

AUGUST 6, 2024

Oversight of Budget Reserves

PRESENTED TO: Assembly Committee on Budget
Hon. Jesse Gabriel, Chair



LEGISLATIVE ANALYST'S OFFICE

California's Budget Reserves

Special Fund for Economic Uncertainties. The state's main discretionary reserve and the budget's end balance. Unanticipated revenues automatically benefit this account, and large unanticipated expenditures reduce its balance. The actual balance in this fund fluctuates substantially based on revenues, but has recently been set around \$3 billion at budget enactment.

Budget Stabilization Account (BSA). The state's only constitutional, general purpose reserve account, also known as the rainy-day fund. Constitutional deposits to (and withdrawals from) the BSA are governed by the rules of Proposition 2 (2014). The balance in the BSA reached around 12 percent of General Fund revenues in 2022-23, but a withdrawal was used to cover part of this year's budget problem. The balance is now \$17.6 billion.

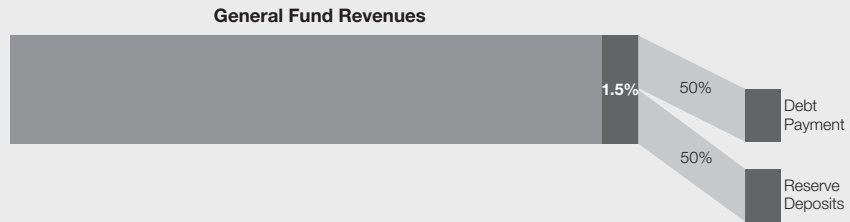
Other Reserves.

- ***Public School System Stabilization Account (Proposition 98 Reserve).*** The constitutional reserve dedicated to schools and community colleges, as funded by Proposition 98 (1988). Constitutional deposits to (and withdrawals from) the Proposition 98 Reserve are also governed by the rules of Proposition 2. Most of the over \$8 billion balance was used in this year's budget.
- ***Safety Net Reserve.*** A statutory reserve set aside specifically for expenses associated with Medi-Cal and the California Work Opportunity and Responsibility to Kids program during a downturn. The entire \$900 million balance was used in this year's budget.
- ***Budget Deficit Stabilization Account.*** A statutory, general purpose reserve established in 2018, which was only briefly funded.

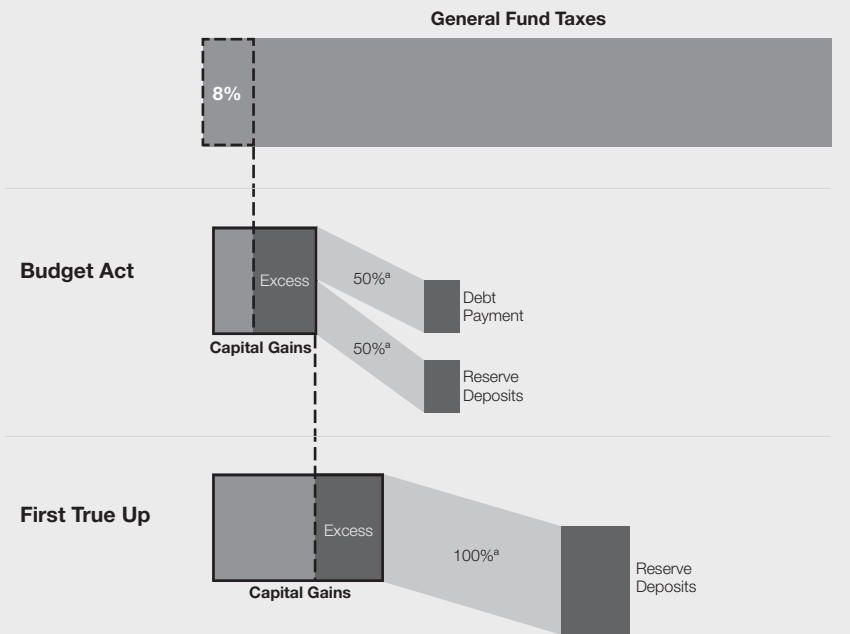


How Proposition 2 Works

Base Amount



Excess Capital Gains



^a Amount reduced by "Proposition 98 increment."
 Note: Second true up not shown.

LAO



Three Questions to Consider When Evaluating the State's Reserve Policies

Why Does the State Have Reserves? Before considering changes to the state's reserve system, we think it's important to consider the reasons California has reserves in the first place. Given the state's relatively volatile revenue structure, reserves help the state afford its core services, including in health and human services and education, over the long term. Without reserves, booms and busts in revenues are more likely to result in significant surges of spending during the upswings and budget cuts to these and other programs during downturns.

Should the Legislature Ask Voters to Increase the BSA Maximum? The constitutional balance of the BSA is capped at 10 percent of General Fund taxes, but we estimate that the state's revenue losses in the three recessions prior to 2020 (the early 1990s, dot com bust, and the Great Recession), represented around 50 percent of General Fund taxes. We do not necessarily think a BSA of this size is warranted—revenue losses are not equal to budget problems and the state has other tools at its disposal to address budget problems, like cost shifts, and other reserve accounts. However, these figures do stand in stark contrast to the current maximum of the BSA.

Should the Legislature Ask Voters to Make Other Changes to the BSA? Over the last decade, the state experienced a near perfect combination of conditions that led to the BSA's success: a long economic expansion; a low interest rate environment that resulted in strong asset market growth; and, as a result, unprecedented and accelerated growth in capital gains revenues. Yet there is no guarantee that the next decade will look like the last one. Further, capital gains revenues are not the only source of volatility in state revenues—the corporation tax, business income to individuals, and even withholding have exhibited notable volatility in recent years. Although changing the BSA rules would involve trade-offs, we encourage the Legislature to take time to evaluate a range of possible changes. For example, we advise assessing changes that could allow the state to build reserves in disparate types and lengths of economic expansions. This might better position the state to realize the benefits of the BSA seen over the previous decade in the future.

