Excerpt from Final Report, Chapter 8:

Create a constitutionally mandated rainy day fund

Description: One of the most effective ways of dealing with cyclical crises in state revenue could be a constitutionally mandated "rainy day fund." Although the Committee was charged with evaluating Washington's tax structure and recommending potential alternatives, a rainy day fund can help reduce the need for large cuts in state government spending during economic down times and reduce the need for tax increases when revenues decrease. Just as with a family budget, savings during high revenue periods can help offset problems when income decreases precipitously.

Rainy day funds are common nationwide. The vast majority of states, including Washington, have some form of fund for stabilizing the ups and downs in the health of the state's economy. Washington State has enacted statutes establishing various kinds of rainy day funds, including the mechanism in Initiative 601 that is meant to both dampen the growth of spending and provide some reserves.

Statutory rainy day funds have a major weakness: when times are good and revenue is strong, it is difficult for legislators to forego new spending initiatives. There is constant pressure on lawmakers to increase funding for worthy programs and to initiate new services to the public.

Similarly, when the economy takes a downturn, legislators find it difficult to maintain reserves until they are truly needed. Often, when state revenue becomes dangerously low, reserves have already been spent and taxes have not been increased sufficiently to provide the needed revenue. Then, legislators are forced to slash popular programs.

The potential approach outlined here is simple: a constitutional amendment would be adopted that would mandate a rainy day fund. Because the fund would be entrenched in the Constitution, in good times lawmakers would be required to annually add to the fund in an amount determined by a measure of the state's economy or the state government's income. These measures, or "triggers," could be the recent growth or decline of personal income, or forecast growth or decline in personal income, or the recent or forecast performance of state general revenues. These triggers operate somewhat differently, but the key is having a measure that is determined independently of the Legislature and is therefore free from political pressure. Any trigger that uses forecasting would depend upon estimates made by a state forecast council whose independence would be protected by the requirement that its members be confirmed by a 60 percent vote of the State Senate.

During bad times, money would automatically be discharged from the rainy day fund into the general fund. The provision would also allow the Legislature to voluntarily add to the fund any time it chose and withdraw any amount from the fund at any time upon the affirmative vote of 60 percent of each house.

In the sample constitutional amendment in Appendix D, the term "good times" is defined as when the estimated growth of general state revenues for a fiscal year (adjusted for inflation) is more than a specified percentage, such as 1 percent or 3 percent. “Bad times” in the sample is defined as a year in which the estimated growth of general state revenues is less than zero.

Recognizing long-term changes in economic conditions and growth rates, the Legislature should be permitted, by a 60 percent vote of each house, to adjust the “trigger” points for depositing money into the rainy day fund, within fairly tight ranges.

If the balance in the fund reaches more than a specified level (e.g., 5 percent or 10 percent of estimated general state revenues in a fiscal year), a majority vote of the Legislature should be permitted to appropriate the surplus in the following fiscal year’s budget.

A constitutional amendment should provide for a delay of implementation to allow the state to ramp up compliance with the mandatory savings provision.

One possible drawback of a constitutional rainy day fund is that it could force the deposit of surplus revenues when it is apparent that “good times” have already begun to turn. Furthermore, a constitutionally entrenched provision may not keep up with fundamental changes in the economy. In addition, the bond market and rating agencies may view a forced savings plan negatively because it could withdraw available funds when truly needed—this could increase the state’s borrowing costs.

Some observers are concerned that a rainy day fund would be misunderstood by the public to be a budget surplus. This misunderstanding could lead to pressure on the Legislature or initiatives to reduce taxes and force a premature draw on the rainy day fund when state economic performance has not warranted a withdrawal. One way to prevent such a draw would be to use triggers based purely on economic performance (such as state personal income) rather than triggers based on general state revenues, which can be manipulated by the Legislature or by the public through the initiative process.

A draft of a possible constitutional amendment is set forth in Appendix D, together with additional materials on rainy day funds nationally. Also provided is a demonstration of how such a fund would have performed in Washington State if it had been in effect since 1989.

Problems Addressed:

Volatility – The rainy day fund would set aside revenues in the years that revenue growth exceeds income growth to use in years when revenues decrease more than personal income. This alternative addresses volatility of the current tax system and also the volatility in any replacement tax system that may be enacted.

Adequacy – Creation of a rainy day fund would help prevent permanent decreases in the tax base due to legislation or initiatives in good economic years.

Problems Created: None

A majority of the Committee recommends that a constitutionally mandated rainy day fund be created with objective criteria for deposits, maximum required balance, and withdrawals.