California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

ROOM 5019, STATE CAPITOL
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Agenda

May 14, 2014
3:30 p.m. – John L. Burton Hearing Room 4203

State Reserve Fund Proposed Constitutional Amendment

I. Opening Remarks

II. Presentation By:

- Keely Bosler, Chief Deputy Director, Department of Finance

III. Closing Remarks

IV. Public Comment

Senate Committee on Budget and Fiscal Review
Background Paper

Proposed Constitutional Amendment
State Budget Reserve

Summary

In conjunction with his January Budget, the Governor proposed a new budget reserve policy that would supplant the language governing the existing Budget Stabilization Account (BSA) as specified in the Constitution. The measure would also replace ACA 4 (Gatto and Niello), Chapter 174, Statutes of 2010, currently on the November 2014 ballot. The new version of the proposed budget reserve has been modified in several ways from the Governor's original proposal in response to legislative and stakeholder concerns. Below is presented information regarding: (1) the Governor's original proposal and the modified version of this proposal; (2) a brief outline of the state's current reserves and related background information; and, (3) staff comments on the proposal.

Overview of Budget Reserve Proposal

<u>Governor's January Proposal</u>

In his budget, the Governor proposed a constitutional amendment to create a new reserve policy which largely built off of the existing BSA. The Governor's reserve proposal included the following provisions:

- Require deposits to the budget reserve of tax revenues from capital gains that are in excess of 6.5 percent of General Fund tax revenues (after funding of Proposition 98 and certain other payments). The deposit would be estimated in year 1, then subject to subsequent true-ups (positive or negative) in years 2 and 3 in order to square the original estimate with actual tax liability data.

- Create a Proposition 98 reserve equal to 10 percent of the Proposition 98 guarantee, whereby spikes in funding related to capital gains would be retained for future years of decline, smoothing school spending to prevent damaging cuts, while making no changes to the Proposition 98 guarantee. Deposits would be made after required increases in enrollment growth and cost-of-living and once the current maintenance factor was paid.

- Double the maximum size of the budget reserve from five percent to 10 percent of revenues, and allow supplemental payments to the "wall of debt," or other long-term liabilities, in lieu of a year's deposit. Restrict uses of revenues that would otherwise be available to certain onetime uses, such as debt obligations, in the event the reserve fund reaches the maximum funding level.

- Provide that budget reserve withdrawals or deposit suspensions would require a gubernatorial finding of a budget emergency (natural disaster, fiscal emergency, or an inability to fund programs at an adjusted current year level). Limit the maximum amount that may be withdrawn during the first year of a recession to half of the fund's balance, ensuring that the state does not overly rely on the fund at the start of a downturn.

Modified Reserve Proposal

As a result of legislative and stakeholder input, the Administration has agreed to alter the structure and design of the proposed budget reserve fund. These changes would affect both the base of deposits to the reserve, the use of funds that would otherwise go to the reserve, as well as when the reserve may be drawn upon or deposits suspended. The principal, non-technical, modifications to the proposal are:

- **Deposits to the Reserve.** Instead of basing deposits entirely on capital gains, the modified proposal requires that the primary source of the budget reserve is an annual deposit of 1.5 percent of General Fund revenues. Tax revenues derived from capital gains would be directed to the budget reserve when, and only to the extent, these revenues were in excess of 8.0 percent of General Fund revenues ("excess capital gains"). The design of the reserve maintains the true-up provisions, but by substantially lessening the reliance on excess capital gains in most years, the approach incorporates much more certainty in funding the budget reserve and would minimize potential budgeting disruptions in subsequent years.

- **Alternative Use of Reserve Funds.** Under the original proposal, up to 50 percent of the revenues that would otherwise be destined to be deposited in the budget reserve, *could* be appropriated by the Legislature for paying down debt, budget loans, mandate costs, and pension liabilities. The revised proposal would instead *require* that 50 percent of the funds that would otherwise be deposited in the reserve instead be used to pay for such costs for 15 years, through 2029-30. This provision would provide for additional General Fund flexibility in funding programs, while still providing a mechanism to establish a solid budget reserve.

- **Reserve Withdrawals and Deposit Suspensions.** Under the original proposal, fund withdrawal and deposit suspensions were restricted in a manner that would reduce the state's ability to attain pre-recession spending levels. The revised approach allows for withdrawals or deposit suspensions in order to provide for General Fund expenditures up to the highest level of the previous three years, including growth in population and adjustments for cost-of-living. This will allow for the ability of state programs to recover and not be limited to an artificially depressed level of funding based on current year expenditures.

The Department of Finance has provided preliminary estimates, based on the May Revision, regarding the deposits that would be required to be made to the reserve fund, as shown below:

New Reserve Policy
at 2014-15 May Revision
(Dollars in Millions)

		2015-16	2016-17	2017-18
	1.5% under Prop 58			
1	General Fund Revenues and Transfers	$113,224	$118,169	$123,605
2	Prop 58 Transfer (1.5% of General Fund Revenues & Transfers)	$1,698	$1,773	$1,854
	Capital Gain Revenues			
3	General Fund Tax Proceeds	$113,011	$117,803	$122,706
4	Personal Income Taxes from Capital Gains	$9,409	$9,933	$10,471
5	% of General Fund Tax Proceeds	8.3%	8.4%	8.5%
6	8% of General Funds Tax Proceeds	$9,041	$9,424	$9,816
7	Personal Income Taxes from Capital Gains in Excess of 8% General Fund Tax Proceeds	$368	$509	$655
8	Prop 98 Share of Capital Gains Tax Revenue above 8%	$194	$276	$314
9	Non 98 Share of Capital Gain Tax Revenue above 8%	$174	$233	$341
10	Total Available for Rainy Day (Lines 2 and 9)	$1,872	$2,005	$2,195
11	**Debt Repayment (50%)**	**$936**	**$1,003**	**$1,097**
12	**Deposit to Rainy Day Fund (50%)**	**$936**	**$1,003**	**$1,097**
	Cumulative Balance in Rainy Day Fund [1/]	**$2,540**	**$3,543**	**$4,640**

[1/] Includes balance of $1,604m from 2014-15.

Source: Department of Finance

Background on State Budget Reserves

California's Current Budget Reserves

Special Fund for Economic Uncertainties. Article XIII B, Section 5.5, of the California Constitution directs the Legislature to establish a 'prudent' reserve that it deems reasonable and necessary. However, the Constitution does not specify the size of the reserve or the conditions under which funds must be placed into the reserve. The reserve for 2013-14 was budgeted at $1.1 billion upon the adoption of the budget, and later reduced to approximately $700 million based on additional budget actions related to corrections. This general reserve is known as the Special Fund for Economic Uncertainties (SFEU).

Budget Stabilization Account. In addition to this regular annual reserve, voters established an additional reserve account, the Budget Stabilization Account (BSA), with the passage of

Proposition 58 in March of 2004. The proposition requires that three percent of estimated annual General Fund revenues be transferred into the BSA, beginning in 2008-09 and continuing thereafter. Transfers to the BSA are required until the account balance reaches $8.0 billion or five percent of General Fund revenues, whichever is greater. The annual transfer requirement is in effect whenever the balance in the BSA falls below either the $8.0 billion or the five percent threshold. During the time the Economic Recovery Bonds (ERBs) issued by the previous administration are outstanding, 50 percent of the annual transfers to the BSA are to be used for paying off the bonds.

Spending from the fund may occur by transferring moneys from the BSA to the General Fund through a majority vote of the Legislature and approval of the Governor. In addition, there is significant flexibility regarding transfers to the BSA, with the ability to suspend or reduce such transfers for a fiscal year by an executive order. The state deposited funds to the reserve twice (in 2006-07 and 2007-08) but subsequently used the funds during each of those years. The state has suspended the transfer of moneys to the BSA since that time and the BSA currently has a zero balance. The budget proposed by the Governor includes a deposit of three percent of General Fund revenues, which, after payment on the ERBs, would bring the balance in the BSA to $1.6 billion.

Reserve Proposal on November Ballot

Assembly Constitutional Amendment 4. In 2010, the Legislature approved ACA 4 (Gatto and Niello), Chapter 174, Statutes of 2010—a constitutional amendment establishing an additional state reserve requirement. The originally scheduled placement on the June 2012 ballot was later changed pursuant to SB 202 (Hancock), Chapter 558, Statutes of 2011, which shifted the placement of the amendment to the November 2014 ballot.

ACA 4 would tighten up certain aspects of the BSA account requirements in the following manner:

- Limit the ability of the Governor to suspend three percent annual transfers to the BSA.

- Increase the target amount for the BSA from five percent to 10 percent of revenues, and eliminate the $8.0 billion threshold.

- Divide evenly the three percent transfer into the BSA and Supplemental BSA (capital and debt service).

- Limit use of ‘unanticipated revenues’ to Proposition 98 (K-14 education) obligations and transfers to BSA.

- Restrict withdrawals from the BSA to emergencies and years of insufficient revenue, not to exceed 50 percent of fund balance.

- Provide a limited menu of uses for revenue amounts that are received over the cap, including additional deposits to BSA, debt reduction, or tax rebates.

Legislative Analyst's Office Perspective on Budget Reserves

The Legislative Analyst's Office (LAO) has been consistent in its view that the state should increase the level of its reserves, urging the incorporation of regular contributions, as well as one-time revenues, in this effort. In its previous reviews of the state's reserve policies, the LAO has recommended building off of the framework of Proposition 58, which established the BSA, and layering additional requirements that would make the establishment and maintenance of the reserve more robust. In general, some of the LAO's views are congruent with many of the changes to the BSA that are found in the current version of ACA 4; however, there are several aspects of the ACA 4 proposal about which it has raised concerns. Some of these same concerns have been raised by the LAO with respect to the Governor's original January proposal.

The LAO has indicated that targeting a 10 percent reserve would be a good long-term goal, even if the process occurs over a number of years, suggesting that the state's volatile revenue structure is an argument in favor of this size of a reserve. In addition, the LAO has noted that the funds in the BSA could be made less accessible, for example by requiring the passage of a separate bill (outside the budget process) or requiring a super majority to approve the withdrawal of funds. It also views favorably the effort to transfer excess revenues into the BSA, but recommends that a relatively high threshold be reached before such 'excess funds' are directed to the reserve.

The LAO has also warned against overly-proscriptive budgetary formulas—especially if placed in the Constitution—warning that such formulas can have significant unintended impacts, are often based on imperfect information, and can result in a diminution of legislative prerogative and a shift in budgetary authority to the executive branch. For example, the LAO notes in particular the potential issues related to ACA 4's linear regression formula, which—while mechanically straightforward—nevertheless requires the incorporation in inputs, adjustments, assumptions—all compiled by the Administration. It cautions that "…(while) the estimates would be subject to legislative review, future governors may well premise their approval of state budget bills on legislative agreement with their administrations' formula calculations."

Staff Comments

The modified budget reserve proposal addresses a number of issues that had been identified in legislative hearings and over several months of discussion. These alterations will result in improved ability of the state to restore or maintain necessary program funding, provide a more stable and predictable source of deposits for the reserve fund, and improve the budgeting process by reducing the occurrence and magnitude of unanticipated required reserve deposits.

The modified proposal incorporates two important changes that should allow for additional flexibility and latitude in maintaining or restoring public services. First, the measure specifically carves out 50 percent of deposits that would otherwise go to the budget reserve and diverts these to the payment of debt. This avoids the potential of a 'double hit' on the General Fund. Second, the measure allows for a three-year 'look-back' in determining whether a reserve withdrawal or deposit suspension can occur and potentially allow for a higher level of available resources. This feature should decrease the chances of 'locking-in' artificially low spending levels.

The requirement to deposit 1.5 percent of General Fund revenues in the budget reserve moves away from the problematic concept in the original proposal that relied exclusively on excess capital gains-related tax revenues. While the measure does provide for a supplemental deposit to the budget reserve of revenues derived from capital gains realizations income in excess of 8.0 percent of General Fund revenues, this source is expected to be a subordinate component of contributions to the budget reserve, as shown in the table on page 4. This revision implicitly recognizes that revenue components other than capital gains income (bonuses, stock options, corporation taxes, etc.) are also quite volatile by incorporating these revenues in the 1.5 percent deposit.

In addition, the reduced reliance on capital gains (in most years) as a source for reserve funding—which would only be operative in robust periods of capital gains spikes—would eliminate or reduce the impact of a number of technical and fiscal issues that have been raised. Specifically, the revisions would, in most years: (1) reduce the effect on the budget reserve of any changes in federal (or state) tax rates or tax policy that would affect the capital gains base or the realization of these gains; (2) lessen the impact of inevitable misestimations of capital gains tax revenues, minimizing large capital gains true-ups, and facilitating a more certain budgeting process; and (3) make the selection of the capital gains threshold as a percent of General Fund revenues less significant given the subordinate contribution of these revenue sources to the budget reserve.