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Testimony of Robert Zahradnik
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April 23, 2015

Chairman Fonfara and Chairman Berger, Ranking Members Frantz and Davis, members of the Finance, Revenue, and Bonding Committee, thank you for inviting me to participate in today's Forum and to testify on Senate Bill 1135.

My name is Robert Zahradnik and I'm a director of state and local policy at The Pew Charitable Trusts. Pew is a public charity that engages in research and technical assistance at the local, state, and federal levels.

I commend the Committee's focus on Connecticut's level of savings and revenue volatility. Whether your state's goal is to provide high-quality infrastructure and services, reduce taxes, pay down liabilities, or spur economic development, wide swings in resources from year to year can undermine those efforts.

Our research has found that swings in state revenue are growing more dramatic, and that states are not as well prepared as they could be to manage this inevitable volatility in tax collections. This lack of preparation has consequences: for example, while state budget responses to recessions vary greatly, our research has found that states with below-average reserves at the beginning of the Great Recession raised taxes by more than twice as much as states with above-average reserves.

Connecticut faces greater challenges in managing the fiscal consequences of tax volatility than many other states. Pew's research ranked Connecticut 13th highest in the nation on tax volatility with a volatility score of 6.5, which means that revenues typically fluctuated by 6.5 percentage points from the 19-year average in any given year. By comparison, 50-state tax revenue had a volatility score of 5.0. Connecticut is among the 29 states with volatility higher than the national benchmark.

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While Connecticut experiences high levels of volatility, the state's rainy day fund deposit rule is not designed to effectively harness those fluctuations. Our research shows that Connecticut is one of 20 states that make deposits to their rainy day funds based on end-of-year surpluses. Because surpluses are determined near the end of the fiscal year, deposits made under rules like Connecticut's are often the last – and frequently the lowest – priority in the budget process.

To help states manage uncertainty and build stronger reserves, Pew recommends that policymakers tie rainy day fund deposits to revenue volatility. At present, 13 states connect the rules for when, how, and how much to deposit into their budget stabilization funds with underlying revenue or economic fluctuation.

Five of those states link rainy day funds to specific revenue streams. Alaska, Louisiana, and Texas tie their rainy day fund deposits to extraction-related revenue, such as the severance tax on oil and gas production in Texas. Similar to the deposit rule proposed in SB 1135, Massachusetts and California tie their rainy day fund deposits to growth in the most volatile portion of the income tax.

- In Massachusetts, when collections from the state's highly volatile tax on capital gains are in excess of $1 billion, the amount over that level is directed to the state's Commonwealth Stabilization Fund. Not only did the implementation of this policy help to quickly rebuild Massachusetts' fund balance to pre-recession levels, but it was also cited as one of the reasons why the state's general obligation debt was upgraded from AA to AA+ in a September 2011 report by Standard & Poor's.

- In California, fluctuations in capital gains revenue drive much of the overall volatility in personal income tax collections. In November voters approved Proposition 2, which captures a share of growth in this unpredictable tax stream, setting money aside in the rainy day fund whenever capital gains collections exceed 8 percent of general fund revenue. Once again, Standard & Poor's took note and cited the policy as one of the reasons why the state's debt was upgraded from A to A+ on the day after the ballot initiative passed.

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In both instances, Standard & Poor's noted that the new rainy day fund policies would be useful for counteracting the impact of tax volatility in years to come by more effectively building up reserves.

Pew's research also recommends states establish a threshold above which tax collections are directed to one-time uses, such as savings. Consistent with this recommendation, SB 1135 would direct deposits to the Budget Reserve Account when the estimated and final payments portion of income tax revenue comes in above the level set as the "sustainable path." Estimated and final payments are the most volatile portion of the personal income tax in Connecticut.

Finally, Pew recommends that policymakers establish a clear fund purpose and regularly evaluate the balance history and deposit and cap policies to ensure the fund is fulfilling its intended purpose.

SB 1135 includes these recommendations, and would thus constitute a strong step towards fiscal stability by building resources during times of growth for Connecticut to use in the next, inevitable downturn.

Thank you for the opportunity to speak in support of SB 1135. I am happy to address any questions the members of the committee may have.