FEBRUARY 18, 2026

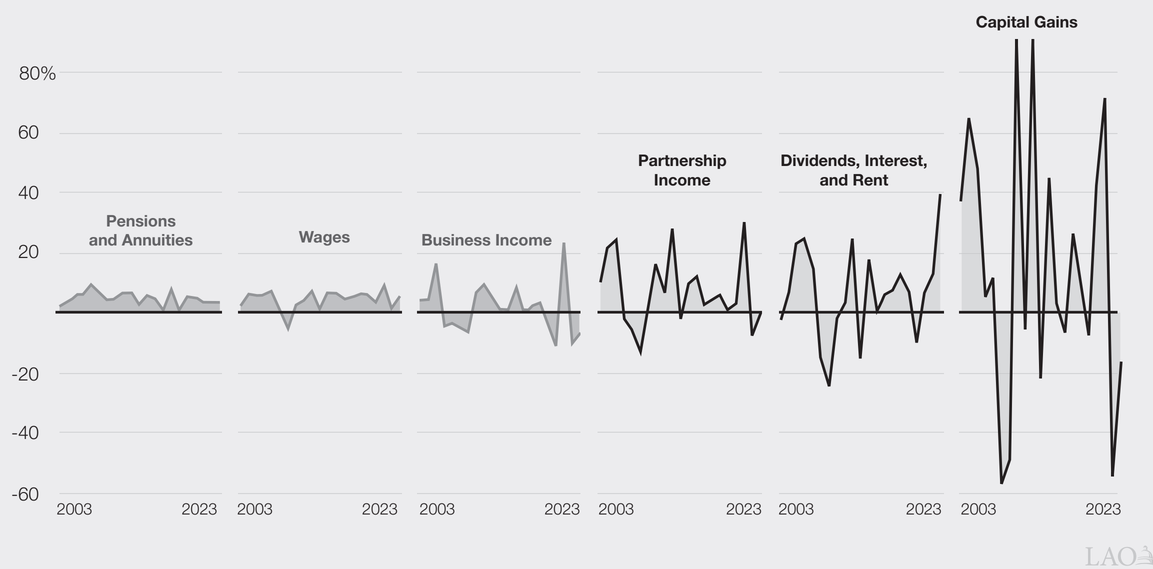
Revenue Volatility and California's Reserve Policy

PRESENTED TO: Senate Committee on Budget and Fiscal Review
Hon. John Laird, Chair

LEGISLATIVE ANALYST'S OFFICE

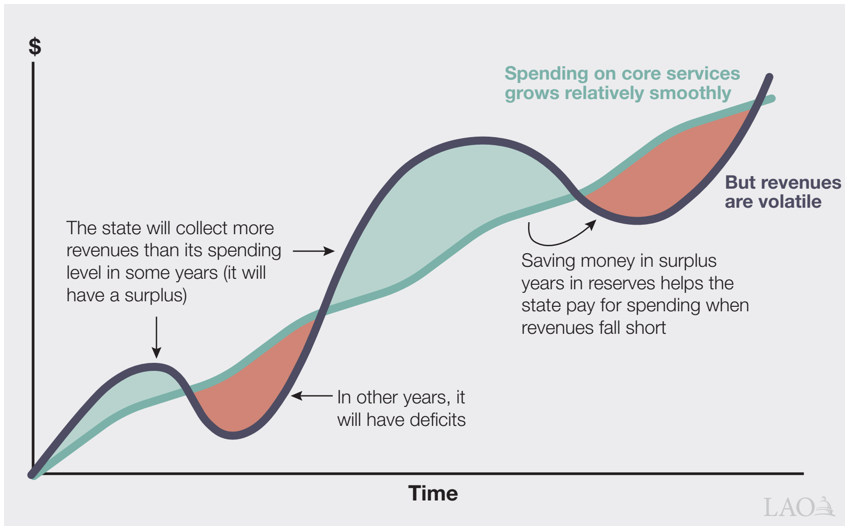
Why Are California's Revenues Volatile?

Recent Volatility of Key Personal Income Tax Components



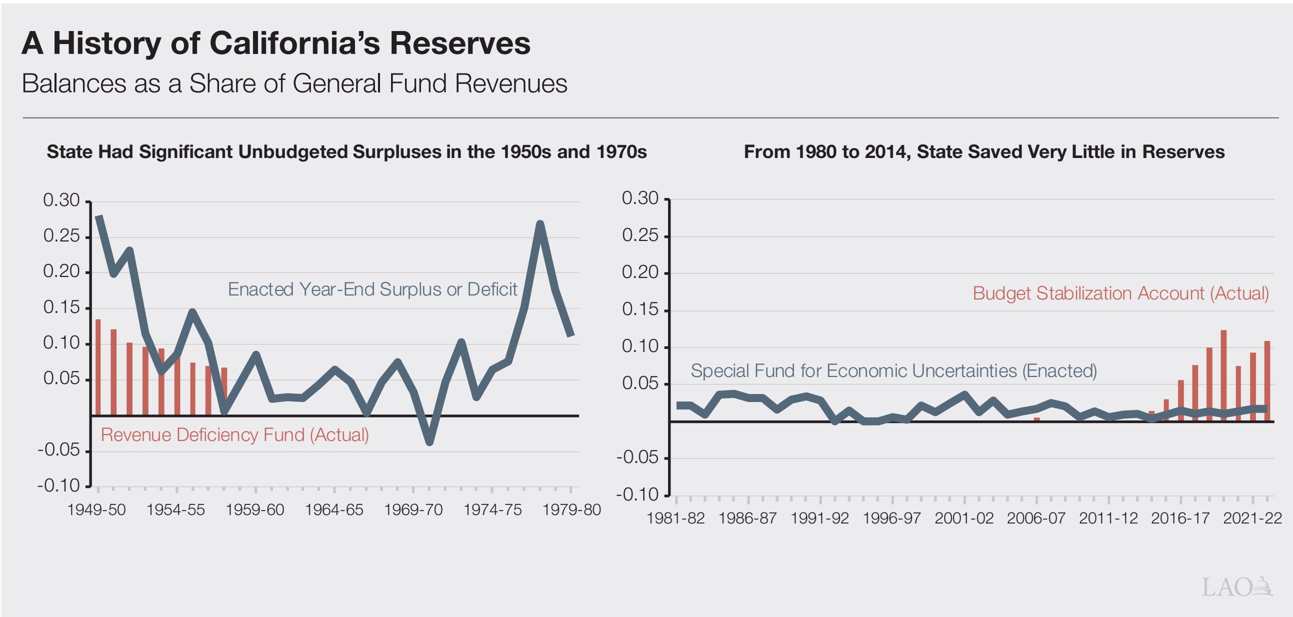
- ***Revenues Are Volatile.*** From year to year, revenues can grow very quickly or contract quickly.
- ***Reasons for Volatility.*** The personal income tax (PIT) makes up most of the General Fund revenues. Taxable personal income is more volatile than the overall economy, primarily because: (1) incomes of high-income taxpayers are more sensitive to changes in the economy and asset markets and (2) the state's progressive rate structure concentrates taxes on these volatile incomes.
- ***Volatility Presents Two Related but Separate Issues.*** Reserves, ideally separate ones, can address two distinct challenges: (1) forecast error, and (2) downside risk.

How Reserves Work



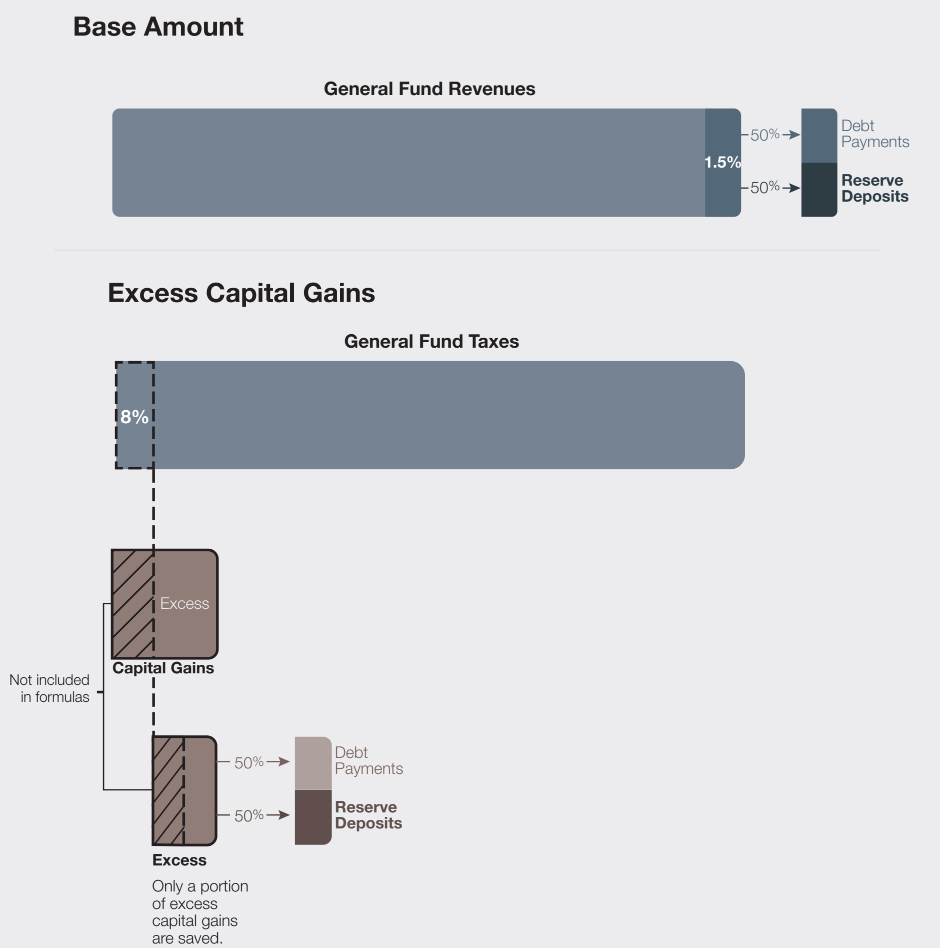
- ***Revenues Are Volatile, but Core Spending Grows Steadily.*** Compared to revenues, the ongoing growth in costs of the state's programs—the core spending level—is much steadier.
- ***Reserves Allow the State to Smooth the Difference.*** Reserves can be saved when revenues are surging and then spent when revenues decline below that long-term trajectory.

History of California's Reserves



- Before 1980, state reserves and surpluses varied widely.
- For over three decades, state had very little in reserves.
- Proposition 2 (2014) substantially improved the state's reserve policy.

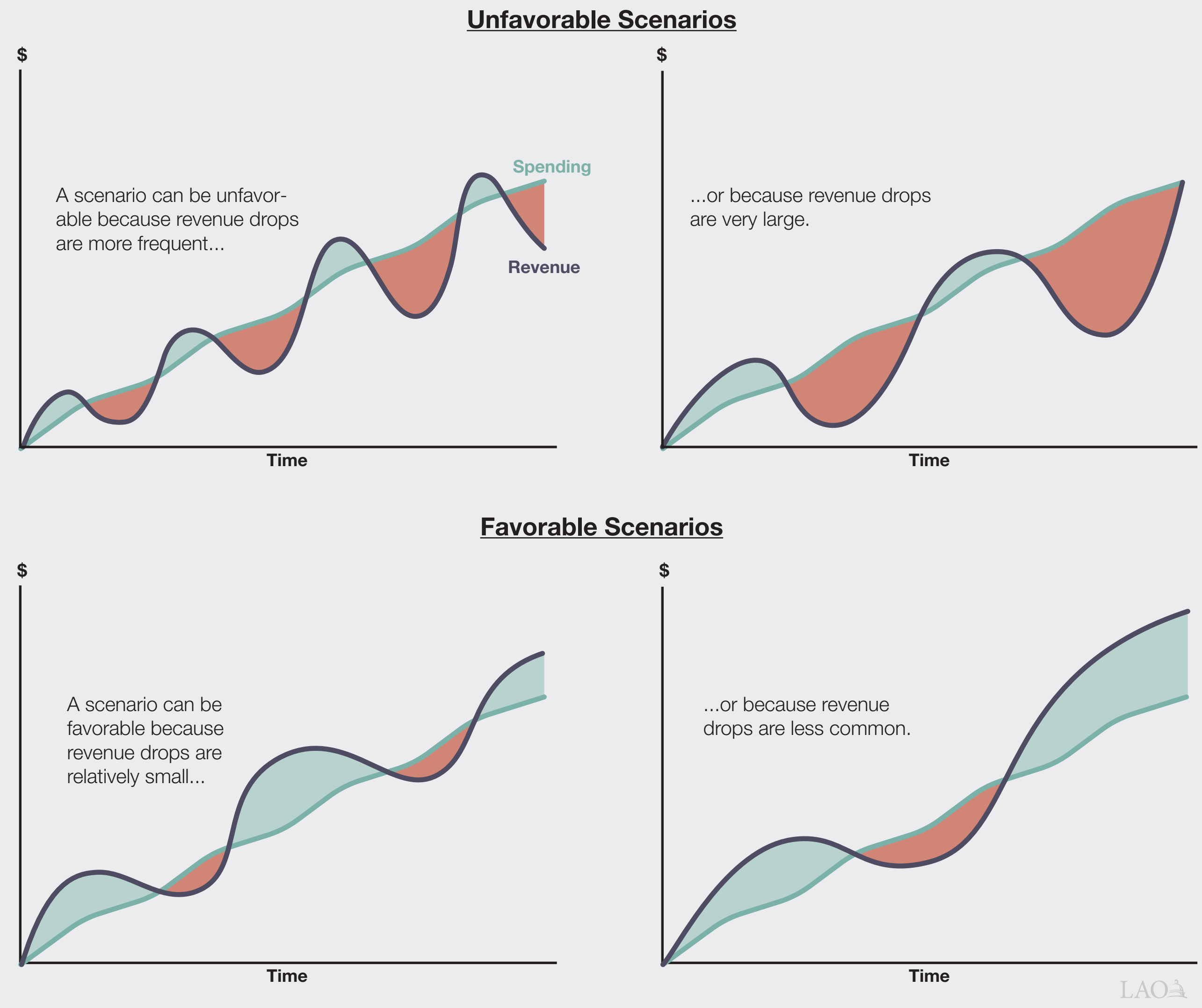
How Proposition 2 Works



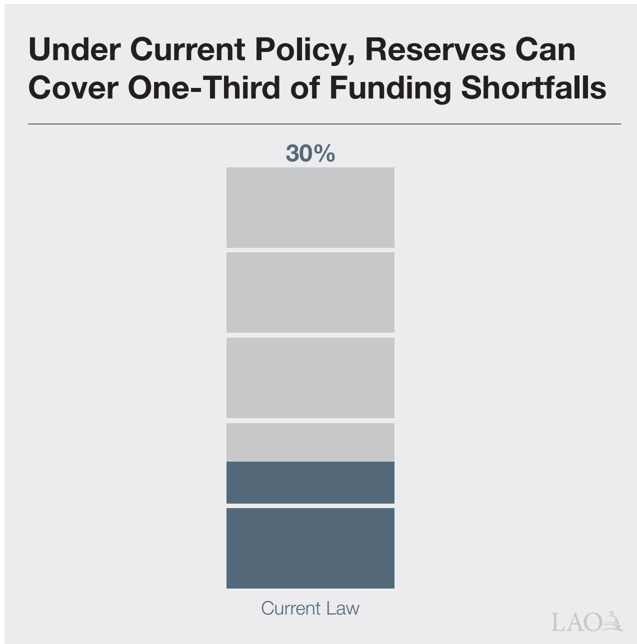
Note: For simplicity, this figure does not show the mechanics of true ups and downs.

How Should We Evaluate California's Reserve Policy?

Future Scenarios Can Vary Widely

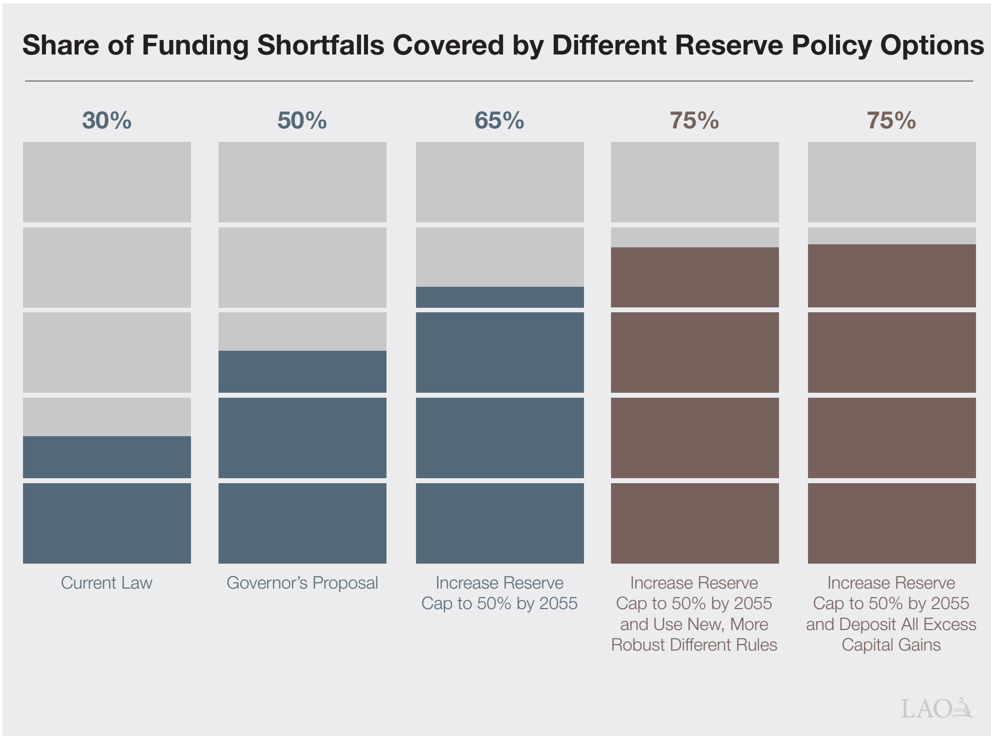


Limitations of the Current Reserve Policy



- A reserve policy "performs well" if it meets the central goal of reserves—that is, it allows the state to save enough so that the state can pay for spending on its core services when revenues drop.
- Our analysis uses simulation-based tools—similar to those used in insurance markets and the state's pension system—that use information about the past to forecast many different variations of the future. These are reported across 50 years and thousands of simulations.

LAO Recommendations



LAO Recommendations

- ***Raise the Cap to 50 Percent by 2055.*** The increase could be phased in over time: 20 percent to take effect immediately after the next statewide election, 25 percent in 2030, and increasing by 5 percent every five years until the cap reaches a maximum of 50 percent in 2055.
- ***Options to Reach This Higher Threshold.*** If the cap is raised, the state would also need to set aside more in reserve deposits to dependably reach this higher amount. We present two alternatives to achieving this:
  - ***Create New, More Robust and Flexible Deposit Rules.***
  - ***Keep Existing Formulas but Set Aside All Excess Capital Gains.***