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Reserve Fund Policies in the Southern States

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Introduction

Reserve funds, often referred to as rainy day funds or budget stabilization funds, act as savings accounts that states maintain to weather unexpected fiscal events. States use these budgetary cushions for various reasons: to cover budget shortfalls, to address cyclical downturns such as recessions and to help with unpredictable events like natural disasters that increase state expenditures (Tax Policy Center). Rainy day funds also help legislators avoid unpopular actions such as increasing tax rates or cutting expenditures when revenues are less than expected. Importantly, reserves are meant to cover one-time events or cyclical downturns, not to act as a backstop for structural imbalance issues where long-term expenditures exceed revenues (Institute on Taxation and Economic Policy 2005).

New York was the earliest adopter of a formalized rainy day fund in 1945. The majority of states followed suit in the wake of the 1980-82 recession, but fund balances did not begin to build appreciably until the 1990s. By the mid-1990s, 45 states had created rainy day funds (Knight and Levinson 1999). As of 2018, all states have a rainy day fund in some form.

This report reviews budget reserves between fiscal year (FY) 2015 and FY 2018 for the 16 states in the U.S. Census Bureau's southern region: Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia and West Virginia. The research stems from the Volcker Alliance's Truth and Integrity in Government Finance project, which evaluates state budgeting and financial management for best practices and the transparent use of funds. In this report, we investigate the following five questions.

- Does the state maintain positive reserve balances at the beginning of the fiscal year?
- Does the state have a sufficient fund cap?
- Does the state have detailed withdrawal policies?
- Does the state have strong deposit and replenishment policies?
- Are deposits to the reserve fund tied to revenue volatility?

These questions are linked to several best practices concerning state reserve fund policies (Government Finance Officers Association 2015; International Monetary Fund 2018; McNichol 2013; Pew Charitable Trusts 2015; Volcker Alliance 2017). First, rainy day funds should act as a financial cushion to relieve cyclical deficits. They should not be used to fund structural, or ongoing, deficit issues or to finance new policy initiatives that will require additional funding in the future. Second, a state should use a fund cap large enough to allow the state to save for economic downturns but not so large that funds are diverted from essential services. Third, policies should narrowly, and explicitly, tailor the purpose of reserve funds and place strict parameters around withdrawal practices and the replenishment of those funds. Finally, tying deposits and fund balances to volatility and historical trends helps states save in good times and deposit less in hard times.

In addition to these best practices, states must also strive to balance equity. Building a reserve fund, essentially, requires overtaxing the public in one year for use in another, meaning today's taxpayers may not benefit from the future use of their reserved tax dollars. As such, states must understand their economic needs well to build a prudent reserve fund without significantly overtaxing the public. The following sections explore the importance of reserve funds, best practices in reserve funding policies and the state of reserve funds in the South. We also highlight cases of southern states following best practices and those needing improvement.

Importance of Reserve Funds

Rainy day funds are important for two central reasons. First, the economic cycle ensures that states will experience economic downturns, and second, the timing and severity of downturns are often unpredictable. Moreover, when states experience revenue declines, state spending often increases to support social safety net services such as unemployment insurance and Medicaid (Institute on Taxation and Economic Policy 2005). The Great Recession highlighted the significance of rainy day funds as many states struggled with steeply declining revenues and insufficient reserves. Rainy day funds have since become a salient issue across the United States because many states' reserve levels may not be adequate during another severe recession (Pew Charitable Trusts 2014). This concern has prompted renewed discussion about best practices when structuring reserve funds, particularly deposit policies, fund caps, and rules and restrictions concerning withdrawals and repayment. Some states, discussed below, have recently adopted legislative changes to improve the health of their reserve funds by altering deposit policies and placing stricter boundaries on withdrawals, rules that are not common throughout the South.

State of Reserve Funding in the South

The structure and health of reserve funds in the South vary considerably, as they do across the country. This section looks at the variety of reserve fund policies, beginning with recent trends in reserve fund balances in the South as well as the fund caps that limit these balances. Then, we discuss the policies governing reserve fund withdrawals, deposits and replenishment. Finally, this section examines the prevalence of states linking reserve fund deposits to volatile revenue sources.

RESERVE FUND BALANCES

Over FY 2015 to FY 2018, the national average reserve fund balance, expressed as a percentage of general fund expenditures, rose from 6.3 to 6.7 percent. Texas and West Virginia maintained reserve balances above the national average in all four years and had the highest balances as a percentage of general fund expenditures in the South during that time. At the close of FY 2018, Texas held $10.5 billion in its reserves, 19.1 percent of its general fund expenditures. Although West Virginia's reserves have been one of the highest in the South, its reserves declined in dollar amount and by percentage of general fund expenditures from FY 2015 to FY 2018.

Georgia's reserve balance was higher than the national average from FY 2015 through FY 2017. The FY 2018 balance is not yet available, but the state's reserves are expected to grow and will likely surpass the 6.7 percent national average. During the Great Recession, Georgia had relatively healthy reserves, but unprecedented revenue declines necessitated drastic spending cuts as well as layoffs and furloughs for state employees (Salzer 2017). Georgia Governor Nathan Deal took office in 2011 and made building the state's Revenue Shortfall Reserve a policy priority after the state's financial struggles. The original goal of $2 billion in reserves by the end of Deal's term in January 2019 was met more than two years early.

Other states have improved reserve funding during the FY 2015-18 period, including Alabama, Arkansas, North Carolina and Tennessee. However, $162 million of the increase in Alabama's reserve fund in FY 2017 came from debt: a December 2016 bond issued to backfill reserves the state previously borrowed. Notably, Arkansas had no rainy day account until the formation of the Long-Term Reserve Fund in 2016, which held $123 million, or 2.3 percent of general fund expenditures, in FY 2018.

A few states in the South have seen decreases in their reserve balances since FY 2015: Louisiana, Mississippi and Virginia. Virginia made several withdrawals in recent expansionary years, prompting a rebuke in 2017 from Standard and Poor's (S&P) Global. The rating agency noted, "The planned use of the revenue stabilization fund is out of step with the current economic cycle and a reversal of its past practices of building reserves during periods of economic growth" (Martz 2017). Table 1 shows the reserve fund balances for the southern states on the last day of the fiscal year for FY 2015 through FY 2018.

Table 1. Reserve Fund Ending Balances and Percentage of General Fund (GF) Expenditures, FY 2015-18

STATE	FY 2015		FY 2016		FY 2017		FY 2018	
	BALANCE ($M)	% OF GF EXP.	BALANCE ($M)	% OF GF EXP.	BALANCE ($M)	% OF GF EXP.	BALANCE ($M)	% OF GF EXP.
Alabama	412	5.3%	530	6.8%	766	9.4%	788	9.4%
Arkansas	N/A	0.0%	123	2.3%	123	2.3%	128	2.3%
Delaware	213	5.5%	215	5.5%	221	5.4%	232	5.6%
Florida	1,139	4.1%	1,354	4.6%	1,384	4.6%	1,417	4.4%
Georgia	1,431	7.1%	2,033	9.3%	2,309	10.0%	N/A	N/A
Kentucky	77	0.8%	209	2.0%	151	1.3%	8	0.1%
Louisiana	470	5.4%	359	4.1%	287	3.1%	314	3.3%
Maryland	774	4.8%	832	5.0%	833	4.8%	859	5.0%
Mississippi	395	7.1%	395	7.0%	269	4.7%	277	4.9%
North Carolina	852	4.1%	1,102	5.1%	1,838	8.3%	1,838	8.0%
Oklahoma	385	6.0%	241	3.9%	93	1.6%	70	1.3%
South Carolina (GF)	320	4.7%	328	4.6%	348	4.6%	363	4.6%
South Carolina (Capital)	128	1.9%	131	1.8%	139	1.8%	146	1.8%
Tennessee	459	3.7%	568	4.4%	668	5.0%	800	5.5%
Texas	8,460	17.5%	9,679	18.1%	10,290	19.2%	10,457	19.1%
Virginia	468	2.6%	237	1.3%	549	2.7%	282	1.4%
West Virginia	869	20.5%	784	18.8%	652	15.4%	718	16.7%
National Average	902	6.3%	1,039	6.6%	1,094	6.8%	1,078	6.7%

Source: State budget documents; Volcker Alliance; National Association of State Budget Officers

Note: If balance exceeds a fund cap (see Table 2) at the end of the fiscal year, some reserve funds may revert back to the general fund.

FUND CAPS

Fund caps place limits on how large reserve funds can grow. Oklahoma, for example, limits its Constitutional Reserve Fund to 15 percent of the previous fiscal year’s net revenues. The benefit of a cap is that it prevents a state from overinvesting in the reserve fund. Because the use of reserve funds is usually restricted to certain circumstances, having too large a reserve can negatively affect current funding or policy priorities. In contrast, the primary drawback of a fund cap is that it restricts how much a state can save, potentially preventing the state from maintaining sufficient funds to help cover expenditures related to unexpected events. The difficulty lies in defining the ideal cap for a rainy day fund, which may not be the same for all states, as state economies differ and “rainy day” events by their nature are unpredictable in timing and magnitude. States must find an appropriate cap for their economic environment so they can maintain sufficient reserves without overtaxing their taxpayers. Table 2 illustrates the differences in reserve fund cap calculations for the 16 southern states.

Table 2. Reserve Fund Caps of the Southern States, FY 2018

STATE	CAP BALANCE
Alabama	10% of prior year general fund (GF) appropriations
Arkansas	$125 million
Delaware	5% of current year estimated GF revenue
Florida	10% of prior year GF revenue
Georgia	15% of prior year net revenue
Kentucky	5% of current year GF revenue
Louisiana	4% of prior year GF revenue
Maryland	7.5% of estimated current year GF revenue
Mississippi	7.5% of current year GF appropriations
North Carolina	Percentage of prior year GF appropriations, adjusted annually based on economic conditions
Oklahoma	15% of prior year GF revenue
South Carolina	General Reserve: 5% of prior year GF revenue; Capital Reserve: 2% of prior year GF revenue
Tennessee	8% of current year estimated state tax revenue for GF and education trust fund
Texas	10% of prior biennium general revenue
Virginia	15% of the average income and retail sales tax revenue for the three prior years
West Virginia	13% of prior year GF appropriations

Sources: State statutes; Volcker Alliance; Pew Charitable Trusts

All of the southern states have a reserve fund cap or target balance, with most states basing the cap on current or prior year revenue collections or appropriations. Moody's Analytics recommends that states hold at least 10 percent of their annual revenues in reserve to withstand another recession without substantial cuts to expenditures or raising taxes (White, Yaros and Merollo 2017). Only four southern states have caps greater than 10 percent: Georgia, Oklahoma, Virginia and West Virginia. Others have suggested an even higher cap closer to 15 percent (Government Finance Officers Association 2015; McNichol 2013). In fact, several states increased their fund caps in 2010 in response to the economic downturn of the Great Recession. The Georgia General Assembly increased its cap from 10 to 15 percent (Georgia Senate Research Office 2010). Voters in Virginia and Oklahoma approved measures to raise their caps from 10 to 15 percent, as well (Cassidy and Okos 2011; McNichol 2013). Half of the states in the South have caps set below 10 percent, and Arkansas's cap of $125 million falls well below 1 percent of its revenue collections.

Virginia is the only state in the group that incorporates historical trends in revenue collections into the calculation of its cap value. The state takes the average of income and retail sales tax — volatile revenue sources — from the past three completed fiscal years. North Carolina restructured its rainy day fund policies as of FY 2018 and is the only southern state to set a target balance every year instead of a static percentage of the budget. The state adjusts the target balance based on economic conditions, such as tax revenue volatility, so that the target balance covers two years of need for nine of 10 scenarios in which revenues decline (North Carolina General Statutes §143C-4-2). The most recent target balance proposed

for FY 2019 set the cap at 8.8 percent of general fund appropriations, below the recommended reserve balance of 10-15 percent (State of North Carolina 2018).

WITHDRAWAL POLICIES

Limiting reserve withdrawals to narrow and explicit purposes is viewed as a central aspect of good reserve fund policy (Pew Charitable Trusts 2015). This structure limits withdrawals to times of heightened financial need, such as a budget deficit or natural disaster. Without narrow and explicit purposes for reserve funds, state officials and lawmakers have latitude to decide when and how funds should be used. While state officials often use the funds for appropriate purposes, states are at risk of using the funds in non-emergency situations without limiting withdrawal policies. Instead of using the account as a safety net for the state, it may become another source of revenue from which lawmakers can draw to fund recurring expenses or new programs, leaving the state less prepared for a true emergency.

In the South, withdrawal policies vary, but 14 of 16 states can withdraw reserves to cover budget gaps. In Georgia, for instance, reserves are used to cover budget gaps, but funds greater than 4 percent of the previous year's net revenues can be released for appropriation by the governor (O.C.G.A. §45-12-93). Additionally, the legislature can withdraw 1 percent of the previous year's net revenues from the reserve as a midyear budget adjustment for K-12 education. Some states access reserves if actual revenue collections fall short of official estimates: Virginia requires revenue collections to fall 2 percent or more below the most recent official forecast (Volcker Alliance 2017). In Texas, the legislature can access reserves for budget imbalances, but doing so requires a supermajority vote from both houses. In contrast, Kentucky and Maryland do not have strong withdrawal policies in place. This lack of clarity allows reserves to be used for non-emergency purposes. Consequently, Maryland regularly builds some of its reserves into its budget, as discussed below.

DEPOSIT AND REPLENISHMENT POLICIES

Like withdrawal rules, state deposit policies vary throughout the South. The simplest deposit system places any unobligated general fund balances at the end of the fiscal year in the reserve fund. Some states use a variation of this practice, obligating a percentage of the general fund balance or percentages of other budget factors, such as total general fund appropriations, to the reserve. Finally, some states use more complicated deposit methods that calculate a deposit by incorporating the state's recent economic growth.

Replenishment policies are also a significant part of a fund's structure, though many states do not require withdrawn funds to be repaid. Viewing reserves as a debt to be repaid, however, helps ensure that policymakers only use the funds for emergency purposes. Because rigid or rapid repayment schedules may add unnecessary budgetary pressure in the uncertain economies following recessions or natural disasters, states should establish replenishment requirements that use a reasonable repayment period. Without measures to ensure withdrawn funds are replaced in a timely fashion, a state's reserves fund may not be able to cushion an emergency. Unfortunately, as McNichol (2013) noted, "Most states place a

low priority on replenishing their funds, depositing only whatever surpluses are left over at the end of the year." Table 3 details the variety of deposit and replenishment policies in practice in the southern states.

Table 3. Reserve Fund Deposit and Replenishment Policies of the Southern States, FY 2018

STATE	DEPOSIT POLICY	REPLENISHMENT POLICY
Alabama	10% of prior year appropriations	10 years to repay
Arkansas	50% of interest on state treasury balances	None
Delaware	Year-end surplus	None
Florida	5% or more of prior year revenues	5 equal transfers, starting 3 years after funds withdrawn
Georgia	Year-end surplus	None
Kentucky	Year-end surplus	None
Louisiana	25% of nonrecurring revenues; mineral revenues in excess of $850 million	None
Maryland	Year-end surplus	None
Mississippi	Year-end surplus	None
North Carolina	15% of growth in tax revenues	None
Oklahoma	Year-end surplus	None
South Carolina[1]	5% of prior year revenues without exceeding fund cap	5 years to repay
Tennessee	10% of revenue growth	None
Texas	50% of year-end surplus	None[2]
Virginia	Formula based on revenue growth	None
West Virginia	50% of year-end surplus, up to 13% of prior year appropriations	None[3]

Sources: State statutes; National Association of State Budget Officers; Pew Charitable Trusts, 2017.

[1] Applies to General Reserve fund only

[2] Applies to withdrawals authorized by general assembly; withdrawals by comptroller for cash flow purposes must be repaid by last day of the biennium

[3] Applies to withdrawals authorized by general assembly; withdrawals by executive order for cash flow purposes must be repaid within 90 days

Seven southern states transfer year-end surpluses to their reserve funds, and four additional states transfer a portion of the surplus. Alabama, Florida, South Carolina and Tennessee require a percentage of their budget as a reserve deposit. Virginia and North Carolina use more complicated deposit rules. In both states, recent growth in revenue sources is incorporated into the deposit calculation. This inclusion of revenue volatility in the reserve fund deposit is discussed in more detail in the next section.

Three states require repayment of withdrawn funds: Alabama, Florida and South Carolina. In Alabama, for example, the legislature must replenish the general fund rainy day account within 10 years; South Carolina must repay within five years. Florida, on the other hand, allows repayment to be put off until three fiscal years after the funds were withdrawn. At that point, the state must make five equal transfers annually to replenish the fund. However, the legislature has the authority to alter the repayment schedule, weakening Florida's replenishment requirement.

LINKING DEPOSITS TO REVENUE VOLATILITY

Revenue volatility refers to the variability over time in a revenue source, such as income tax, capital gains tax, sales tax or severance tax, which can contribute to fiscal instability (Ruben and Randall 2017). Linking reserve deposits to volatility and historical trends in revenue growth encourages states to save more during periods of healthy economic growth and allows them to deposit less when hit by financial hardships that lower revenues. The majority of states in the South do not incorporate revenue volatility into their reserve fund policies, and many have low fund caps that hinder the ability to save more reserves during good economic times. Texas and Louisiana tie oil severance taxes to their rainy day funds, and during the 2017 legislative session, Maryland adjusted its reserve fund policies to capture above-average nonwitholding taxes. Three southern states, however, link deposits more broadly to volatility in multiple revenue sources: Tennessee, North Carolina and Virginia.

In Tennessee, 10 percent of year-over-year growth is placed in the reserve fund every year. In years when no growth is expected, no deposit is required. The Pew Charitable Trusts (2014) noted, "[Tennessee] does not deviate from this practice, making savings a straightforward, predictable practice, rather than a yearly debate." In the 2017 legislative session, North Carolina instituted reserve policy changes similar to those in Tennessee. The new policies replaced the previous practice of saving one-quarter of any unreserved general fund balances with a deposit based on expected revenue growth. North Carolina now saves 15 percent of projected revenue growth at the beginning of the fiscal year.

Virginia's reserve funding structure is unique in the South. The state uses a formula to calculate a deposit based on growth over a historical average. The annual required deposit consists of one-half of the tax revenue growth in the income, sales and corporate income taxes in excess of the average of the prior six-year revenue growth. Unlike Tennessee and North Carolina, whose deposits are based on a single prior year's growth, Virginia uses a six-year average, which ensures that the state does not save too much or too little in an atypical year.

Best Practices in the South

Best practices in reserve funding allow states to save sufficient money in good times and restrict the use of the funds to specific events. While many southern states have positive aspects to their rainy day funds, notable examples of healthy reserve policies are seen in Virginia and North Carolina. Virginia's Revenue Stabilization Fund is one of the few in the South that ties deposits to revenue volatility and historical trends. The state's formulaic approach to annual deposits captures the volatility of Virginia's major revenue sources. Furthermore, the withdrawal rules are narrow and limited. The state can only access reserves if revenue collections fall 2 percent or more below projections, and the withdrawal may not surpass half of the available balance nor can the reserve cover more than half of the projected revenue shortfall. This policy requires the state to rely on other financial management options, such as cutting expenditures, and ensures that the reserve fund is never depleted for a single event. These aspects of Virginia's Revenue Stabilization Fund exemplify policy structures that help build a healthy rainy day fund.

As discussed earlier, S&P Global advised Virginia on its recurrent use of rainy day funds in recent, expansionary years. Although Virginia has followed its strict reserve practices, recurring differences between projected and actual revenues have allowed the state to access significant reserves over several years. Virginia's strong reserve policies cannot account for other budget issues such as errant revenue or expenditure forecasting.

North Carolina is another southern state using many best practices in its reserve fund policies. The realization that reserves inadequately covered shortfalls during economic downturns like the recession of 2001-02 and the Great Recession led lawmakers to alter the state's savings policies in 2017 (North Carolina General Assembly 2017). The state made three important changes. First, North Carolina altered deposits to incorporate revenue volatility by saving 15 percent of prior year general fund revenue growth. Second, it restricted the use of rainy day funds. Prior to 2017, the state could withdraw reserves for poorly defined purposes, meaning funds could be withdrawn even during economic growth, and the governor or legislature could potentially use reserves to fund policy priorities. The state's new policies create clear conditions for withdrawal, ensuring the reserve funds are accessed only during economic downturns. Finally, the state instituted a target balance fund cap, one of only three states in the country with such a cap (Zahradnik and Bailey 2017). The target balance is jointly determined by executive and legislative groups: the Office of State Budget and the Management and the Fiscal Research Division of the General Assembly. These groups set the target balance based on revenue volatility so that reserves cover two years of need for nine out of 10 negative economic scenarios. These changes bode well for the state's ability to weather future economic downturns.

Southern States with Room for Improvement

On the other end of the spectrum, the reserve policies of Arkansas, South Carolina and Maryland have room for improvement with respect to the policies discussed above: fund cap limits, deposit policies, withdrawal and replenishment rules, and the incorporation of revenue volatility. Arkansas does not adhere to a majority of the practices recognized for a strong rainy day fund. The state's Long-Term Reserve Fund does not limit reserves to explicit emergency uses and does not tie deposits to volatility. Without explicit limits placed on rainy day fund uses, the state can withdraw from the reserve for purposes other than covering shortfalls. Statutes also do not limit Arkansas officials from draining the entirety of the reserve fund's balance, and there are no policies for replenishing withdrawn funds. Additionally, a low fund cap of $125 million prevents the state from maintaining an adequate balance to cover shortfalls during financial crises. A study by the Mercatus Center at George Mason University recently ranked Arkansas among the bottom six states in preparedness to handle a future recession (Elder 2016).

South Carolina also has room to improve its rainy day fund policies. In the South, the state is noteworthy for its use of two interrelated rainy day funds, the General Reserve Fund and the Capital Reserve Fund. The General Reserve is a traditional rainy day fund that covers operating costs during economic downturns, while the Capital Reserve is used to fund capital projects. At the end of a fiscal year, any

remaining balance in the Capital Reserve is allotted to a prioritized list of capital or maintenance projects. State law dictates that the Capital Reserve balance be used before withdrawing from the General Reserve Fund during a shortfall, acting as additional support for the state's main reserve fund. However, this system may have the unintended consequence of pushing off capital maintenance costs. As Capital Reserve funds are withdrawn before General Reserve funds, South Carolina subsequently has less available money to fund capital projects.

Additionally, the state's General Reserve Fund and Capital Reserve Fund are capped at 5 percent and 3 percent of prior year general fund appropriations, respectively. Following the economic turmoil of the Great Recession, South Carolina, like many other states, looked for options to prepare for future financial hardships. The state subsequently raised the cap on its General Reserve Fund from 3 percent to 5 percent, but both fund caps remain well below the 10-to-15-percent suggested minimum and may not provide sufficient support should another significant recession hit the state (Government Finance Officers Association 2015).

Lastly, Maryland's Revenue Stabilization Account is an example of reserve policies that, while not severely deficient, have room for improvement, particularly in regard to withdrawal policies. Although Maryland has made recent changes to incorporate volatility into its reserve deposits, the state maintains lax rules underlying reserve withdrawals. For instance, if the estimated rainy day fund balance is below 7.5 percent of estimated general fund revenues, the government must appropriate the lesser of $50 million or an amount sufficient to reach 7.5 percent. However, the state is then allowed to withdraw funds from the reserve down to a 5 percent balance, building reserves into the state's budget upfront. In FY 2015, for example, the state allocated $50 million to the reserve fund but, after withdrawals, the fund gained only $14.8 million in new appropriations (Deschenaux 2015; Maryland General Assembly 2016). Not only does this policy of allowing the broad use of reserve funds leave the state with a low balance should a true "rainy day" occur, but the state may be using the reserves to fund recurring programs that add continuing expenditures to future budgets.

Conclusions

The rise of reserve funds has helped stabilize state finances during economic downturns. The structure of the reserve fund, however, can have dramatic effects on how well a state can support its budget during challenging fiscal times. Moreover, states have unique structures and economies, and policymakers must find a balance between saving money for a rainy day and overtaxing their citizens. While several states in the South have exemplary rainy day fund policies, all states have room to improve their rainy day fund structure to build reserves in good economic times and limit their uses to necessary circumstances. Even strong reserve fund practices are only a piece of the larger budgetary picture, as S&P Global's assessment of Virginia shows, and states should strive for sound fiscal practices that allow the reserve funds to function properly.

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