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This memo was produced by Pew's State Fiscal Health Team at the request of the Kansas Legislative Budget Committee to inform on best practices related to rainy day fund design.

During the 2016 legislative session, the Kansas legislature enacted House Bill 2739. The bill created a budget stabilization fund and also called 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. Pew has extensively researched these issues and has identified the following best practices for budget stabilization fund design.

Funding the Budget Stabilization Fund

Unlike a general fund ending balance, states can determine clear rules for depositing money into a budget stabilization fund. 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 examples of states currently tying deposits to revenue growth include:

- **TENNESSEE:** sets aside 10 percent of year-over-year revenue growth
- **VIRGINIA:** sets aside 50 percent of growth in revenue that exceed the 6-year growth average
- **IDAHO:** sets aside up to one percent of total revenue when revenue growth exceeds 4 percent

Expending from the Budget Stabilization Fund

Another advantage of a budget stabilization fund is that the state can set clear and objective rules for withdrawal. Kansas state law can explicitly define what constitutes a "rainy day." When conditions are unspecific 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
- Anytime revenue falls below the initial base budget projections
- Disasters and/or declared state of emergency

Some states set different voting requirement thresholds for using 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 the state's reserves should 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 the Budget Stabilization Fund, Kansas should evaluate and make decisions on the following policy questions.

Deposit Rules
✓ What revenue conditions should trigger deposits to the 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 the Budget Stabilization Fund's balance?
✓ Should deposits stop when the fund's target balance is reached?

Technical Assistance by The Pew Charitable Trusts

As Pew testified to the House Appropriations Committee and Senate Ways and Means Committee in March 2016, many states put policies in place immediately following revenue downturns. This ensures there is a structure for saving set by the time revenue recovers. If needed, Pew can inform policy design through a more comprehensive presentation on best practices, drafting or advising on legislation, or offering testimony to inform the reserve fund debate in Kansas.