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Texas's Rainy Day Fund: How to Use It Responsibly

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Key Points

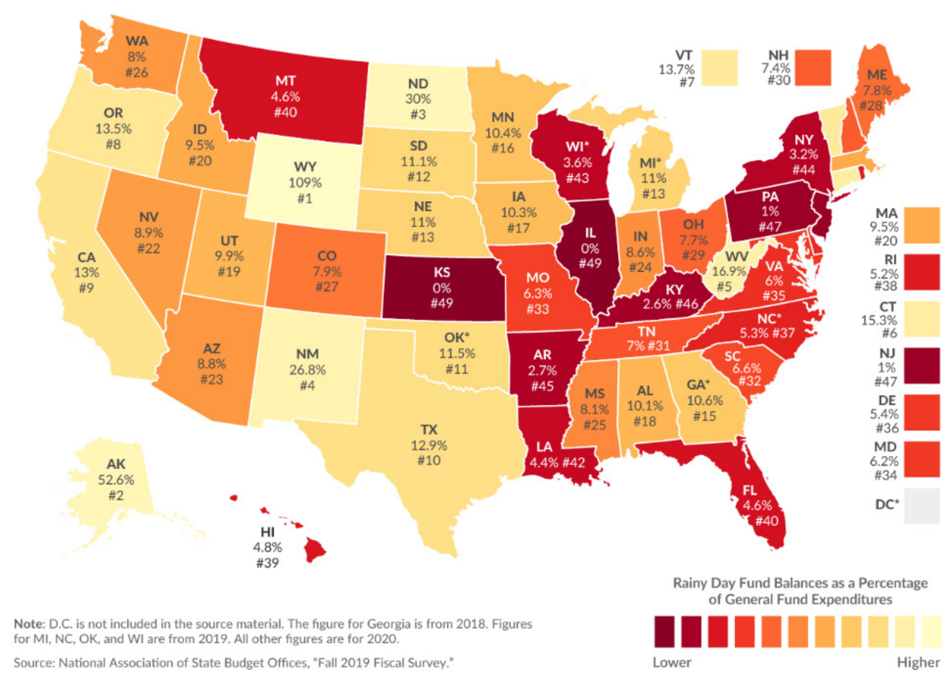
- Texas ranks high in economic growth and must maintain a balanced budget, but the current economic situation could strain Texas taxpayers' ability to pay for the state budget.
- Texas must exercise fiscal restraint and find responsible budget reductions before it taps into the state's rainy day fund.
- Texas state leaders have appropriately begun the process of finding savings in the budget, but additional savings are likely needed and should be realized before using taxpayer money in the rainy day fund.

Background

Economic business cycles can substantially influence the predictability and reliability of taxpayer dollars to fund state budgets. As a result of this volatility, many states, like Texas, have chosen to prepare for the inevitable economic downturns and resulting revenue shortfalls by establishing revenue stabilization funds—more commonly referred to as "rainy day funds." The official names of these funds vary by state, as do their structure and funding, but states tend to rely on rainy day funds as a necessary budgeting tool. Texas's is called the Economic Stabilization Fund (ESF; Texas Comptroller, 2020a).

At the end of 2019, Texas's economy was humming along with the most jobs created (342,800 jobs) and one of the highest annual job growth rates (2.7%) in the nation (Bureau of Labor Statistics, 2020). This job creation supported increased economic activity in Texas, which contributed to more sales tax receipts to the state's treasury. Given severance taxes on production of oil and natural gas in Texas are the primary source of the state's rainy day fund balance, the increased oil and gas production contributed to there being $10 billion in the fund at the end of fiscal year 2020 (Federal Reserve Bank of Dallas, 2019; Texas Comptroller, n.d.; Texas Comptroller, 2020b). The fund's amount ranked second highest in the

Figure 1
Texas Ranks in the Top 10 in Being Prepared for a Rainy Day



Note. Image taken from State Rainy Day Funds and the COVID-19 Crisis by J. Walczak and J. Cammenga, 2020 (https://taxfoundation.org/state-rainy-day-funds-covid-19/).

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nation (NASBO, 2020) and in the top 10 of largest funds as a share of general fund expenditures (see **Figure 1**; Walczak & Cammenga, 2020).

Like Texas, most of the states with the highest rainy day fund balance as a percentage of general fund expenditures (e.g., Wyoming, Alaska, North Dakota) have had a strong stream of severance taxes collected from increased oil and gas production over time. Due to the volatility of these taxes and the historical volatility of economies that depend on oil and gas activity, many of these states have elected to save some of the severance taxes in years when prices and production are high (Elder, 2016). Texas has become less dependent on this industry's activity both economically and fiscally, but it is not immune (Ginn & Roach, 2015). Savings in the rainy day fund help cover unforeseen shortfalls in total state tax receipts such as from economic downturns, natural disasters, and potentially unprecedented situations like the COVID-19 pandemic and forced shutdowns by state and local governments.

In 2020, Texas experienced a severe COVID-19-induced recession with an annualized 29% decline in gross state product in the second quarter and an unemployment rate that reached a high of 13.5% in April—both measures are the worst on record (BEA, 2020a; BLS, n.d.). This unprecedented economic disruption sent the U.S. economy into a recession in March without a dated end yet (NBER, n.d.), though there was a record 37.6% increase in the U.S. private sector's economic output in the third quarter (BEA, 2020b). With slower growth in Texas and across the country and fewer people employed, the state's tax receipts declined which resulted in Texas Comptroller Glenn Hegar (2020) projecting a budget deficit of $4.6 billion at the end of the current 2020-21 budget. To deal with this potential budget deficit from an unexpected shortfall in tax receipts, the Legislature should first prioritize budget cuts along with passing a budget that is no more than the Conservative Texas Budget (Ginn et al., 2020a). Only then the Legislature should look at responsible ways to use the taxpayer dollars in the rainy day fund, as necessary, without raising taxes or fees.

Details of Texas's Rainy Day Fund

Texas voters approved the creation of the rainy day fund with the passage of a constitutional amendment in 1988 after a period of uncertain state revenue when oil and gas comprised a large share of economic output and were highly volatile in the 1970s and 1980s. The ballot language that Texans approved was, "The constitutional amendment establishing an economic stabilization fund in the state treasury to be used to offset unforeseen shortfalls in revenue" (HJR 2, 1987). Article 3 Section 49-g of the Texas Constitution requires a three-fifths vote in each chamber to use the rainy day fund to cover an unexpected revenue shortfall and a two-thirds vote in each chamber to use it for other reasons. Texas's rainy day fund is primarily funded by severance taxes collected as a portion of oil and gas production. Since the state's production of oil and gas has historically fluctuated based on market activity and geopolitical factors, the purpose and use of dollars withdrawn from the fund must be worthy.

Since its inception, deposits to the fund have totaled $21.8 billion (LBB, 2019). While the ballot language in HJR 2 clearly noted that these taxpayer dollars were to be used for unexpected declines in tax receipts, they have been used for many other purposes. In total, only 27.4%, or $3.2 billion, of the $11.6 billion spent from the fund over time have been used for the initially intended purpose. For example, the Legislature in 2019 appropriated $4.9 billion from the fund to assist with expenditures, such as for Hurricane Harvey-related relief and $1.2 billion for the 2020-21 biennium (LBB, 2020).

As noted above, there may be a need to use some of the money in the rainy day fund to deal with a decline in tax receipts due to the COVID-19-induced recession and substantially lower-than-expected severance taxes deposited into the fund as oil and gas production fell after a decline in their demand and then their prices. Given the rainy day fund's constitutional limit of 10% of the state's general revenue (GR)-related funds, excluding interest and investment income in the previous budget cycle, the maximum that can be in the rainy day fund during the 2020-21 biennium is $18.6 billion (LBB, 2019). This means that given past withdrawals from the fund for reasons not consistent with shortfalls in tax receipts and even with increased deposits over time, the Legislature will likely have $8.8 billion available at the end of fiscal year 2021 to deal with any shortfalls (Hegar, 2020).

The Future of the Rainy Day Fund

Since Texas operates on a biennial budget, the constitutional maximum of 10% of certain biennial GR-related funds is actually a 20% cap for each year of the budget cycle. Each dollar in the fund to go toward covering shortfalls in tax receipts means that there are fewer dollars in the pockets of families and employers in the private sector. Therefore, every dollar spent from the fund should have a clear purpose that does not waste taxpayer dollars that could otherwise be supporting productive activity in the private sector, which can help people to be more prosperous. Moreover, the state's economy—and therefore tax receipts—is much less reliant on oil and gas activity than previously (Ginn et al., 2018). Research suggests that Texas could have a biennial cap closer to 7%, or annually 14%, to cover the most severe fiscal downturns (Elder, 2016), which should primarily be solved with spending restraint. Alternatively, if this money is spent each session, the rainy day fund will quickly dwindle, leaving less available for future shortfalls. Additionally, the state's credit rating could also be at risk if the balance falls below a specified amount relied on to obtain a favorable AAA credit rating which varies depending on the credit rating agency. A credit rating of AAA is the most favorable issued by the major credit rating agencies such as Standard & Poor's (S&P), Fitch, and Moody's. It is meant to measure the ability of the state to pay its debts and the general health of its economy. A favorable rating lowers the interest cost of bonds and the impact on taxpayers (Ginn et al., 2016; Texas Comptroller, 2020a).

There will likely be calls to tap the rainy day fund in 2021 given the projected decline in tax receipts due to COVID-19 and resulting lockdowns and more demands put on the budget. The Texas Comptroller's latest forecast is that Texas could face a $4.6 billion budget deficit in the current 2020-21 budget period, but he also noted that this is highly speculative given the amount of uncertainty in the economy (Hegar, 2020). Fortunately, Texas state leaders have appropriately begun the process of finding savings in the budget by directing some state agencies to identify 5% reductions in their 2020-2021 budget, which could amount to about $1 billion (Office of the Texas Governor, 2020). But prioritizing additional budget savings are likely needed and should be realized before using taxpayer money from the fund (Ginn et al., 2020a). Moreover, at the very least, it will be important to keep appropriations of all funds in the budget below or no greater than the rate of population growth plus inflation, found in the Foundation's Conservative Texas Budget (see **Figure 2**; Ginn et al., 2020b).

Figure 2

2022-23 Conservative Texas Budget Criteria

Moreover, allocation of taxpayer money in the rainy day fund should be done sparingly to sustain the state's AAA credit rating and not put taxpayer dollars at risk. Specifically, using one-time money in the fund to pay for ongoing expenditures only delays needed difficult decisions that should be made with general revenue funds and depletes one-time funds available for revenue shortfalls, future emergencies, or tax relief. Additionally, allocating these funds to riskier savings options that could support higher rates of return to pay for unfunded liabilities is not warranted. As the Legislature should first consider major pension reforms and reducing the debt (Ginn, 2020).

Recommendations

Given voters approved the rainy day fund to cover shortfalls in tax receipts, we provide recommendations to improve the fund's future usage only after budget cuts have been prioritized to keep the state's credit rating high and to avoid raising taxes or fees (Ginn et al., 2020a; Ginn et al., 2016):

- Increase the threshold to use the rainy day fund money "at any time and for any purpose" from the current two thirds of members present in each chamber to four fifths of all members in each chamber.
- Lower the constitutional maximum limit from 10% to 7% of biennial GR-related funds in the previous biennium, which would make it a cap of 14% annually.
- Use excess state revenue above the fund's cap or from budget reductions to cut taxes instead of increasing spending.

Conclusion

Texas ranks high in economic growth and must maintain a balanced budget, but the current economic situation due to the COVID-19-induced recession is straining Texas taxpayers' ability to pay for the state budget. The Texas Legislature must exercise fiscal restraint and find responsible budget reductions before it taps into the state's rainy day fund. Texas state leaders have appropriately begun the process of finding savings in the budget by directing some state agencies to identify 5% reductions in their 2020-2021 budget. But additional savings are likely needed and should be realized before using money from the fund. The state's fund is a valuable tool for covering unexpected revenue shortfalls, like those during the COVID-19 pandemic, but it should be used sparingly. Instead, budget reductions should be prioritized along with the passage of a 2022-23 budget that increases by no more than the Conservative Texas Budget to support prosperity in Texas. ☆

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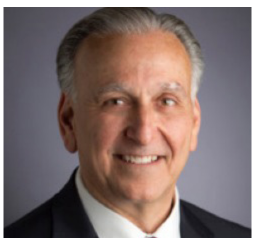

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The Honorable Talmadge Heflin is a distinguished senior fellow for the Conservative Texas Budget at Texas Public Policy Foundation. Prior to joining the Foundation, Heflin served the people of Harris County as a state representative for 11 terms. Well regarded as a legislative leader on budget and tax issues by Democratic and Republican speakers alike, he for several terms was the only House member to serve on both the Ways and Means and Appropriations committees.

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