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Testimony to House Committee on Appropriations
House Bill No. 2340
March 16, 2017

Chairman Waymaster and Members of the Committee:

I appreciate the opportunity to provide informational testimony related to House Bill 2340. My name is Stephen Bailey, and I am a senior researcher on state budget policy issues at The Pew Charitable Trusts. Over the past four years, Pew has extensively researched the policies that govern budget stabilization funds, commonly referred to as "rainy day funds." Through an evidence-based assessment of all 50 states, Pew has determined best practices for budget stabilization fund design. As H.B. 2340 maintains language related to the study of risk-based budget stabilization practices in other states, I would like to take this opportunity to share with you some findings from our research as well as review Kansas's recent rainy day fund policies.

During the 2016 legislative session, the Kansas Legislature enacted House Bill 2739. The bill was an important first step for Kansas in creating a path for long-term savings, establishing a budget stabilization fund and also calling upon the Legislative Budget Committee to identify and recommend deposit rules, withdrawal provisions, and policies to calculate the appropriate risk-based balance for the fund.

Just as families create rules that guide how and when they use their savings account versus their checking account, a budget stabilization fund will allow Kansas to be clear–in law–about the purpose and objectives for saving. Kansas now has an opportunity to establish rules to best plan for the future and begin to build back reserves when the time is right.

Funding a Budget Stabilization Fund

Unlike a general fund ending balance, Kansas can determine clear rules for depositing money into its budget stabilization fund. History has shown that state budgets tend to be pro-cyclical, meaning that they typically grow when the economy grows, and shrink during periods of recession. This can be a problem, as growth in budgets during the good times can lead to expenditure commitments that are funded with one-time, unreliable revenues. When the economy declines, states are forced to cut spending or increase taxes when residents and businesses can least afford it.

To help mitigate this problem, a best practice established by Pew research is to link deposit rules to revenue growth. In other words, when revenues exceed a pre-determined level, then a certain percent of that above-level revenue growth is saved. This technique prevents unreliable revenues from funding the general budget and ensures larger reserves are available to use when revenues decline. Some replicable examples of states currently tying deposits to revenue growth include:

- **Virginia:** sets aside 50 percent of growth in revenue that exceed the 6-year growth average
- **Idaho:** sets aside up to 1 percent of total revenue when revenue growth exceeds 4 percent
- **Tennessee:** sets aside 10 percent of year-over-year revenue growth

Expending from a Budget Stabilization Fund

Another advantage of a budget stabilization fund is that Kansas can set clear and objective rules for withdrawal. Kansas state law can explicitly define what constitutes a "rainy day." When conditions are not specified or

unclear, they can complicate – rather than simplify – the policy debate. At times, a lack of clarity around when state officials can withdraw from the fund causes withdrawals to be made too frequently, while at other times it can prevent them even when fiscal conditions are dire. Common types of withdrawal conditions include:

- Revenue declines or projected declines by a pre-determined threshold;
- Declines of an economic indicator (e.g. personal income growth) by a pre-determined level;
- Revenue drops below the initial base budget projections;
- Disasters and/or declared states of emergency.

Some states set different voting requirement thresholds for accessing the fund depending on the withdrawal condition used. In Texas, for example, a 3/5 vote is required to expend from its fund if revenues decline compared to the previous year, but a 2/3 vote is required to expend from its fund if a revenue forecast comes in lower than the initial budget.

Calculating Risk-Based Balance

Nearly every state with a budget stabilization fund sets a target or cap for how large the fund can grow. This maximum savings level should reflect the amount of budgetary risk a state intends to offset, which the state can adjust to reconcile policymakers' preferences with other budget priorities and political sensitivities. In order to set a risk-based savings level, state policymakers first need to make the following determinations:

1. How much of a revenue shortfall should the fund cover? All or only a portion of it?
2. How long should the state's reserves be able to cover a shortfall?
3. How severe of a downturn should the fund guard against?

Once state lawmakers answer those questions, they can more accurately assess an optimal savings target. Minnesota currently determines its optimal reserve level based on this risk analysis, by setting their savings target at a level sufficient to cover a typical revenue shortfall based on the state's historical experience. In 2014, lawmakers amended state law to reference a report by the executive budget office that determines how much the state should ideally save in order to fully offset 9 out of 10 possible recession-driven revenue shortfalls for up to two years. Minnesota created a direct link between the fund purpose and their actual savings target every year. Fitch Ratings praised the technique when they upgraded the state to "AAA" in July 2016.

Next Steps for Kansas

In order to establish policies for a budget stabilization fund, Kansas should evaluate and decide on the following policy questions:

Deposit Rules

- ✓ What revenue conditions should trigger deposits to a budget stabilization fund?
- ✓ Once those conditions are met, how much should be saved?
- ✓ Should the deposits be built into the budget at the beginning of the fiscal year?

Withdrawal Rules

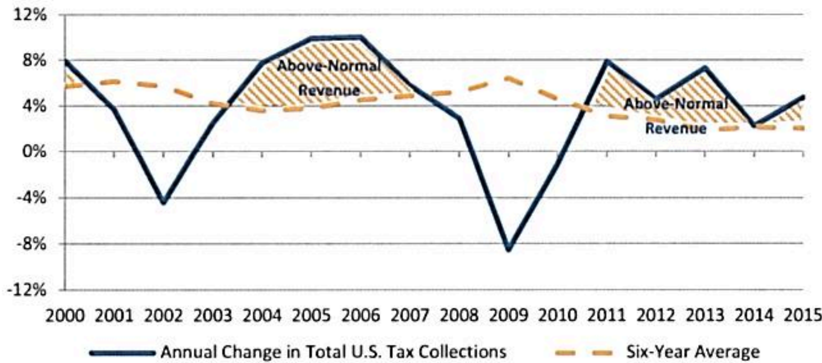
- ✓ What are appropriate uses for the rainy day fund?
- ✓ Should some fund uses require a lower voting threshold than other uses (e.g. simple v. super majority)?
- ✓ Should there be a limit on how much can be expended from the fund in a given year?

Fund Size

- ✓ Should there be an evidenced-based target for a budget stabilization fund's balance?
- ✓ Should deposits stop when the fund's target balance is reached?

Deposit Rules

States should set aside a percentage of annual revenue when growth exceeds its typical rate. For example, Virginia saves 50 percent of all revenue above the average six-year growth rate, a practice that Moody's praised as "a strong feature of its Aaa rating and will help to prepare it for future downturns."



Step 1: Identify level when revenue growth is above-normal.

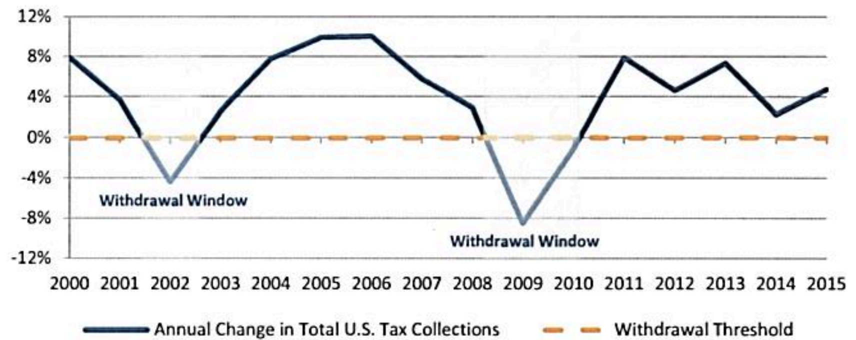
Step 2: Save a portion of revenue that exceeds that level.

Withdrawal Rules

Budget stabilization funds should establish clear, measureable, and objective conditions for when money can be expended from the fund. As a best practice, states should be able to access their rainy day funds when revenues or a specified economic indicator (e.g. state personal income) drops below a pre-determined level.

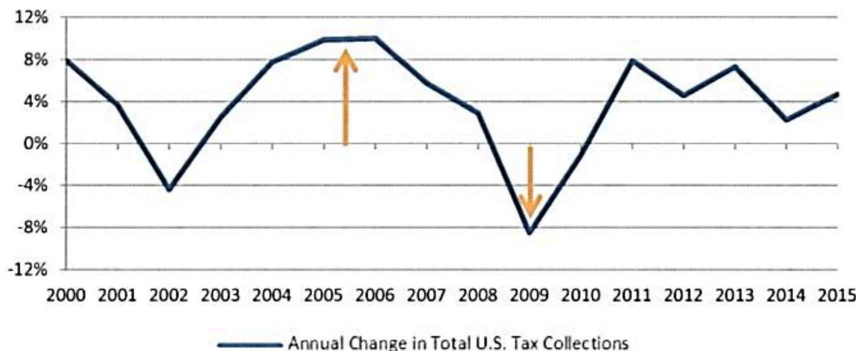
Step 1: Determine level of revenue decline when the budget stabilization fund can be accessed.

Step 2: When revenue falls below that level, lawmakers have the option of using fund.



Optimal Size

The maximum size of a budget stabilization funds should be evidenced-based. The fund should be allowed to grow to a level large enough to offset a major recession, but not too large to unnecessarily store money that could be better used for tax reductions or programs. As a best practice, states should examine their historical revenue fluctuations.



States with a history of larger revenue fluctuations should save more than states with relatively stable tax streams.