INTERIM JOINT COMMITTEE ON APPROPRIATIONS AND REVENUE

Minutes of the 2nd Meeting
of the 2021 Interim

July 7, 2021

Call to Order and Roll Call

The 2nd meeting of the Interim Joint Committee on Appropriations and Revenue was held on Wednesday, July 7, 2021, at 1:00 PM, in Room 149 of the Capitol Annex. Senator Christian McDaniel, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Christian McDaniel, Co-Chair; Representative Jason Petrie, Co-Chair; Senators Danny Carroll, David P. Givens, Alice Forgy Kerr, Morgan McGarvey, Stephen Meredith, Michael J. Nemes, Robin L. Webb, and Stephen West; Representatives Lynn Bechler, Danny Bentley, John Blanton, Randy Bridges, Myron Dossett, Joseph M. Fischer, Ken Fleming, Kelly Flood, Chris Fugate, Al Gentry, Robert Goforth, David Hale, Mark Hart, Angie Hatton, Jason Nemes, Ruth Ann Palumbo, Melinda Gibbons Prunty, Brandon Reed, Steve Riley, Sal Santoro, James Tipton, and Lisa Willner.

Guests: John Roenker, Chief Economist, Legislative Economic Analysis, Legislative Research Commission, Katie Scott, Staff Economist, Legislative Economic Analysis, Legislative Research Commission; David Eager, Executive Director, Kentucky Public Pensions Authority (KPPA), Rebecca Adkins, Executive Director, Office of Operations, KPPA, Erin Surratt, Executive Director, Office of Benefits, KPPA, Beau Barnes, Deputy Executive Secretary of Operations and General Counsel, Teachers' Retirement System (TRS); and John Hicks, State Budget Director, Office of State Budget Director (OSBD).

LRC Staff: Jennifer Hays, Grant Minix, Sarah Watts, and Chase O'Dell.

Pandemic Relief - Update on Federal Funding

John Hicks, State Budget Director, OSBD, provided an updated on pandemic relief and federal funding.

Mr. Hicks testified that there were seven federal acts related to COVID-19 which appropriated funds to and through Kentucky state government. The $867 million award to Kentucky from the Families First Coronavirus Response Act was primarily for Medicaid. Kentucky was awarded $7 billion through the CARES Act, of which $4.7 billion was for unemployment insurance. Kentucky received over $2 billion through the Coronavirus

Response and Relief Supplemental Appropriations Act. The American Rescue Plan Act has awarded $6.7 billion to the state. In total, $16.9 billion has flowed to and through Kentucky as a result of the federal acts related to COVID-19. Most of these funds are flowing through existing programs.

Mr. Hicks detailed the funds that flowed through each cabinet of state government. The bulk of funds flowing through the Labor cabinet were for unemployment insurance. A significant amount of funding flowed through the Department of Education via the American Rescue Plan Act and the Coronavirus Response and Relief Supplemental Act. A large amount of funds passed through the Health and Family Services Cabinet, through the Department of Public Health and the Department for Community Based Services. Over $1 billion in funds have flowed through Kentucky state government to childcare recipients and providers. The Department of Local Government distributes the $300 million in funds from the American Rescue Plan Act to most cities. Of the $252 million which flowed to the Transportation Cabinet, $164 million came through the Coronavirus Response and Relief Supplemental Act to be used on highways. There are $1 billion in funds from the American Rescue Plan Act state fiscal recovery fund that have not been appropriated by the General Assembly.

The largest federal pandemic grants outside of unemployment insurance were from the Elementary and Secondary School Emergency Relief Fund. Other large programs included the enhanced federal share for Medicaid benefits, the child care stabilization program, the higher education emergency relief fund, and assistance to cities and counties.

In response to a question from Senator McDaniel, Mr. Hicks testified that funds which flowed to existing programs would return to the federal government if not spent. All of the money from the Coronavirus relief fund was received upfront. Half of the dollars from the state fiscal recovery fund were received upfront, with the other half coming in twelve months. If those funds are not spent, they are returned to the U.S. Department of Treasury. By law, dollars from those two funds cannot be reallocated. In response to another question, Mr. Hicks stated that the administration still expects to spend all CARES Act funds awarded.

In response to a question from Representative Tipton, Mr. Hicks stated that the funds for highways are being used for maintenance projects more than for new projects. On the emergency eviction relief funds, the Kentucky Housing Corporation and the media have informed the public on the funds and programs available to assist the public.

In response to a question from Senator Carroll, Mr. Hicks testified that most of the federal funds went through existing programs and were based on formula allocations. With the Coronavirus Relief Fund, decisions regarding fund distributions went through the Governor's Office. The General Assembly appropriated funds from the State Fiscal Recovery Fund. Mr. Hicks applauded cabinet reporting of funds during the pandemic.

In response to a question from Senator Givens, Mr. Hicks assured that the administration is not posing recurring obligations on the Commonwealth through the use of these federal funds. Agencies using the funds understand that these are one-time funds. In regards to the American Rescue Plan Act's State Fiscal Recovery Fund, states can reduce taxes but cannot use the federal funds to replace the portion of tax revenues reduced as a result of a tax policy action.

Senator Carroll expressed his concern with organizations being unable to sustain wage increases once federal funds go away.

In response to a question from Representative Nemes, Mr. Hicks testified that federal funds will not be in jeopardy when Kentucky's state of emergency ends.

Inflation and Impacts on the Future of our Economy

John Roenker, Chief Economist, Legislative Economic Analysis, Legislative Research Commission, and Katie Scott, Staff Economist, Legislative Economic Analysis, Legislative Research Commission, discussed inflation and its impacts on the future of the economy.

Ms. Scott testified that the variables in the economy which impact inflation are the amount of dollars in the economy, the velocity of money, and the amount of goods to purchase in the economy. Inflation is measured through the Consumer Price Index (CPI). The CPI reflects changes in the prices paid for various consumer goods. The core CPI removes food and energy prices.

Controlling inflation is the responsibility of the Federal Reserve. The Federal Reserve is statutorily mandated to ensure maximum employment, stable prices, and moderate long-term interest rates.

The Federal Reserve has three tools to control the money supply and control inflation or deflation. The Federal Reserve can change the federal funds rate, which is the interest rate on the money banks lend to each other. It can also change the reserve ratio, which is the amount of money banks have to keep in their vaults. Lastly, the reserve can conduct open market operations, which is the buying and selling of treasury bonds.

The International Monetary Fund has referred to the period beginning in 2020 in response to the COVID-19 pandemic as the "Great Lockdown". The money supply has increased 74 percent compared to pre-pandemic levels. The velocity of money dropped almost 77 percent at its lowest point. Velocity has begun to recover. There have also been changes in output in the economy, particularly with supply chain issues.

There are several theories for the cause of current inflation. One current theory is supply shock, with things such as chip shortages leading to higher prices. Another theory is misleading comparisons, with one example being that gas prices dropped sharply while people were locked down, but now have risen above 2019 levels. Another theory is monetary policy, with the drastic increase of the money supply.

The all-items CPI was up five percent compared to May, 2020. The core CPI is up 3.8 percent. Volatile indexes such as gasoline and fuel oil indexes are up 56 and 50 percent, respectively, since May, 2020. Used car and truck prices are up 30 percent. Transportation services are up 11 percent. Stable indexes such as food, electricity, shelter, and medical are under less pressure.

Last year, the Federal Reserve shifted its policy to target an average of two percent inflation over the long-term. The Federal Reserve decided to keep the federal funds interest rate at zero to .25 percent until maximum employment is achieved. The latest projection is for inflation to reach 3.4 percent in 2021 and 2.1 percent in 2022. The governors of the reserve voted unanimously to keep the current monetary policies in place as of June 16, 2021.

In response to a question from Senator Givens, Ms. Scott testified that when considering inflation, current price levels are compared relative to 2020. In response to another question, Mr. Roenker stated that the Federal Reserve views current pressures on the economy such as the current microchip shortages as transitory pressures which will eventually resolve themselves. He continued that this is why the reserve is returning to its baseline projection of two percent inflation in 2022. In response to another question, Mr. Roenker testified that the reserve has revised its inflation projections from previous estimates.

In response to a question from Senator Carroll, Ms. Scott stated that the Federal Reserve is attempting to balance things out in their approach. Mr. Roenker testified that it is telling that the reserve voted unanimously not to change its policy.

In response to a question from Representative Fischer, Mr. Roenker stated that the General Assembly should listen to the fact that the Federal Reserve Board is not expressing much worry.

In response to a question from Representative Petrie, Mr. Roenker testified that his professional opinion would be to listen to the Federal Reserve Board's advice.

Public Pension Report – Financial Status and Future Needs

David Eager, Executive Director, KPPA, Rebecca Adkins, Executive Director, Office of Operations, KPPA, Erin Surratt, Executive Director, Office of Benefits, KPPA,

and Beau Barnes, Deputy Executive Secretary of Operations and General Counsel, TRS, provided a report on the financial status and future needs of the various retirement systems.

Mr. Eager outlined three key events which will lead to the retirement plans being fully funded by 2048. Senate Bill two, passed in 2013, established tier three and required full funding of the ARC. The economic and mortality assumptions were reset in 2017 and 2019. House Bill eight, passed in 2021, changed the method of funding for the Kentucky Employees Retirement System (KERS) non-hazardous plan. Each employer will pay its percentage of the total plan liability.

Through May 31, 2021, all pension year-to-date performance was up 23 percent, resulting in a net increase of $2.9 billion in assets. Fund performance totaled $176.8 million above the benchmark. The KERS non-hazardous plan had a net cash flow of $234 million with investment income. The County Employees Retirement System (CERS) had net cash flow of negative $100 million with investment income.

As of May 31, 2021, the KERS non-hazardous plan market value is up 20.4 percent year-to-date. KERS non-hazardous member contributions for fiscal year 2021 were down to $82.5 million from $89.4 million in fiscal year 2020. Mr. Eager testified that this was the result of the last phase of employee reduction and the loss of contributions associated with it, which will not be seen again. KERS has more contribution inflows than outflows. Insurance fund cash flows are also positive.

Mr. Eager reviewed the impact of fiscal year 2021 investment returns on the unfunded liability of the KERS non-hazardous plan. There will be $628 million less in unfunded liability by 2027 as a result of investment returns in fiscal year 2021. The funded ratio is now projected to reach 26 percent by 2027, up three percent from the previous projections. In fiscal year 2018, the funded ratio was 12.9 percent.

Because of investment returns in fiscal year 2021, employer contributions for KERS non-hazardous are projected to total $1.024 billion in fiscal year 2022, down from the initial projection of $1.034 billion.

For the CERS non-hazardous plan, the 2027 unfunded liability is now projected to total $6.16 billion, $1.4 billion less than initial projections. The CERS non-hazardous plan is now projected to be 63 percent funded by 2027, up from earlier projections of 55 percent. CERS non-hazardous employer contributions are now projected to total $561 million in 2027, down from earlier projections of $683 million for that year.

In response to a question from Senator McDaniel, Ms. Adkins testified that the five year window for the CERS rate collar began in 2018. Those CERS employers will catch-up to the rates they would have otherwise been contributing before the end of the window.

In response to a question from Senator Givens, Mr. Eager testified that statute states that KPPA' s actuary calculates each employer's share of the total liability. He continued to say that 44 of the 110 employers have appealed their calculations. Mr. Eager encouraged the legislature not to require KPPA to provide individual member information to employers. In response to another question from Senator Givens, Mr. Eager stated that 54 employers have received individual employee liability information. These are employers who cannot leave the system. Twenty-two employers who can leave the system will not be given individual employee liability information.

Mr. Barnes described the process and necessity of experience studies. There have been several significant changes to assumptions which will impact TRS' budget request. The investment return assumption has been lowered from 7.5 to 7.1 percent for all plans. The payroll growth assumption has been lowered from 3.5 to 2.75 percent. New teacher-specific mortality tables have been developed and implemented.

As a result of the recent changes, total TRS annuity trust liabilities have increased $2.95 billion from $35.58 billion. New mortality tables accounted for a $1.49 billion increase in liabilities. The lowering of the assumed investment returns accounted for a $1.65 billion increase in liabilities. The lowering of salary assumptions for teachers lowered liabilities by $400 million.

TRS will request an additional $629.4 million from the budget for fiscal year 2023. The fiscal year 2024 request will be based on the 2021 annual valuation.

In response to a question from Representative Tipton, Mr. Barnes testified that for fiscal year 2023, there will be $435 million which will be needed for the SEEK formula as an addition to the $629.4 million budget request. The fiscal year 2023 budget request is a $50 million increase over the previous year.

In response to a question from Senator Carroll, Mr. Barnes stated that the actuary provides specific assumption numbers, while the TRS board ratifies those assumptions. The board does not have the authority to change or not follow the assumptions.

In response to a question from Senator McDaniel, Mr. Barnes testified that dropping 2016 returns off of the valuation and adding 2021 returns would lead to less pressure on the general fund.

With no further business to come before the committee, the meeting was adjourned at 2:55 p.m.