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Senator Mark Leno
Chair, Committee on Budget and Fiscal Review
California State Senate
State Capitol, Room 5019
Sacramento, CA 95814

February 27, 2014

Dear Chairman Leno and members of the committee:

Good morning, my name is Mary Murphy. I am a senior researcher with The Pew Charitable Trusts, an organization that is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public and stimulate civic life. One focus of our work is helping states manage their long-term fiscal health by conducting research on common financial and economic challenges. We work across the 50 states, highlighting solutions for lawmakers to consider and offering customized research and technical assistance.

First, I want to thank you for inviting me to this hearing. I am grateful for the opportunity to share some of our research findings on revenue volatility and best practices in rainy day fund design.

Pew focuses on volatility because it is one of the central challenges in state budgeting, influencing both the timing and size of budget surpluses and shortfalls. This is particularly important in California, which has above-average revenue volatility compared to other states.

Our research has identified steps states can take to better manage this volatility. For one, prioritizing saving in periods of growth can lessen the need for difficult choices like tax increases or service cuts in lean times. With California now anticipating several years of significant revenue surpluses, this is an opportune time to consider changes to when, how, and how much the state saves in good times for use in bad times.

As my colleague Jonathan Griffin of the National Conference of State Legislatures noted in his testimony, rainy day fund design includes a number of key elements, including setting the right target size for funds and establishing withdrawal rules that protect savings. These details ensure that resources are available to guard against the "downs" of the business cycle. It is also critical

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to provide the appropriate level of flexibility in the design of the budget reserves. The administrative details, such as the timing of deposits, are also important.

Pew's research has identified three best practices for establishing deposit mechanisms. First, we recommend that policymakers regularly study volatility to understand the fluctuations unique to their state's economy and revenue structure. Second, we recommend states use the results of this analysis to inform savings policies. Directly linking deposit mechanisms to volatility makes saving a consistent, predictable practice during times of growth. Third, Pew recommends state policymakers set explicit goals for funds. Establishing a clear purpose for your budget reserve allows you to work out the details and mechanics of saving to meet those goals and effectively manage volatility.

My remarks today will highlight rules already in place in other states that may inform your consideration of both Assembly Constitutional Amendment (ACA) No. 4 and the capital gains-based proposal set forth in the governor's budget.

First, to harness volatility and build savings at the right times, it's important to regularly examine and understand your state's unique patterns of volatility.

Although the California Legislative Analyst's Office did a comprehensive study in 2005, we recommend that states conduct this kind of study on a regular basis, since revenue volatility patterns – and the underlying economic and policy conditions that drive that volatility – change over time.

For example, Utah conducts a volatility study every three years and incorporates the recommendations into its reserve fund policies. Following recommendations from this analysis, Utah policymakers have increased the maximum balances of their two budget reserve funds twice since 2008.

The second of the best practices Pew identified is that states should design reserve funds that work to harness volatility in their tax collections. States should put aside money when they have money to save – namely, during times of revenue growth. As you know, both ACA 4 and Governor Brown's proposal would harness a portion of revenue growth for use in future downturns. Although they share this goal, the proposals function in very different ways.

Both of these options would connect savings to volatility in some way – a practice that is not commonly found across the states. In fact, 38 states do not directly consider volatility in connection to their reserve fund policies. Just 12 states tie the size and timing of deposits to volatility in their taxes or economies. We find that in these dozen states, saving during good times is a consistent and predictable budget practice.

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I would like to note that California has taken a modest step toward tying deposits to volatility. Deposits to the Special Fund for Economic Uncertainties are based on year-end surpluses. While this type of deposit rule is not uncommon, and used by 19 states, it does leave room for improvement.

The deposit structure proposed in ACA No. 4 is one strategy we've seen other states use, in order to capture savings in years of unusually rapid growth. Along with other policy changes, it would link fund deposits to above-trend revenue growth – depositing money whenever total tax collections surpass a 20-year trend.

This is comparable in some ways to Virginia, which ties rainy day savings to the historical trend of the state's total general fund revenue. Virginia compares the prior year's growth to a six-year trend. One-half of revenues in excess of this trend are automatically set aside in its Revenue Stabilization Fund.

Arizona links savings to total growth in a slightly different way: instead of connecting deposits to above-trend growth in *revenue,* the state looks at above-trend *economic* growth to determine savings. This rule has worked well in Arizona because the state has revenue collections that track fairly closely with its relatively volatile economy. However, many states have patterns of revenue volatility that are notably disconnected from economic fluctuations, in both timing and magnitude. For this reason, a similar rule may not work in California as it has in Arizona.

The strategy in Governor Brown's 2014-2015 budget proposal links savings directly to a specific driver of revenue volatility: capital gains tax revenue.

Capital gains revenue is expected to bring in about 10 percent of total general fund revenue in fiscal 2014, although it can fluctuate widely with the booms and busts of the stock market. In fact, the California Legislative Analyst Office noted that swings in capital gains revenue drive much of the volatility in collections from the state's progressive personal income tax, the largest source of money for spending on state programs and services.

Pew's research has examined similar rules already in place in other states. In Massachusetts, the state takes capital gains taxes above a certain threshold and sets aside the excess in a rainy day fund. This policy allows the state to harness growth during spikes in capital gains, ensuring funds are available during downturns. Since the rule was implemented in fiscal 2010, the state's rainy day fund has more than doubled. In fiscal 2012, it was almost $1.7 billion. The rule requires that all capital gains tax collections above $1 billion are deposited into the fund, and annually adjusts that threshold upwards based on growth in nominal GDP. We consider this detail to be a smart policy choice made with a longer time horizon in mind.

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Instead of focusing on capital gains revenue, both Louisiana and Texas connect their deposit rules to fluctuations in severance taxes. This is a major driver of revenue volatility in these states. While both states set aside severance tax collections above a specific threshold, Texas' approach highlights the importance of periodically revisiting those benchmarks. Deposits to that state's rainy day fund are based on a 1987 benchmark, which has not changed since the fund's initial creation. The result of this fixed threshold is that the state transfers large sums to the fund, but has less budgetary flexibility.

Our third policy recommendation is that all states – including California – should set clear goals for their reserve funds. Considering the purpose of the fund at the outset allows policymakers to make informed decisions about all aspects of rainy day fund policy design. That includes the appropriate level of savings needed to prepare for the next downturn, rules for withdrawing and using reserve money, and ensuring that deposits are made according to the adopted rules.

In conclusion, to design the most effective reserve funds for managing uncertainty, all states would benefit from:

- Regularly monitoring their sources and drivers of revenue volatility to ensure savings remain commensurate with their experiences;
- Putting in place polices that connect reserve deposits to volatility; and
- Setting clear goals for reserve funds.

Thank you for your time and attention. I look forward to answering your questions.