How Much Should Your State Save?

Determining the optimal size of a rainy day fund

The problem

All state tax revenue is sensitive, to various degrees, to the business cycle. Recent evidence suggests that state tax collections have grown more volatile over the past decade. Shifts in personal income toward capital gains, greater reliance on revenue from extractive industries such as oil and natural gas, and a narrowing of the sales tax base because of online sales and untaxed services all contribute to this increasing volatility.

Research by The Pew Charitable Trusts has found that, during the growth years of the mid-2000s, rainy day funds in 21 states hit their maximum balances, preventing them from saving more for use during the Great Recession. State budget shortfalls outstripped savings nearly 2 to 1 entering that recession, leaving many with little flexibility in responding to budget crises.

On the other hand, a smaller number of states have amassed great savings, possibly at the expense of other budgetary priorities. But absent a clear purpose for saving, states find it extremely difficult to set a meaningful savings target—and their inability to do so can confound their efforts to manage budgetary ups and downs.

Factors to consider

Policymakers can take steps to strengthen their funds to better manage volatility and plan for the future. In order to arrive at an optimal savings target, Pew recommends that state policymakers consider three key questions:

1. **What is the purpose of the rainy day fund?** To make evidence-based determinations about how much to save, policymakers must first decide what they want to accomplish with the fund, and how and when its balances should be drawn upon. To that end, the fund should have an explicit purpose that is narrowly defined in law. Pew found that fewer than half of the states have this type of definition in state law.
2. **How volatile are the state's revenue collections?** States should study how their revenue systems react to the ups and downs of the business cycle so they can align their savings target with their historical experience with volatility. If the purpose of the fund includes spending considerations such as maintaining program funding commitments or overall state spending at a certain level, the analysis should incorporate those factors as well. Rigorous examination of historical data on revenue volatility is essential to developing an evidence-based savings target.
3. **How much budgetary risk does the state wish to offset through savings?** Some states use savings to cushion the impact of budget cuts in response to a recession, while others strive to put away enough to avoid cuts altogether. Still others may want to save more to address large mandatory spending commitments on entitlements or other financial pressures that may arise. Clear parameters can provide guidance to policymakers as they determine how much a state needs to save in order to achieve its goals.

For more information on the optimal size for state rainy day funds, please see Pew's report *Why States Save*.

For further information, please visit:
pewtrusts.org/why-states-save

Contact: Catherine An, communications officer
Email: can@pewtrusts.org
Project website: pewtrusts.org/why-states-save