

## Commentary: State badly needs a rainy day fund

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By George W. Evans

Oregon's budget crisis is the direct result of the lack of a rainy day fund and indirectly due to past tax kickers. The principle of the rainy day fund is simple: income tax revenue automatically rises in boom times and falls in recessions, so common sense and a sound economic policy dictate that part of the revenue during periods of strong growth be set aside in a special fund to finance expenditures in recessions.

This is common sense, because it is a principle that would be followed by a prudent household facing systematic fluctuations in income. It is sound economics because it helps to smooth government expenditures and stabilize the state economy. Economists agree that government budgets should also be balanced over the business cycle, running surpluses in booms and using them to finance deficits in recessions. Such a policy acts as an automatic stabilizer, restraining the economy during booms and stimulating the economy during recessions.

The way to implement this policy at the state level is through a rainy day fund. The advantage of such a fund is painfully obvious now that we have entered a recession, but it should have been anticipated by setting up a rainy day fund in Oregon in the early 1990s.

What political forces prevented setting up a rainy day fund that would have avoided the current budget crisis? The principal obstacle has been the "tax kicker," which returns to households the "excess" tax revenues that are generated during booms.

I understand the argument made in favor of the kicker, that it prevents state spending from increasing if politicians are tempted to spend the excess tax revenues. But this argument fails to apply if the excess tax funds are instead set aside in a rainy day fund that can *only* be tapped during recessions. In contrast, the kicker operates with a perverse and devastating cyclical timing. Because the kicker deprives us of the rainy day fund, it in practice leads to downward pressure on state government spending during recessions, and therefore acts to intensify the recession.

Consider the kicker checks that were sent out in the previous three biennia, in late 1995, 1997 and 1999. Those tax refunds added unneeded fuel to the late 1990s boom by increasing household incomes and consumer spending. If a rainy day fund had been established by the mid 1990s, as advocated by many at the time, this tax revenue could instead have gone into a fund that would now be available to sustain state and local spending. According to the Legislative Revenue Office, personal tax refunds for the 1993-5, 1995-7 and 1997-9 biennia totaled \$762 million and corporate kicker tax credits totaled \$370 million. (I do *not* include the most recent personal tax kicker, paid this year, because tax refunds in a recession are one legitimate use of a rainy day fund).

The total of \$1.132 billion (plus interest) would have been enough to cover the projected \$710 million budget shortfall for the 2001-3 biennium. The current State budget crisis would have been much less acute, and possibly *entirely* avoided, if a rainy day fund had been in place, and tapping the rainy day fund would have also helped reduce the extent of the recession in Oregon.

The current regime of balancing the budget year by year is bad economics. At the national level this “Hoover economics” approach to fiscal policy is widely understood to be discredited. The same principle applies at the state level. Current budgetary choices remain critical, but we are operating under artificial constraints. Not having a rainy day fund in place is subjecting us to unnecessary economic distress. Surely we can at least now agree to change our flawed budget policy design so that we are never again compelled to face a recession so unprepared.

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