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Kansas Senate Ways and Means Committee

In Support of Senate Bill 509: Establishing a budget stabilization fund in the state treasury; revenue and expenditures; review of risk-based practices by the legislative budget committee.

Chairman Masterson and members of the Ways and Means Committee:

Pew supports Senate Bill 509 because it establishes a budget stabilization fund and calls for an evaluation to inform the rules of the fund. Both of these elements are consistent with Pew's best practices for long-term budgeting.

First and foremost, with the passage of this bill, Kansas would immediately join 46 other states that have legally defined rainy day funds. To be clear, Pew considers rainy day funds to be separate savings accounts designed to operate across multiple business cycles and provide supplemental funding during revenue downturns or for other general purposes. Pew has analyzed savings policies in all 50 states to identify the practices that lead to the most effective long-term fiscal health. Our research finds that rainy day funds provide states with an opportunity to proactively save with a clear purpose in good times and then effectively utilize those reserves during downturns in ways that an undesignated ending balance cannot.

Just as families create rules that guide how and when they use their savings account versus their checking account, a rainy day fund will allow Kansas to be clear—in law—about the purpose and objectives you are trying to achieve through savings. Using the new budget stabilization framework in Senate Bill 509, Kansas has an opportunity to establish rules to best meet its savings goals.

Regardless of their economy or tax policy, all states need an effective savings policy because of revenue volatility. Revenue volatility is the unavoidable fluctuation in revenues that occur throughout the business cycle. As you know from experience, large and unpredictable swings in revenue can undermine efforts to accomplish budgetary goals such as reducing taxes, paying down debt, investing in infrastructure, or funding education.

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.

While Kansas would take a significant step with the creation of a budget stabilization fund, all rainy day funds are not created equal. Pew has identified best practices for making deposits, withdrawals, and determining an evidence-based savings target for rainy day funds. Our research suggests that a well-designed rainy day fund would not only provide Kansas with a fiscal cushion during unavoidable revenue downturns, but it would also be a tool that helps create a structurally sustainable long-term budget. But, as a note of caution, a poorly designed rainy day fund can exacerbate budget issues by moving one-time revenue in and out of the budget at inappropriate times.

For these reasons, Pew also supports Senate Bill 509 because it calls for an evidence-based evaluation of the best practices for the budget stabilization fund. Kansas has a unique opportunity to learn from other states' experiences and to establish the best fund rules. When rainy day funds were first established in most states, there was little prevailing research on the most effective rainy day fund guidelines and, as a result, many states have adopted rules that are less than optimal.

For example, only 14 states currently tie their rainy day fund deposits directly to revenue or economic growth, which is considered a best practice. This approach to saving calls for states to deposit above-normal revenues into their rainy day fund, a policy we refer to as depositing based on volatility. There are two key benefits for

states that choose to save this way. First, states are able to save the most when revenues are highest. Second, unsustainable revenues are prevented from being used to fund recurring expenditures. After all, above-normal revenues cannot be relied on from year-to-year, so it is better to save those funds for the times when revenues decline. By depositing above-normal revenues into the rainy day fund, those unsustainable dollars are not available to fund recurring expenditures, helping to keep the budget structurally balanced.

When it comes to fund use, a Pew-identified best practice is for states to link their withdrawals to objective measures like declining revenues or a weakening economy. However, Pew research indicates fewer than 20 states do this, as most states can withdraw in the presence of any budget deficit. By linking withdrawals to objective measures of revenue and economic performance, states can use information from across the business cycle to determine whether a budget gap is driven by a temporary reduction in revenues or a structural problem in the budget. Additionally, these types of objective triggers can help take some of the politics out of the decision.

Finally, fewer than five states are using evidence – like revenue volatility and forecast error – to determine how much they should save to meet their fund goals. Pew research finds that 21 states' savings targets were too low prior to the Great Recession, actually preventing those states from saving more during the growth years of the mid-2000s. States that study their revenue volatility and use that information to inform their savings targets will be more likely to save enough for the next downturn.

With the passage of Senate Bill 509, Pew believes Kansas will be following a prudent and pragmatic approach to create the best possible savings policies for your state. Kansas can use lessons learned from other states in the areas I have mentioned to develop an effective, informed fund policy from the onset.

While a review of risk-based practices would entail a rigorous analysis of Kansas' budget trends, this is not a task that is unprecedented. Pew has assisted a number of states in passing and implementing studies with the goal of informing rainy day fund design. Should Senate Bill 509 be passed, Pew offers its support and

resources to assist in completing a fund evaluation in whatever timeframe is deemed appropriate by the Legislature.

Thank you again for your time and for considering this bill. If you have any questions, please do not hesitate to contact me at sbailey@pewtrusts.org.