

STATE POLICY BRIEF

Rainy Day Funds as a Strategy to Manage Budget Shortfalls

How Advocates Can Help Ensure States Use All Available Tools to Avoid Significant Cuts to Programs Supporting Children and Families

Introduction

After several years of strong growth, state budget conditions are beginning to weaken due to a combination of factors. In addition, recent federal policy changes are projected to raise administrative costs for states, increase states' share of program expenses, and ultimately limit state revenue sources and subsequent levels in the years ahead, putting early childhood programs and services at risk for funding cuts.

With many states maintaining strong reserve balances, this resource explores how advocates can help ensure state policymakers use the tools available, including rainy day funds, to manage budget pressures and avoid significant cuts or scaling back of programs that support children and families in the short term, giving them space to explore longer-term solutions, like identifying and dedicating new revenue sources. It specifically explores:

- How federal policy changes in HR-1 are adding to strains on state budgets

- The purpose and current status of rainy day funds

HR-1 Brings Additional Stress to Already Strained State Budgets

States are facing increasing [budget pressures](#) caused by slowing revenue growth compared to prior years, stagnant employment numbers, the end of one-time pandemic relief funds, rising costs associated with [disaster](#) mitigation and relief, and recently imposed federal [tariffs](#) (which continue to be [challenged](#) in legal battles). To add to the already rocky fiscal landscape in states, federal legislation passed in 2025 under HR-1, also known as the One Big Beautiful Bill Act, shifts significant cost onto states for the Supplemental Nutrition Assistance Program (SNAP) and Medicaid, along with tax code changes. All states will face these changes stemming from HR-1, and as a result, this federal legislation has implications on all state budgets not just this year, but in the coming years as various pieces of this law are [implemented](#).

[Fiscal conditions](#) vary across states, but these converging pressures are already contributing to projected budget shortfalls in some states in 2026, where expenditures are expected to [outpace](#) revenues (and unlike the federal government, every state except Vermont is required to [balance](#) their budgets every budget cycle). At the same time, many states have spent decades building up reserve funds (also known as rainy day funds), leaving them better positioned to respond to emerging fiscal challenges.

Rainy Day Funds as a Budget Management Tool

State rainy day funds are designed to help respond to unexpected emergencies and economic downturns while minimizing the need for significant program cuts or tax increases. Also known as budget stabilization or reserve funds in some states, these accounts act like an emergency savings account and are designed to provide a financial cushion during periods of fiscal stress. As of 2026, [every state](#) has at least one rainy day fund, though the rules governing them, including how funds are deposited and when they can be withdrawn, vary widely. Some states even maintain multiple reserve funds for different purposes. Most states cap the size of their reserves typically between [5 and 15 percent](#) of general fund spending and take different approaches when balances exceed those limits. Excess funds may be retained in the general fund, allocated to

specific priorities, used for one-time expenditures, or returned to taxpayers through tax relief.

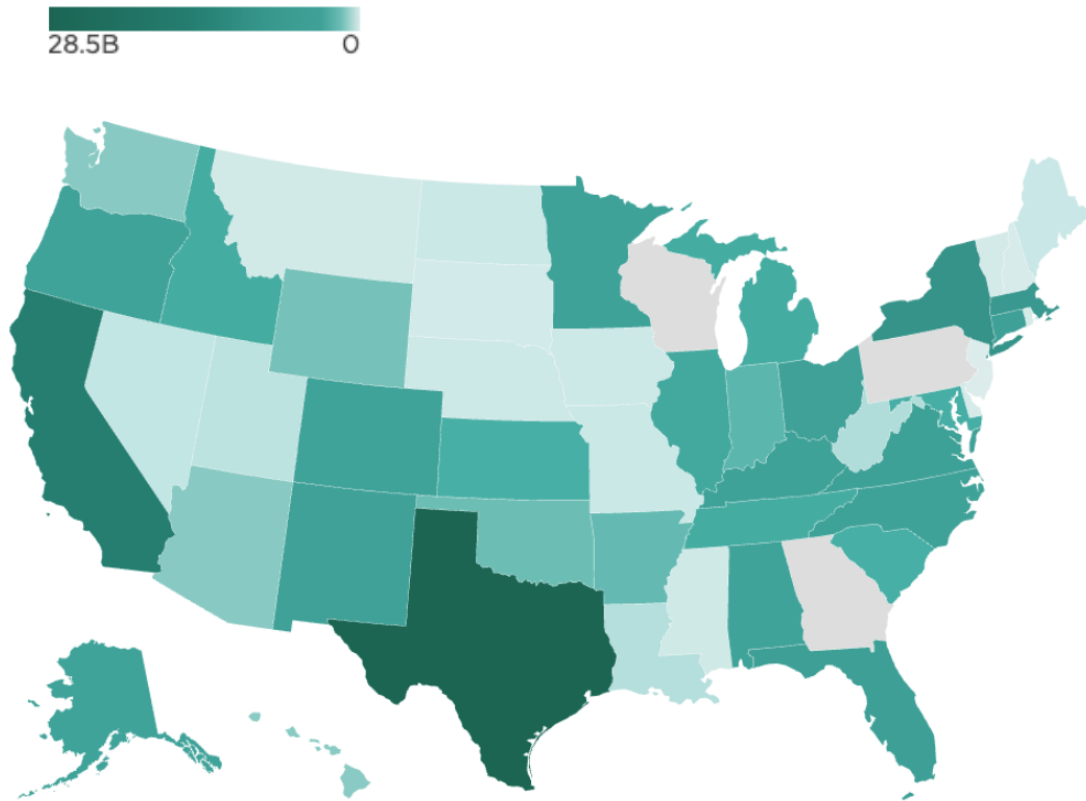
Some rainy day funds have strict restrictions that make it difficult for states to take advantage of this important tool. In many states, accessing these funds requires [legislative approval](#), sometimes by a simple majority and in other cases by a supermajority. Other rainy day funds depend on specific conditions such as a declared budget emergency by the governor in order for state policymakers to access.

Status of Rainy Day Fund Balances Across States

States have been building their rainy day fund balances since the early 2000s and in FY 2025, reserve fund balances hit record high levels of [\\$174 billion](#) across all states, which was more than double the amount in FY 2019. Most states still have healthy rainy day fund balances, but the strength of rainy day funds among states varies widely. A few states have seen the strength of their rainy day funds decline as they respond to various budget pressures, and a recent [analysis](#) of rainy day fund balances found that the number of days that reserve balances could cover state operations fell in FY 2025, the first decline since 2009, with [New Jersey](#) reporting they did not even have one days' worth of spending available after draining its reserve for the second time since the pandemic. The [National Association of State Budget Officers](#) (NASBO) found that six states reported projected rainy day fund decreases in their enacted FY 2026 budgets, and of those who reported decreases in the last two years, this was mostly due to drawdowns to manage their budget. Some other states withdrew funds to comply with legal maximum limits.

States do not frequently tap into their reserves, but they have used them during prior periods of budget uncertainty. Past NASBO reports found that many states relied on these reserves during and after the Great Recession to manage severe budget shortfalls, including about half of states in [2009](#) and [13 states](#) the following year, when fiscal conditions were among the most difficult on record. More recently, some states have continued to use reserve funds as a budget management tool in reaction to budget deficits, including [California](#), [Colorado](#), and [Oklahoma](#) in 2025. During the 2026 legislative cycle, governors in [Alaska](#), [Maryland](#), [Michigan](#) and [Pennsylvania](#) have proposed tapping reserves to help address projected fiscal 2027 shortfalls.

Rainy Day Fund Balances as of Fiscal Year 2026



State Rainy Day Fund Balances as of fiscal year 2026, as reported by the National Association of State Budget Officers (NASBO). Data are unavailable in Wisconsin, Georgia, and Pennsylvania.

Why States Should Use Rainy Day Funds Now

As federal changes and budget pressures place increase strain on state budgets, deficits are emerging and policymakers need short- and long-term strategies to manage their impact or risk having to cut funding for critical programs and services. In some states, we are already seeing [these cuts](#) impact early childhood educators and the children and families they serve. In 2025, [federal](#) funding formula changes resulted in Tennessee eliminating some enhanced reimbursement rates, reinstating copayments for some families, and [terminating](#) Tennessee’s Early Childhood Training Alliance (TECTA) program, which provided tuition assistance and training for early childhood

educators for the last 33 years. More recently, [Missouri's](#) proposed FY 2027 [budget](#) includes \$51.5 million in cuts to the state's child care subsidy program that would eliminate all rate enhancements, including rates for providers who are accredited, serve high-needs populations (such as children in foster care or with disabilities), or offer non-traditional hour care.

Withdrawing from rainy day funds is an immediate, short-term strategy states can take to prevent these harmful cuts and total program elimination. With many states still maintaining strong reserve balances, policymakers should consider using rainy day funds as a first line of defense to prevent significant funding cuts or scaling back programs and to sustain key programs, such as those that support access to child care for families and the early childhood workforce.

Reserve funds should be used strategically, as they are one-time resources and often come with restrictions on how and when they can be accessed, and withdrawals can impact a state's [bond rating](#) if a state ultimately does not manage its long-term finances well. A Brookings Institute [analysis](#), however, found that saving during growth periods and drawing on reserves during downturns is actually a credit positive, with no overall negative impact when funds are used as intended. While policymakers should be cautious about withdrawals, rainy day funds are intended for use during budget crises, with the expectation that they will be replenished as conditions improve.

The current stormy and uncertain [fiscal outlook](#) is exactly the kind of moment these funds are meant for. Many states still have healthy rainy day fund balances and should consider how to use available reserves to avoid deepening economic strain. Cutting funding for child care and early childhood education would only worsen existing challenges around access and affordability, and risk leading to further revenue constraints - an outcome states cannot afford. Rainy day funds are a temporary band-aid to reduce budget shortfalls, but they are not long-term solutions. Reserves cannot permanently replace federal investments and dedicated state support.

Creating Reserve Funds Specifically for Early Childhood Education

In addition to general-purpose rainy day funds, some states have established reserve funds dedicated to specific priorities, such as for K–12 education or Medicaid, allowing

them to target resources toward critical needs even during periods of fiscal uncertainty. These funds can play an important role in protecting key investments, including early childhood education, when broader budget pressures arise.

In the past year, a few states have taken the lead in directing surplus funds to strengthen and sustain early childhood systems. In 2025, Montana enacted legislation creating the [Montana Growth and Opportunity \(GO\) Trust](#), a permanent fund designed to manage and allocate volatile state revenues. Within this structure, the [Montana Early Childhood Account](#) was established to direct funds annually toward child care initiatives, including technical assistance grants, workforce recruitment and retention, provider training and education, and quality improvement efforts. This fund received a one-time [\\$10 million](#) public investment in 2025 and will receive a portion of the interest earned on the GO Trust going forward, allowing it to grow over time. Private donations, grants, or gifts may also be made toward the Montana Early Childhood Account.

That same year, Connecticut established an [Early Childhood Endowment](#) to dedicate general fund surpluses to long-term investments in the early care and education system. Funds from the endowment are intended to support higher wages for early educators, provide health care subsidies, expand access to preschool and infant/toddler care, eliminate copayments for lower-income families, and cap child care costs for others. While the state was able to make a \$300 million contribution in 2025 to launch the fund, an updated revenue outlook is showing the state is facing a [budget deficit](#) and the governor's office is projecting the contribution for 2026 will be much smaller than last year's amount, potentially at \$30 million, which highlights some limitations of relying on volatile funding sources.

In 2026, [Indiana](#) enacted legislation to expand allowable uses of its Financial Responsibility and Opportunity Growth (FROG) fund to include the state's child care subsidy program, subject to State Budget Committee approval. The FROG fund was established in 2025 with \$300 million from the general fund and is separate from the state's primary rainy day fund. It was initially limited to covering unexpected costs in a small number of agencies. A recent [announcement](#) from Indiana's governor would allocate an additional \$200 million to the FROG fund for child care, which comes after a recent revenue report showing higher than initially anticipated [revenue collections](#) from individual income, sales, and cigarette taxes as of March 2026.

These three funds reflect a growing recognition among states that reserve funds can be used more flexibly to support families and stabilize essential services during times of fiscal strain.

How Advocates Can Take Action

This is a critical moment for advocates to push back against proposed cuts and urge policymakers to pursue alternative strategies to manage budget pressures, including the use of rainy day funds, where available. Protecting investments in early childhood education is essential to supporting the stability of the early childhood education workforce, maintaining access to quality care for children and families, and supporting a strong economy. Advocates play a key role in shaping these decisions by engaging legislators on how early childhood programs support children's development, family's security, and economic stability, and by underscoring the long-term consequences of funding reductions or total policy elimination.

As fiscal uncertainty grows, advocates should be prepared with clear policy recommendations, data, and stories that prioritize maintaining funding for critical programs. Because many of the same families affected by potential changes to programs like SNAP and Medicaid may also rely on child care subsidies and other supports, coordinating with partners across sectors who will also be impacted by HR-1 is key to strengthening advocacy efforts over the next few years. Building partnerships with groups like health providers, disability advocates, retailers, and farmers and producers can help align messaging, strengthen available data, and better track impacts from any enacted cuts. Working together can amplify the call for protecting essential programs and highlight the interconnected effects of budget decisions across multiple programs.

In some cases, budget deficits are simply too large to be addressed by any single strategy alone, and states typically don't rely on rainy day funds alone to address a shortfall. Tapping into rainy day funds is often coupled with hiring freezes for state personnel, early retirement buyouts, new or increasing existing taxes, and unfortunately, some funding reductions. A recent example is Washington, who was facing a large budget deficit in 2026 and despite drawing down \$880 million from the state's rainy day fund and implementing an [income tax](#) on wealthy individuals, the enacted [FY 2027 budget](#) still cuts [\\$150 million](#) from the state's child care subsidy program, among other

rollbacks for children and families. This underscores the need for advocates to monitor and share with policymakers the impact of these reductions going forward.

Advocates can take action by urging state policymakers to:

- Clarify how reserve funds can be accessed and deployed in their state
- Consider using legislative channels to ensure child care and early education are allowable uses for rainy day funds
- Use rainy day funds as a first line of defense to avoid significant rollbacks to child care and other programs impacting children and families
- Consider using excess reserves for one-time investments in child care
- Learn from other states' approaches to using reserve funds to sustain essential services for early childhood education, like Connecticut, Indiana and Montana have done
- Monitor, track and report on impacts of enacted funding cuts
- Longer-term, support sustained, [dedicated revenue](#) for early childhood education, such as in Vermont, Massachusetts, and New Mexico

Advocates should also urge federal policymakers to grow investments in programs that provide needed revenue to states to invest in child care and early learning, such as the Child Care and Development Fund, and to push back on federal budget cuts that are putting additional strains on state budgets.

Sustaining early childhood systems will ultimately require ongoing, robust federal and state investment. In the near term, advocates can help ensure states use the tools put in place to provide a financial cushion during economic downturns, including rainy day funds, to protect families and child care educators from the immediate impacts of a budget shortfall.