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Budget Reserve Proposals

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented to:
The Legislature

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Presentation Outline

- What are some of the key challenges for California's state budget process?
- How do the two reserve proposals (ACA 4 and the Governor's proposal) try to address these issues?
- What are some of the implementation issues that the Legislature will want to consider related to the proposals?
  - For example, how much of the focus of this type of this type of measure should be on purposes other than building reserves (such as paying for debt or infrastructure)?
- How would the proposals affect the balance of power between the Legislature and the Governor?
- What is the role of capital gains in state budget volatility?
- What are some other alternatives to the two current proposals?
- At the conclusion of this handout, we provide simplified summaries of the current rainy-day fund procedures, ACA 4, and the Governor's proposal.

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California's Budget Process: Background

☑ **State Currently Has Two Reserves**

- California now has two state budget reserves: the Special Fund for Economic Uncertainties and the Budget Stabilization Account (BSA, created by Proposition 58 in 2004).
- Proposition 58 requires 3 percent of General Fund revenues to be deposited into the BSA until its balance reaches the higher of $8 billion or 5 percent of General Fund revenues. Transfers can be suspended or reduced by order of the Governor.
- Funds in the reserves can be transferred to the General Fund through a majority vote of the Legislature and approval of the Governor.

☑ **Proposition 98 Minimum Guarantee**

- Proposition 98 establishes funding requirement for schools and community colleges, known as the minimum guarantee.
- Minimum guarantee set by one of three formulas, known as Test 1, Test 2, and Test 3.
- Proposition 98 allows school and community college funding to grow slower than the economy in some situations, but creates requirement—known as maintenance factor—to accelerate funding in future years. The administration estimates outstanding maintenance factor of $7.9 billion at end of 2013-14.

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California's Budget Process: Key Issues

☑ **Significant Revenue Volatility**

- Capital gains responsible for a part of this volatility.
- In general, volatile income sources are concentrated among taxpayers paying highest income tax rates.

☑ **Complex Proposition 98 Formulas a Major Factor in Budget Decisions**

- Some counterintuitive results. (For example, decreases in state revenue sometimes lead to increases in the Proposition 98 minimum guarantee.)
- On the margin, minimum guarantee can sometimes increase more than state revenue increases.

☑ **Poor Track Record in Setting Aside Reserves During "Good Times"**

- In the past, a tendency to commit to ongoing spending or tax relief commitments when times are good.
- From 2008-09 through 2011-12, state's combined reserves had multibillion-dollar *negative* balances.
- The higher school spending requirements generated by revenue increases can make it difficult to build reserves.

The Two Budget Reserve Proposals

☑ **ACA 4**

- Aims to set aside funding each year for infrastructure or paying down bond debt.
- Aims to deposit 1.5 percent of General Fund revenues to a reserve when times are good, plus extra amounts when available resources exceed (1) a 20-year regression estimate or (2) the prior year's spending adjusted for population and inflation.
- Required deposits would stop when reserve balance reaches 10 percent of General Fund revenues.
- Does not directly change Proposition 98 funding requirements.
- Allows use of reserves when budget resources are not enough to fund last year's General Fund spending adjusted for population and inflation.
- Generally allows use of no more than 50 percent of the reserve in one year.

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The Two Budget Reserve Proposals
(Continued)

☑ **Governor's Proposal—Main Rainy-Day Reserve**

- Focuses on revenue volatility caused by annual changes in capital gains taxes.
- After funding Proposition 98 and optional payments on certain state debts, portion of taxes in strong capital gains years would go to a rainy-day reserve. Deposits would stop when this reserve reaches 10 percent of General Fund tax revenues.
- Governor must declare budget emergency in order for state to use rainy-day reserve funds.
  - One type of budget emergency under proposal: when resources for non-Proposition 98 spending grow slower than inflation and population growth.
  - Allows use of no more than 50 percent of the main rainy-day reserve in first year of a budget emergency.

☑ **Governor's Proposal—Proposition 98 Reserve**

- A separate Proposition 98 reserve created by the measure could grow to 10 percent of the Proposition 98 guarantee—totaling about 6 percent of General Fund revenues.
  - Funding only would be deposited in Proposition 98 reserve if (1) Test 1 is operative, (2) total school funding has been increased for enrollment growth and the higher of two cost-of-living factors, and (3) maintenance factor created before 2014-15 has been retired.
  - Allows entire Proposition 98 reserve to be used in first year of a budget emergency. Funds can be withdrawn up to the amount needed to cover enrollment and cost-of-living growth.
  - The amount of annual deposits is capped at the difference between the Test 1 and Test 2 levels.

The Two Budget Reserve Proposals

(Continued)

☑ **Key Strengths of Both Proposals**

- ***Both Save for a Rainy Day.*** Both proposals aim to take budgetary resources "off the table" in strong revenue years, saving them for a rainy day.
- ***Both Create a Bigger Rainy-Day Reserve.*** Both proposals increase the target size of the state's key rainy-day reserve to about 10 percent of General Fund revenues.
  - In addition, the Governor's measure creates a separate Proposition 98 reserve that hypothetically could grow to about 6 percent of state General Fund revenues.
- ***Both Aim to Limit Use of Reserve in First Year of Downturn.*** Both proposals limit the use of rainy-day reserves during at least the first year of a budget downturn. Therefore, all the reserves could not be used at once.
- ***Both Aim to Reduce Severity of Future Budget Deficits.*** Both proposals aim to reduce the likelihood that ongoing spending commitments will outpace revenues during future economic downturns.

Implementation Issues for Legislative Consideration

☑ **More Complexity for an Already Complex Budget Process**

- Both proposals require complex computations. It is uncertain how these computations will affect state budgeting in the future.

☑ **ACA 4's Regression Potentially Difficult to Administer**

- Reliable data does not currently exist to administer the ACA 4 regression model.
- The model would be affected by subjective judgments concerning past tax policy changes.

☑ **Governor's Capital Gains Formulas Require Subjective Judgments**

- The Governor has emphasized how poorly equipped the state is to estimate capital gains revenues. We agree.
- Yet, his proposal relies on such estimates. These estimates rely on subjective judgments that could increase or decrease initial reserve deposits, compared to those intended by the measure.
- Two subsequent years of capital gains "true ups" would mean that even more *prior-year* budget numbers (in addition to Proposition 98 and revenue accruals) are changing even as the Legislature tries to balance *next year's* budget.
- In recent decades, a year with 6.5 percent of taxes from capital gains has been a *below average* capital gains year. We do not know what an average year will be in the future. If the Legislature wishes to adopt such a calculation, a different threshold percentage could be considered.

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Implementation Issues for Legislative Consideration *(Continued)*

☑ **Both Measures Use Funds for Purposes Other Than Building Reserves**

- ACA 4 dedicates funds that otherwise could go to reserves to state infrastructure spending.
  - The text of ACA 4 could be read to allow some of these funds to be used for regularly scheduled bond principal payments that the state would be paying in any event.
- The Governor's proposal allows funds to be used for certain wall of debt, infrastructure, or extra pension and retiree health payments, rather than building reserves.
  - Ongoing *annual* payments are needed to address pension and retiree health funding needs (such as those of CalSTRS) rather than unpredictable payments of capital gains from this type of mechanism.

☑ **Deposits Into Proposition 98 Reserve Unlikely Under Governor's Proposal**

- Deposits can occur only in Test 1 years, which historically have been rare (operative twice in the last 24 years).
- Based on our latest forecasts, the state is unlikely to retire outstanding maintenance factor within the next five years—meaning no deposits would be made during this time even if Test 1 were operative.
- Even if Test 1 is operative and existing maintenance factor is retired, state must fund enrollment and higher of two cost-of-living factors before depositing residual. Providing adjustments for cost of living are prioritized over deposits into reserve.

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Capital Gains Only Partially Responsible for Volatility

General Fund Major Revenues, Change From Prior Year

- Capital gains *are* very volatile.
- Even if capital gains were not taxed, state revenues would be volatile under current tax system, as shown in the above figure.

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Capital Gains Only Partially Responsible for Volatility *(Continued)*

- Other General Fund revenue components also are volatile, but not addressed directly in Governor's measure:
  - Business profits (taxed under either corporate or personal income tax).
  - Other investment income.
  - Bonuses and options.
  - Taxable sales of durable goods, vehicles, and building materials.
- High-income taxpayers—taxed at the highest rates—receive much of these volatile income sources. Concentration of income among those taxed at higher rates has helped spur both revenue growth and volatility over time.

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The Balance of Power

☑ "Power of the Purse" a Fundamental Legislative Power

- Governor able to veto items of appropriation, but Legislature can override vetoes with two-thirds vote.
- Otherwise, a majority of the Legislature generally controls state spending, including appropriations from the existing Proposition 58 reserve.
- The power of the purse is perhaps the preeminent power of California's Legislature.

☑ Both Measures Designed to Constrain Legislature's Spending Power

- By requiring money to be taken off the table in strong revenue years, both measures aim to constrict the ability of the Legislature to spend state tax revenues in certain circumstances.

The Balance of Power *(Continued)*

☑ **Differing Gubernatorial Powers Under the Two Measures**

- ACA 4 allows use of reserve funds in certain weaker revenue years. By declaring an emergency under Article XIII B of the State Constitution, however, the Governor could allow the Legislature to move reserve funds to the General Fund in some additional circumstances.
- Under the Governor's proposal, the Governor would have to declare a budget emergency before such a reserve withdrawal would occur.
- ACA 4 delegates various formula calculations to the executive branch. While the Legislature would have to include the key formula calculations under the Governor's measure in each budget act, these complex formulas inevitably would require detailed expertise from executive and/or legislative staff members.
  - Under the Governor's measure, annual budget debates may focus on what level of capital gains to assume, despite the Governor's prior insistence that the state is poorly equipped to project these gains.

An Alternative: Amendments to Proposition 58

☑ **Build on the Strengths of Proposition 58**

- In his 2014-15 budget proposal, the Governor allows Proposition 58 to work exactly as intended—with a planned deposit to the rainy-day reserve and a final repayment on the state's deficit bonds.

☑ **Expand Size of Rainy-Day Reserve**

- Proposition 58 could be amended to increase the size of the reserve, similar to provisions of both ACA 4 and the Governor's proposal.

☑ **Restrict Frequency of Suspensions/Reductions of Reserve Deposits**

- Proposition 58 could be amended to limit the number of suspensions and reductions of reserve deposits to a fixed number in every rolling ten-year period.

☑ **Restrict Frequency of Reserve Withdrawals**

- Similarly, Proposition 58 could be amended to limit the number of reserve withdrawals in every rolling ten-year period and/or to limit the amount that can be withdrawn in any one year, similar to both ACA 4 and the Governor's proposal.

☑ **Ensure Reserve Deposits Consistent With Annual Budget Agreements**

- Currently, Proposition 58 requires the Governor to decide whether to suspend or reduce rainy-day reserve deposits no later than June 1. Yet, the Legislature passes the annual budget on June 15, and the Governor signs the budget plan on or before July 1. Proposition 58 could be amended to allow the Governor to alter his initial determination on or before July 1 to ensure the rainy-day reserve deposit plan is consistent with the enacted budget plan.

Existing Rainy-Day Reserve Process (Proposition 58)

Rainy-Day Reserve Deposit

June 1: Governor decides whether to suspend or reduce the annual rainy-day reserve deposit of 3% of General Fund Revenues.[a]

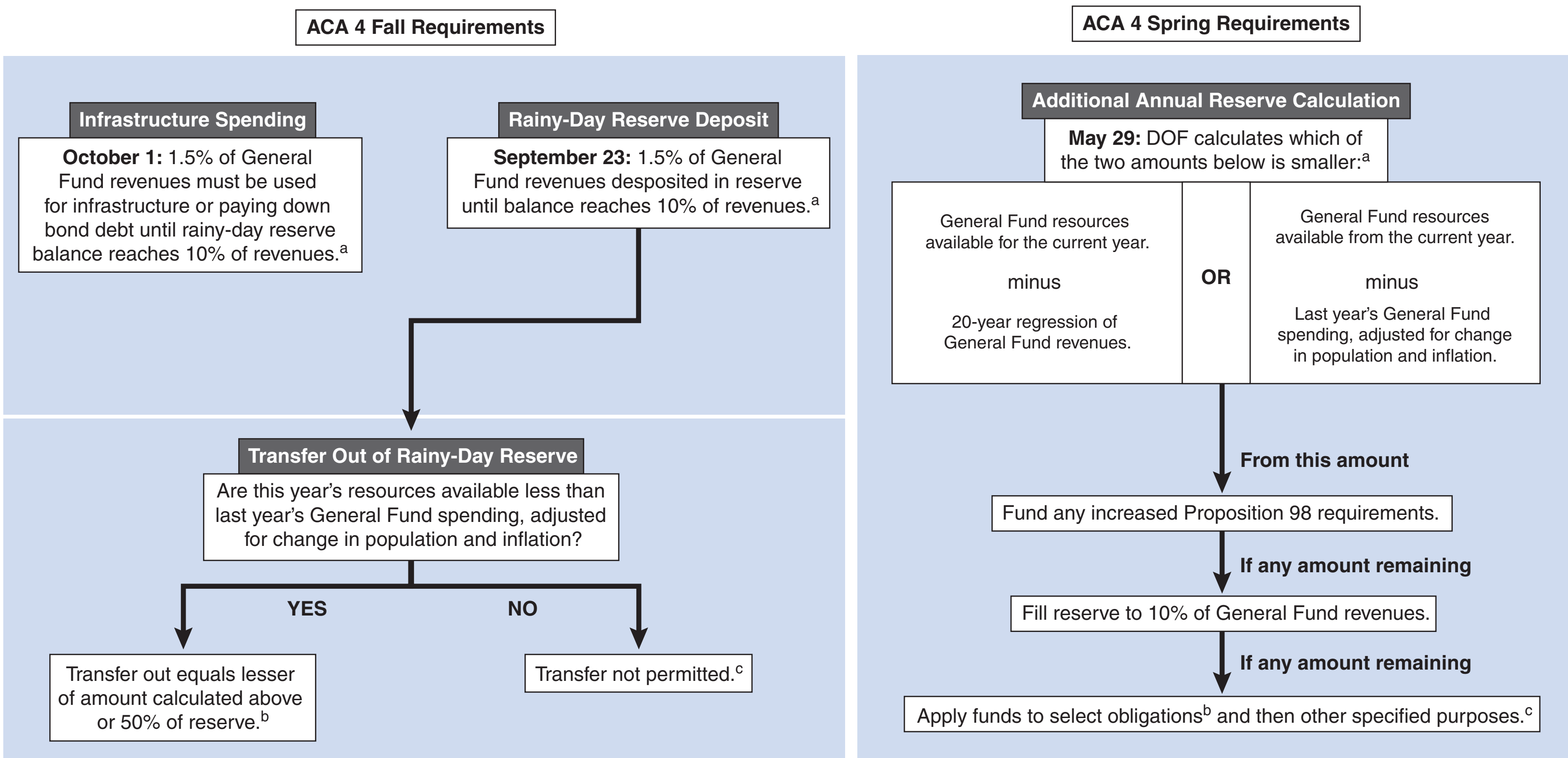
September 30: Based on Governor's decision, deposit—if any—is transferred to rainy-day reserve.

Transfer Out of Rainy-Day Reserve

Funds transferred back to the General Fund with majority vote of the Legislature.

[a] Once balance of rainy-day reserve reaches the greater of $8 billion or 5 percent of General Fund revenues, deposits to the reserve are no longer required.

ACA 4 Summary



[a] Deposit can only be suspended or reduced by executive order in years in which a transfer out of the reserve is permitted.

[b] If transfers out of the reserve were allowed in both of the two preceding fiscal years, transfer out can be up to the amount calculated in the previous box.

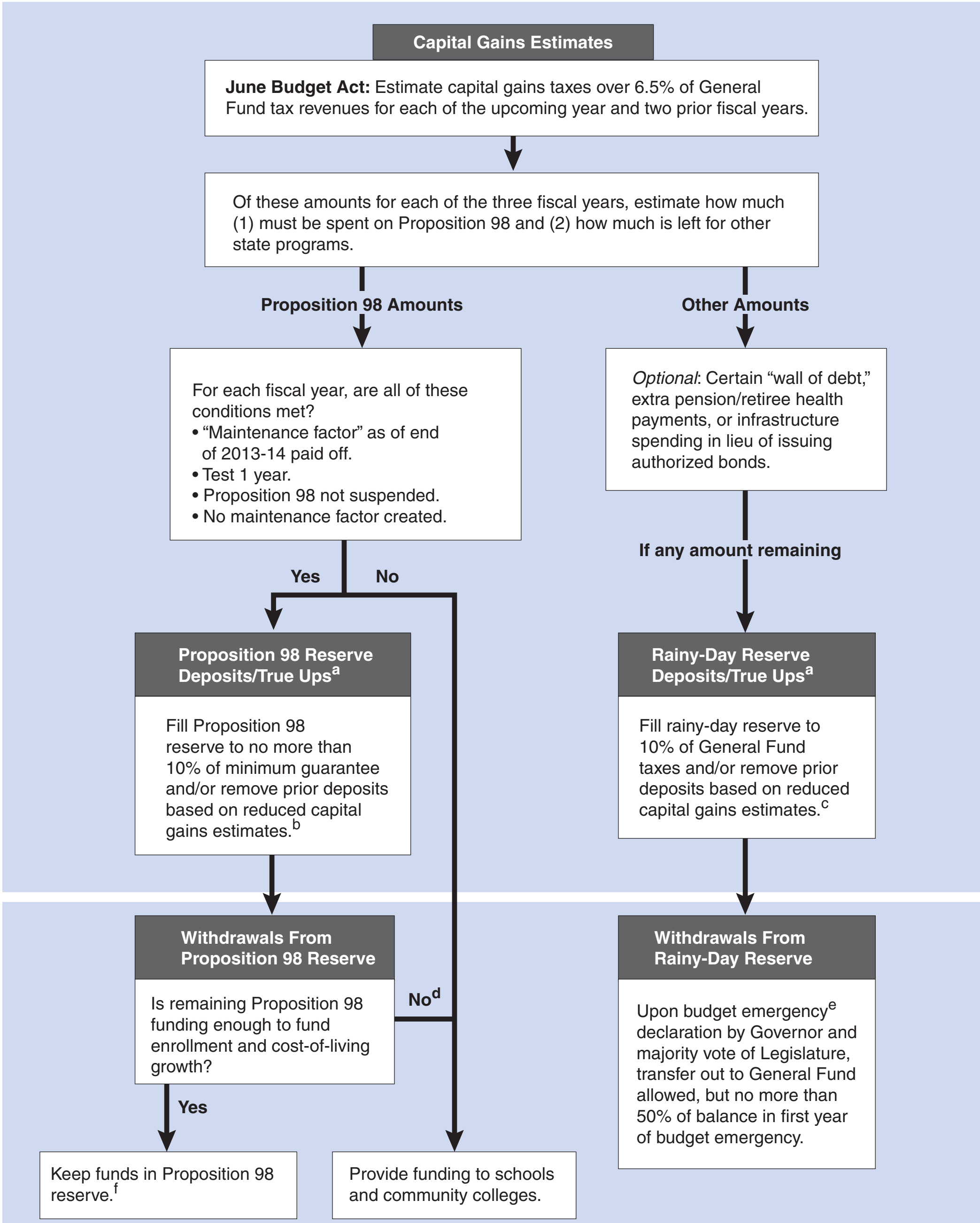
[c] Upon executive order of the Governor declaring an emergency under Article XIII B of the Constitution, any amount needed to respond to the emergency can be transferred out of the reserve.

[a] If amounts are less than zero, no further action is required.

[b] Includes Proposition 98 "settle-up" and Transportation Investment Fund borrowing.

[c] Includes building reserve past 10 percent, one-time infrastructure/capital outlay, reducing general obligation or other bonded indebtedness, one-time tax relief, or reducing unfunded liabilities for "vested" retiree health benefits.

Initial Summary of the Governor's Reserve Proposal



[a] Upon budget emergency declaration by Governor and majority vote of Legislature, deposits may be suspended or reduced. Proposition 98 reserve deposits are made, provided that school enrollment and cost-of-living growth are already funded.

[b] Once this reserve reaches 10 percent of Proposition 98 guarantee, increased school funding requirements related to these capital gains taxes flow to schools. Reserve deposit capped at difference between Test 1 and Test 2 funding levels.

[c] Once the rainy-day reserve reaches 10 percent of General Fund taxes, the capital gains taxes covered by this part of the measure may be spent for infrastructure, deferred maintenance, or to pay down/avoid debts listed in the "optional" box above.

[d] Withdraw funds to cover enrollment and cost-of-living growth.

[e] Budget emergency defined as: (1) emergency pursuant to Section 3 of Article XIII B of the Constitution (including natural disasters), (2) emergency pursuant to Section 10 of Article IV of the Constitution (Proposition 58 fiscal emergency), or (3) a determination by the Governor that available resources for non-Proposition 98 spending in the next fiscal year will not be more than the prior year's non-Proposition 98 spending adjusted for population growth and inflation.

[f] Upon budget emergency declaration by Governor and majority vote of the Legislature, transfer out for school funding purposes allowed.