Building a Better Rainy Day Fund

Virginia's New 15-Percent Cap on Reserves

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Executive Summary

The November 2010 Virginia elections brought voter approval of a constitutional amendment to increase the funding cap on the state's Rainy Day Fund from a maximum of 10 percent of key revenues to 15 percent. Virginia is one of five states that considered and passed ballot measures to improve its Rainy Day Fund this past fall. Legislation under consideration in the General Assembly now would implement this new provision. As a result, understanding what this change means for Virginia's budget is important.

The increase in the funding cap better equips Virginia for challenging economic times. For instance, with a 15-percent cap on its Rainy Day Fund, Virginia would have entered the Great Recession (in 2008) with an extra $594 million in the fund. Such resources would serve as a first line of defense against debilitating cuts to core services. By increasing the cap on the fund, officially known as the Revenue Stabilization Fund, Virginia has enhanced its ability to weather the storm of future economic downturns. The recently approved ballot question amends Virginia's Constitution so that the balance of the fund can grow larger during times when revenue growth is high. An adequately sized Rainy Day Fund benefits the state's economy because it prevents Virginia from having to make crippling spending reductions when revenues are down and needs are high.

While the cap has increased from 10 to 15 percent, the rules for calculating the size of an annual deposit have not changed. This means that in a given year, the state will not necessarily be on the hook for larger deposits when a deposit is constitutionally mandated. The size of the deposit is still based on the difference in actual sales and income tax collections in the current year and average collections over the past six years.

What has changed is that the state must continue to make deposits until the balance hits 15 percent of the average sales and income tax revenues from the past three years. The state will likely take longer to reach the fund's maximum balance under the higher cap, but that does not necessarily mean that the state must contribute any more to the fund per year than in the past.

Virginia's new cap will allow the state to better prepare for downturns. However, even with the increase, Virginia's reserves will not grow to the level recommended by experts.

Background on Rainy Day Fund Caps

Virginia is not alone in its decision to cap the balance of the Rainy Day Fund. Most of the states that have such funds have placed caps dictating the fund's maximum size. While the bulk of states cap rainy day funds between 5 and 15 percent of general fund operating budgets, Virginia uses a slightly different formula.

No other state uses Virginia's approach. Instead of using a proportion of the total general fund as the cap, the balance of Virginia's Rainy Day Fund cannot exceed a certain percentage of the average annual tax revenues. Such revenues are derived from taxes on income and retail sales over the previous three years. While these tax revenues are the two largest sources of Virginia's general fund dollars, other taxes such as insurance premium taxes, recordation taxes, and other miscellaneous taxes yield between about 8 and 12 percent of the general fund every year.

What this means for Virginia is that the 10-percent cap we had in place prior to the passage of the constitutional amendment—and the 15-percent cap that became effective January 2011—represents less than 15 percent of the state's total budget. In other words, by exempting other tax revenues from the Rainy Day Fund calculation, Virginia's new effective cap on the fund, in terms of the dollars it takes to run state government and core services, is substantially less than 15 percent.

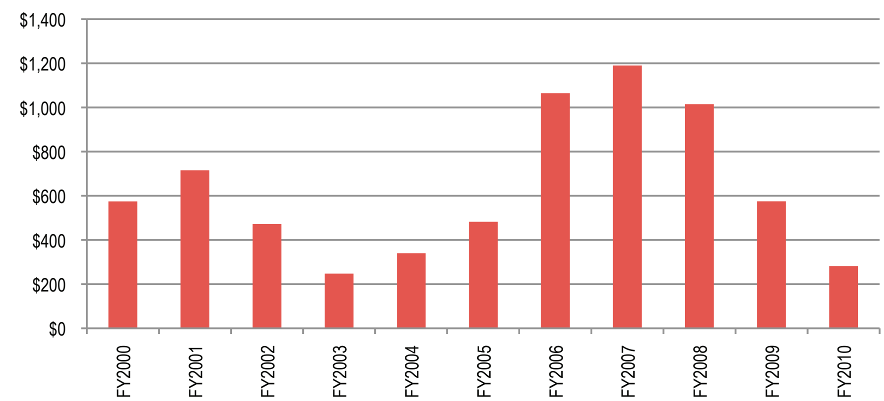
Where We Are

When fiscal year 2010 ended this past June, Virginia's Rainy Day Fund held a balance of roughly $281.6 million. As shown in Figure 1, the fund has served its intended purpose as a budget stabilizer. The balance has grown during times of economic growth, and fallen in times of revenue loss.

Virginia's Rainy Day Fund has helped lessen the severity of the cuts needed to close massive budget shortfalls during the Great Recession. Leading up to the recession, the fund hit its highest balance to date—roughly $1.2 billion in 2007. This amount represented the maximum balance for that year. Since fiscal year 2008, however, Virginia has withdrawn roughly $1.13 billion in reserves from the Rainy Day Fund. This amount closed approximately 15 percent of the total budget gap occurring over the course of the FY2008-2010 period of economic downturn (see Figure 2).

A Budgetary Cushion for the Commonwealth

Figure 1: Revenue Stabilization Fund Balance at Year-End, FY2000-FY2010



Source: APA reports on Revenue Stabilization Fund.

Rainy Day Fund Helps Close Shortfalls

Figure 2: Share of Fiscal Year Revenue Shortfall Closed by Rainy Day Fund Withdrawals, FY2008-2010

Source: Author's analysis of APA reports and Secretary of Finance presentation to JMC, December 2009.

Rules for Deposit

Deposits into the rainy day fund can be made at any time during the budget process, but are constitutionally mandated in certain years when the growth in particular revenues is high. More specifically, the state must make a deposit into the Rainy Day Fund when the growth in corporate income, individual income, and sales tax revenues exceeds the average growth rate over the previous six years. The size of the deposit must equal one-half of the revenue growth in excess of the previous six-year average (See Figure 3). The Revenue Stabilization Fund is invested and accrues interest just like any other general fund; however, once the balance hits the cap, excess funds are transferred to the general fund.

Size of Mandatory Deposits Have Not Changed

While the cap has gone from 10 to 15 percent, the rules for calculating the size of an annual deposit have not changed. This means that in a given year, the state will not necessarily be on the hook for larger deposits when a deposit is constitutionally mandated. The size of the deposit is still based on the difference in actual sales and income tax collections in the current year and average collections over the past six years. This formula has not changed.

Building Virginia's Rainy Day Fund

Figure 3: Rules for Deposit

STEP 1: Is current growth in individual, corporate and sales tax greater than the average growth for the previous six years?

IF NO: no mandatory deposit.

IF YES: Continue to STEP 2.

STEP 2: Calculate the difference between current growth in individual, corporate and sales tax revenues and average growth in individual, corporate and sales tax revenues for the previous six years.

STEP 3: Multiply one half of the difference from STEP 2 by current individual, corporate and sales tax revenues.

STEP 4: Does balance of the Rainy Day Fund exceed 15 percent of the average annual income and sales tax revenues over the previous three years?

IF NO: Deposit into Revenue Stabilization Fund.

IF YES: Transfer surplus into general fund.

What has changed is that the state must continue to make deposits until the balance hits 15 percent of the average sales and income tax revenues from the past three years. The state will likely take longer to reach the fund's maximum balance under the higher cap, but that does not necessarily mean the state must contribute any more to the fund per year than it would have previously.

The only scenario in which the state is on the hook for larger deposits than under the lower cap is when the fund reaches levels in excess of the old 10-percent maximum balance. For example, in 2006 the state was on track for a deposit into the Rainy Day Fund of $584 million based on revenue growth figures. Yet, depositing this full amount would have brought the fund above its constitutional cap by around $19 million. As a result, that excess $19 million was transferred back to the general fund. Had the state had a 15-percent cap in place, this $19 million would not have been transferred to the general fund and remained there. In this sense, there are certain scenarios in which the state would deposit more into the Rainy Day Fund than it would have under the lower cap. Generally, however, this is not the case.

Why the New Cap is Good for Virginia

Had Virginia had the 15-percent cap in place prior to the downturn, the Commonwealth would have had an estimated $594 million extra in resources to help close the budget shortfalls that plagued Virginia during the Great Recession. These additional resources could have helped prevent crippling cuts to core services such as education and health care at a time when the needs of Virginians were high.

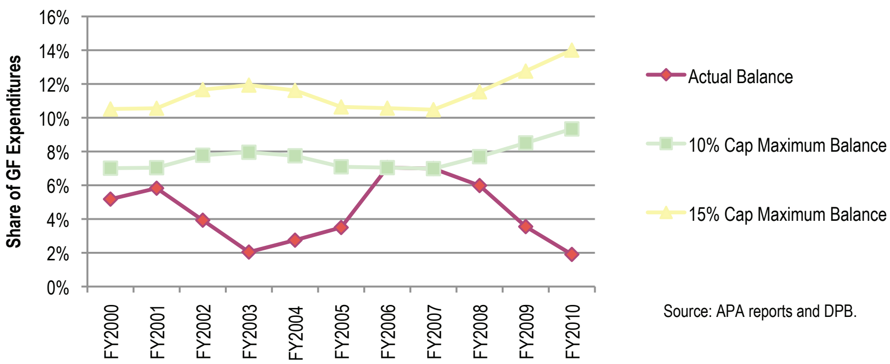
Virginia's new cap will allow the state to better prepare for future downturns. Yet, even with the increase, Virginia's reserves will not grow to the level recommended by experts. The Government Finance Officers' Association's (GFOA) recommendation for an adequate reserve fund is at least 15 percent of a state's annual expenditures. Given that Virginia defines the base of our cap differently, Virginia needs a larger percent cap in order to capture 15 percent of annual operating expenditures.

Figure 4 illustrates this point. Because Virginia excludes certain general fund revenue sources from its cap calculation, the new 15-percent cap doesn't translate into the recommended 15 percent of the budget. How close the state's new cap gets to that recommendation depends upon how strong sales and income tax revenues are in a given year. In years such as 2010, where more than one in every 10 general fund dollars was generated through sales or income tax revenues, Virginia's 15-percent cap comes much closer to the recommended 15 percent of the budget level.

Another meaningful way to look at the Rainy Day Fund's cap is to see it in terms of the number of days it would support the state's general fund operating expenses. In 2006, for example, when the fund was at its maximum balance, it represented enough resources to support about 25 days of state operating expenses. Had the fund been subject to a 15-percent cap, it would have represented enough resources to support 38.6 days of operating expenses. The GFOA recommends that a rainy day fund hold enough resources to support at least one to two months of regular general fund operating expenditures. Virginia's new cap will allow the state to build up enough resources to work toward this goal.

A Smaller Share of the Budget

Figure 4: Virginia Rainy Day Fund Balance as a Share of General Fund Expenditures, FY2000-2010



Source: APA reports and DPB.

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