs that help struggling families in times of economic distress.

## APPENDIX: North Carolina Rainy Day Fund Timeline

**1990:** Rainy Day Fund (or RDF, officially known as the Savings Reserve Account) created with a \$141 million deposit, which is fully drawn down to address budget gap.

**1993:** \$121 million withdrawn from RDF to support state payroll restoration.

**1994:** A total deposit of \$213 million more than doubles the ending balance of the RDF.

**1995-1998:** Four years of minimal contributions to the RDF lead to an increase in the ending balance from \$501 million to \$523 million, only 4 percent growth.

**1999:** Withdrawals to cover the Intangible Tax liability required by the Bailey vs. NC case and the aftermath of Hurricane Floyd deplete the RDF ending balance from \$523 million to \$38 million, a 93 percent reduction.

**2001:** \$248 million withdrawal to cover budget shortfall caused by recession fully depletes the RDF for the first time since 1990.

**2005:** \$316 million deposit is the largest one-year deposit in RDF history.

**2006-2007:** RDF reaches highest ending balance of \$787 million.

**2007:** Statutory 5-percent cap is converted to an 8-percent target.

**2008:** Largest single withdrawal of \$637 million to cover shortfall caused by Great Recession. Year-end balance of \$150 million remains unchanged until May, 2011, when a \$38 million transfer reduced the balance to \$112 million.

**2011:** \$185 million deposit approved for June 30, as state cuts funding for critical public structures like public schools and hospitals in response to \$2.5 billion shortfall.

*\*RDF history through 2008 from OSBM Post Legislative Summary, 2009-11. 2011 information from FY2011-13 Final Budget – Session Law 2011-145.*

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