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Testimony to Nebraska Appropriations Committee
Legislative Resolution 209
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Chairman Stinner and Members of the Committee:

Thank you for the opportunity to provide testimony on evidence-based strategies to mitigate volatility for the Cash Reserve Fund. My name is Robert Zahradnik, and I am a principal officer for state fiscal health project at The Pew Charitable Trusts. Over the past four years, Pew has extensively researched policies that govern budget stabilization funds, commonly called rainy day funds, across all fifty states. We have worked closely with lawmakers in several states to study their revenue fluctuations and put in place policies to harness volatility.

As a part of that work, Pew has researched techniques to deposit, withdraw, and calculate savings targets for rainy day funds based on each state's unique revenue fluctuations. There are 48 states with these reserve funds across the United States, but despite their widespread adoption, the policies that guide them vary a great deal.

Savings Strategies to Mitigate Volatility

Nebraska is one of five states that uses forecast error to determine rainy day fund deposits. Revenue to the General Fund in excess of the certified estimate is set aside to the Cash Reserve Fund. In some instances, revenue that comes in above forecast is unlikely to be recurring, and it makes sense to set those dollars aside. However, at times using forecast error can be disconnected from volatility. If, for example, collections are booming relative to the prior year and the forecaster's estimate is on the mark, there is no requirement to save, which would result in missed opportunities to build reserve balances when it makes the most sense to do so.

As an alternative, 20 states tie their rainy day fund deposits directly to revenue or economic growth. In other words, the saving policy is linked to each state's unique volatility. These rules ensure a state is saving the most in good times. State revenues go through periods of above-normal growth as a result of the business cycle. Rules linked to volatility generate the largest deposits when revenue growth is the most above-normal, thereby preventing unsustainable revenue collections from being used to fund recurring expenditures. For example, Virginia deposits half of general fund revenue growth that exceeds the average of the preceding six years.

When to Use Rainy Day Funds

To help manage use of rainy day funds, a large majority of states have created conditions for withdrawal. These conditions specify when funds are available for use. When designed properly, withdrawal conditions effectively guide a state's leaders in making difficult decisions about when to put rainy day fund balances to use. Nebraska is one of five states without these rules.

As a best practice, withdrawal conditions should be clear and based on objective indicators of revenue or economic performance. For example, Oklahoma's rainy day fund may be accessed when either revenue is projected to drop from one year to the next, or when actual general fund revenue collections fall below the certified estimate.

Rainy Day Fund Optimal Size

Nebraska is one of just four states with a rainy day fund that lacks a cap or savings target. A cap or target can provide a clear savings goal for policymakers and can have two keys advantages:

1. Ensures the balances in the rainy day fund are adequate to sustain the state through a future downturn;
2. Helps prevent policymakers from both under-saving and over-saving, whereby other priorities lose out.

Setting an evidence-based fund cap is important to ensuring that the rainy day fund will meet policymakers' reserve policy goals. However, in the past, the conventional, though arbitrary, standard was to have 5 percent of total revenue or expenditures in a combination of a state's end-of-year balance and budget stabilization fund. State experiences during the Great Recession, however, demonstrated that the 5 percent rule is not universally applicable. In fact, the appropriate financial cushion for each state ultimately depends on state-specific factors. Since the Great Recession, 17 states have raised the cap on their rainy day fund.

Using Volatility to Determine an Optimal Savings Target

One of the most innovative approaches to determine a rainy day fund savings target was created in Minnesota. They have a rigorous two-part process, developed collaboratively by executive and legislative staffs, for setting its savings target. State economists perform an annual analysis of historic volatility in the parts of the state's economy that are subject to taxation, and then update their savings target to provide full coverage for an array of possible revenue downturns.

Since 2014, Minnesota has used this analysis to set an annual savings target. This created a direct link between the fund purpose and their actual savings target. Fitch Ratings praised the technique when they upgraded the state to "AAA" in July 2016.

Options for an Evidence-Based Savings Target in Nebraska

Pew replicated Minnesota's methodology to calculate a range of savings options for Nebraska. Once the volatility was calculated, the analysis produced a range of reserve size options, depending on the severity of downturn Nebraska lawmakers wish to guard against. This amounts to "stress testing," with higher levels of protection requiring higher savings. For example, lawmakers in Minnesota have opted to save enough money to entirely cover the estimated revenue shortfalls that would occur in 90 percent of modeled downturns.

Our analysis suggests that if policymakers in Nebraska want to cover a shortfall over three years, full coverage for:

- **50 percent of downturns requires reserves of 5.4 percent of General Fund revenue;**
- **80 percent of downturns requires reserves of 10.2 percent of General Fund revenue;**
- **90 percent of downturns requires reserves of 13.1 percent of General Fund revenue;**
- **98 percent of downturns requires reserves of 18.6 percent of General Fund revenue.**

The corresponding memo submitted with this testimony outlines a more comprehensive list of potential savings targets.

Ultimately, there is no right or wrong level for what a state's budgetary risk tolerance should be. States may opt to guard against more or less risk depending on their own spending priorities, obligations, and political cultures.

What is most important for setting an appropriate optimal size is ensuring that a reserve fund provides a state's government with its desired level of insurance against recession-driven budgetary risk.