Bolstering Florida's Rainy Day Fund

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PAI 735: Public Finance

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May 2021

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Introduction

Most families have rainy day funds, and these funds are in a savings account waiting to be used when regular income is disrupted or decreased. These savings will allow the family to maintain a particular standard of living until their income stream normalizes. States have rainy days as well; these funds are insurance against the costs of natural disasters, economic downturns, and pandemics. Rainy day funds, also known as budget stabilization funds, are a standardized form of state savings. These funds consist of money deposited during good economic times and disbursed during economic downturns to smooth revenue and fill budget gaps. Rainy day funds give state leadership the flexibility to make timely and rational decisions during a crisis or an economic downturn. There is not a question of whether another downturn is coming; the only questions are when and how large will the next downturn be.

Moody's Analytics did a stress test of state budgets that measured the capacity of a state's ability to withstand a moderate or severe recession. They had some positive results that showed "at least 28 states are prepared for at least a moderate recession, with 12 more within striking distance. This means that the amount of fiscal drag from states and local governments should be considerably less during the next recession and ensuing recovery than the U.S. experienced during and after the Great Recession" (Moody's, 2019). However, only 16 states proved to be prepared for a severe recession.

There is concurrence that states would primarily benefit from having adequate funds ready for the next downturn. However, maintaining a sizeable rainy-day fund incurs opportunity costs and can put unwanted pressure on state policymakers. These reserves are invested in easily liquidated low-yield assets, and these reserves could instead be used for tax cuts or to fund more

public services (Zhao, 2014). States must make a choice between the opportunity cost of saving money and the cost of not being prepared for the next downturn.

50-State Overview

How large should a rainy-day fund be? Across the United States, "additional tax revenue enabled states to increase their rainy-day funds for the ninth straight year, reaching a record 50-state total of $74.9 billion in fiscal 2019. With these savings alone, states could run government operations for a median of 27.9 days, equal to 7.7 percent of spending—also a new high—compared with 17.3 days, or 4.7 percent of spending, just before the recession" (Rosewicz, 2020). Currently, Wyoming and Alaska have the largest rainy days funds because their economy is mainly vulnerable to one industry: oil and gas. Their economy and tax revenue are tied to the ebb and flows of oil prices, so it makes sense for them to have larger than average reserves because their revenue streams can be unpredictable year in and year out. On the opposite end of the spectrum, California has multiple revenue streams, with most of their tax revenue coming from an income tax. In 2020, during the global COVID-19 pandemic that caused a global economic downturn, California experienced a $75 billion surplus (Yamamura, 2021). California began to see higher than expected revenues in August due to "(1) strong PIT payments for income earned prior to the pandemic, (2) surprisingly stable PIT withholding during the pandemic, potentially due to relatively stable employment among high-wage earners, and (3) higher-than-expected sales tax collections" (Uhler, 2020). The savings decisions that California makes are very different from the decisions in states like Wyoming and Alaska.

Overview of Florida Economy

In light of the current coronavirus pandemic, we will examine Florida. Florida's rainy-day fund in 2019 was way below the 50-state median of 27.9 days of expenditures with only 16.8

days (Fiscal 50). Florida relies heavily on the sales tax, and this revenue source was hit hard by the pandemic (The Florida Legislature Office of Economic and Demographic Research 2021). Sales tax makes up 76 percent of Florida's general revenue, and 15 percent of sales tax revenue comes from the tourism sector (The Florida Legislature Office of Economic and Demographic Research 2021). Compared to other types of revenue, sales tax is typically less volatile (Murphy et al 2017). However, a large percentage of Florida sales tax revenue is related to tourism, which suffered greatly during the COVID-19 pandemic and is affected by standard recessions as well. Florida also relies more than the average state on the corporate income tax. Therefore, Florida's budget is still subject to revenue swings from the economy. Sales tax revenue was down 31 percent between March 2020 and December 2020; losses were deepest in May when revenues were down 63.7 percent (The Florida Legislature Office of Economic and Demographic Research 2021). According to the Pew Charitable Trusts' revenue volatility indicator, Florida's revenue volatility is about 1.5 times the 50-state average (Fiscal 50). The tourism sensitive economy and the sales tax dependency put limits on the state's response to the pandemic and forced state leadership to incur more risk by fully reopening the economy against CDC guidance. Gov DeSantis fully reopened Florida in September, but he did not reinstate any new restrictions when COVID-19 cases peaked in January (The New York Times, 2021).

Without changing the underlying structure of Florida's budget, we propose changes to their use of the budget stabilization fund to allow Florida to weather unexpected downturns more easily. We recommend that Florida institute a requirement to contribute a percentage of any revenue growth each year. Our policy proposal for Florida's rainy-day fund will consider the volatility of the revenue and expenditure streams during recessions.

Background on Rainy Day Funds

Because most states are required to balance their budgets, they are vulnerable to economic shocks that can throw projected revenue and spending out of balance. Therefore, having rainy-day funds is important. Florida is no exception – the state constitution contains a balanced-budget mandate (National Conference of State Legislatures 2010, pg. 3).

Academic evidence is clear that maintaining a healthy rainy-day fund is essential for fiscal health. Hou (2013) conducted empirical analysis on rainy day funds in all 50 states and found that states with rainy day funds do not cut spending as much during years of economic downturn as those without. They also use the reserves in planning for future years by avoiding spending cuts or tax hikes (pg. 166). This is important for two reasons. First, following the tax-smoothing model of optimal taxation, taxes have less distortion to the economy if they are predictable, and using budget stabilization funds to plug budget gaps helps states avoid tax hikes. Second, according to Keynesian economic theory, governments have a role to play in stabilizing the economy through counter-cyclical spending. Budget stabilization funds allow states to avoid making spending cuts during economic downturns, which would deepen and prolong the recession (Hou pg. 27).

According to the Tax Policy Center, states contribute to rainy-day funds in four main ways (Rueben & Randall 2017). First, states can transfer any surplus revenue from the fiscal year. Second, they can set a target amount of money for the fund and contribute either a dollar amount or percentage of revenues until that amount is reached. Third, they can automatically contribute a fixed percentage of revenue growth. Fourth, they can rely upon the discretion of the legislature to make contributions. States use any one or a combination of these contribution methods.

Florida's strategy is focused on the second: they are statutorily required to maintain the balance of their budget stabilization fund at 5-10 percent of revenue. Each year, a transfer is made from the General Fund to maintain that balance, and any expenditure from the budget stabilization fund triggers an automatic repayment over 5 years starting 3 years after the expenditure (Florida Code 215.32).

However, this emphasis on the size of the fund creates a disincentive to use the fund for what it was intended to do. Any money used from the fund in times of need comes with an automatic repayment schedule, and if policymakers are unsure whether economic conditions will improve in future years, this future repayment is daunting.

Recommendations

During 2020, Florida did not tap the rainy-day fund at all, despite experiencing a 31 percent decline in tax revenue. There is also no planned use of the fund during fiscal year 2021 or 2022. In fact, the 2022 budget proposes adding $100 million to the budget stabilization fund, despite an uncertain revenue outlook. Instead, Governor DeSantis proposes over $1 billion in cuts over two years (DeSantis 2021). While these cuts are partially offset by federal relief funds, it is clear that Florida is not choosing to use its budget stabilization fund in the way it was intended. Hou (2013) encourages states to use their reserve funds; "saving is not for saving's sake or for improving bond rating; savings are a means but not the end" (pg. 306).

Now is not the time for Florida to be concerned about the balance of their budget stabilization fund, as the COVID-19 pandemic is the very sort of "rainy day" these funds are designed for. However, once the effects of the pandemic have ended, there are actions that Florida should take in order to make sure their rainy-day fund is ready to withstand the next economic downturn. First, they should implement a contribution procedure that is based on

revenue growth rather than fund balance. Second, they should remove the automatic repayment trigger. Third, they should establish clear conditions for when to withdraw from the rainy-day fund that are tied to revenue volatility.

Revenue Growth Contribution Procedure

It is important that a budget stabilization fund be designed so that it can be an automatic, formalized tool. Hou (2013) conducted empirical analysis on budget stabilization funds in all 50 states. One of his findings is that funds that are focused on maintaining a "general balance" tend to have a lower balance than funds that have contribution procedures tied to a formula (pg. 64). In periods of sustained economic gains, such as the several years immediately preceding the COVID-19 pandemic, capping the amount of the fund at 10 percent may be unnecessarily limiting its size. Indeed, Hou (2013) also finds a significant relationship between the level of the cap and the amount of savings in reserves (pg. 64).

Florida should change the budget stabilization fund statute to instead describe the process and conditions for contributing to the fund. For example, Indiana automatically transfers a portion of its general revenue to its "counter-cyclical revenue and economic stabilization fund" if growth exceeds 2 percent (Indiana Code IC 4-10-18). Because this is laid out in statute, the amount is determined by the state auditor and its inclusion in the budget is not subject to political games.

Remove Automatic Repayment

The Florida statute includes a provision that requires any withdrawal from the budget stabilization fund to be repaid in five installments beginning three years after the disbursement. The intent of this provision seems to be fiscal responsibility. While the repayment schedule can be modified by the legislature, this is likely to be looked upon unfavorably by credit rating

agencies who value adherence to written policies (Pew 2020). However, if Florida implements the first recommendation to make contributions automatic and tied to economic conditions, this imposition of fiscal discipline is repetitive and unnecessary.

Economic Downturn Withdrawal Procedure

In Florida, the budget stabilization is required to have at least 5 percent of general revenue in reserves. Funds in the budget stabilization fund can be distributed in any year under authorization of the Governor (Hou pg. 329). However, the conditions for when it is appropriate to use the fund are not clearly outlined. The fiscally conservative environment in Florida creates political pressure to respond to economic downturns through “tightening the belt” (cutting spending) rather than using a budget reserve fund to maintain spending levels. This sets the stage for fiscal policy that could prolong periods of economic downturn. In a more liberal state, similar opaqueness about the budget stabilization fund could lead to its use in years when the economy is strong. For these reasons, The Pew Charitable Trusts recommends defining clear withdrawal conditions for state reserve funds (2020).

Florida should change its budget stabilization fund statute to outline clear procedures for its use that are formulaic and tied to economic fluctuations. Formula-based disbursements, as opposed to discretionary use, take the fiscal decisions out of the political realm. For example, in Arizona, any year with growth less than both two percent and the seven-year growth trend has an automatic percentage of the rainy day fund transferred to the general fund. The economic estimates commission, part of the Department of Revenue, performs the calculations (Arizona Code 135-44). This ensures that the rainy day fund can be used in times of downturn to avoid budget cuts or tax hikes without being subject to political risk.

The formula for withdrawal must be carefully calibrated so that the fund is able to be stretched over multiple years if needed. The balance between saving and spending will vary depending on the state and its economic structure. However, more research is needed in order to determine what formulas would create this balance for Florida (Hou pg. 309).

Conclusion

The state of Florida is subject to budget risk due to the structure of their tax system and large reliance on sales tax from tourism to fund the state budget. Therefore, it is important that Florida maintains a healthy budget stabilization fund that they are able to use during economic downturns to help balance the budget, maintain spending levels, and support recovery. While Florida should be commended for diligently contributing to their reserve fund over time, the structure of their budget stabilization fund has too much focus on the size of the fund at the expense of responsiveness. To improve Florida's budget stabilization fund, the state should modify the statute in three ways: base contributions on economic conditions rather than fund balance, remove the automatic repayment clause, and automate withdrawals based on economic fluctuations.

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The Pew Charitable Trusts is a non-profit, nonpartisan organization that seeks to solve today's challenges using research and data. Their State Fiscal Health team performs research and advises states on fiscal policies, including rainy day funds. They publish a significant amount of resources on rainy day funds, and we reference a number of reports in this bibliography that provided an overview and recommendations for best practices.

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