# California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

ROOM 5019, STATE CAPITOL
SACRAMENTO, CA 95814

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# Agenda

**February 27, 2014**
**9:30 a.m. or upon adjournment of Session**
**Room 4203**

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## *State Budget Reserve Funds; Principles and Alternatives*

### I. Presentation and Analysis of the Governor's Budget Reserve Proposal

Department of Finance

Keely Bosler, Chief Deputy Director
Veronica Chung-Ng, Program Budget Manager
Nick Schweizer, Program Budget Manager

Legislative Analyst's Office

Jason Sisney, Deputy Legislative Analyst
Ryan Miller, Senior Fiscal and Policy Analyst

### II. Multistate Perspective on Budget Reserve Funds

Jonathan Griffin, Policy Analyst, National Conference of State Legislatures, Fiscal Affairs Program
*"Review of Alternative State Budget Reserve Structures"*

Mary Murphy, Senior Researcher, Pew Charitable Trusts
*"Lessons from Budget Reserve Deposit Rule Approaches in Other States"*

**III. Considerations for Structuring a Budget Reserve for California**

Tim Gage, Former Director, Department of Finance, State of California
*"Legislative and Administrative Considerations for Budget Reserves"*

Brad Williams, Senior Partner, Capitol Matrix Consulting
*"Technical Aspects of Reserve Fund Structures"*

Kim Rueben, Ph.D., Senior Fellow, Urban Institute
*"An Analytical Perspective on State Budget Reserves"*

**IV. Public Comment**

# Budget Reserve Funds

## BACKGROUND:

As the state continues its economic and budgetary recovery from the Great Recession, there has been increased focus on how the state might cushion itself against severe budgetary stress in the future. As a result of the economic recession, beginning in fiscal year 2007-08 and continuing through 2011-12, the state was forced to embark on a series of maneuvers designed to balance the state budget. Lacking a meaningful reserve during the last several years of fiscal stress, the state has been forced to rely on several other methods to balance its budget, including mid-year expenditure reductions, internal and external borrowing, tax and fee increases, and contingent expenditure reductions—also known as ‘trigger cuts.’ An earlier period of fiscal stress, beginning in 2002, relied heavily on budgetary borrowing, leading to creation of the Wall of Debt. Each of these approaches to balancing the budget has resulted in significant political, economic and fiscal costs.

Instead of these costly approaches, one of the significant alternative means through which budgetary balancing can be achieved is through establishing and maintaining an adequate budget reserve. Such a reserve—known as a budget stabilization account or a rainy day fund—can simultaneously address multiple budget and policy goals, including:

- Protecting expenditure programs during economic downturns, thus retaining the integrity and continuity of essential government-financed programs.

- Reducing ongoing spending commitments that cannot be sustained over the long-term, avoiding over-commitments and boom and bust funding.

- Avoiding pro-cyclical budget reductions and program curtailments that would otherwise provide economic stimulus and activity during economic downturns.

- Providing permanent improvement in the financial condition of the state by improving credit ratings and lowering borrowing costs.

- Allowing budget planning to occur using reasonable revenue projections by addressing the ‘risk asymmetry’ associated with fiscal forecasting.

Establishing and maintaining a budget stabilization fund is not without its own identifiable drawbacks, including the possibility that such funds could alternatively be used for such items as capital spending or tax reductions. In addition, it is highly unlikely that a reasonably funded reserve would ever be adequate to completely address fiscal challenges of the magnitude experienced in the last few years. Still, most states maintain some type of budget stabilization account, as discussed below, and state fiscal experts are virtually unified in the belief that such set-aside funds should be established and maintained as one of the tools available to states to deal with budget uncertainty. The question for the Legislature is the design of such a budget reserve, given alternative use of funds, the state's revenue system, and political realities.

**State Approaches to Budget Reserves**

According to the National Conference of State Legislatures (NCSL), almost all (47) states have established budget reserve funds. Only Arkansas, Kansas, and Montana do not maintain such reserves. Budget stabilization funds vary in design and purpose from state to state, but their underlying role is to receive deposits when capacity to generate revenue is strong, and use such funds for budgetary relief when revenue generation is weak.

State budget stabilization funds are created either through statutory or constitutional authorization. While most states' budget stabilization funds are statutorily created, 11 states (Alabama, Alaska, Delaware, Louisiana, Missouri, Oklahoma, Oregon, South Carolina, Texas, Virginia and Washington) have constitutionally authorized funds. Five states (Alabama, Alaska, California, Oregon and South Carolina) have one statutorily and one constitutionally authorized budget stabilization fund. Eight states (Alabama, Alaska, California, Iowa, New York, Oregon, South Carolina and South Dakota) maintain at least two separately operating budget stabilization funds. States have often created multiple funds to house certain sources of unanticipated revenues—for example, a one-time carve-out of oil and gas royalty funds or money received from mineral extraction litigation and dispute settlements. In addition, multiple funds can address differences in revenue sources, since personal income, corporate income, sales, motor fuels, and severance taxes all react differently to fluctuations in economic and business cycles.

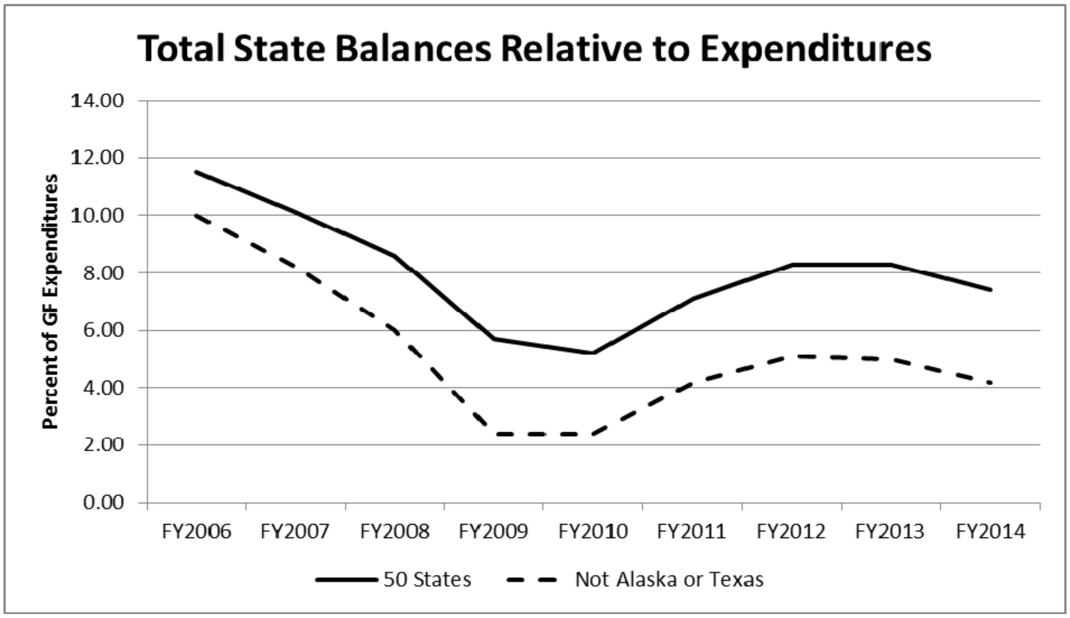
Generally, deposits to a budget stabilization fund stem either from a line-item appropriation in the budget or from a portion of a fiscal year-end surplus. Some states' constitutional or statutory language prescribes what percentage of the surplus must be deposited into the budget stabilization fund. Other states require a deposit of a determined percent of general state revenues each fiscal year—regardless of economic conditions—to the budget stabilization fund until the balance reaches a specified percent of estimated general fund revenues. In other states deposits are triggered when state revenues or economic growth exceed specified levels.

Budget stabilization funds exist to provide stability to state budgets experiencing economic fluctuations; 'revenue shortfall' or 'budget deficit' are the most common conditions for using budget stabilization funds, with 35 states using such a test. Typically, withdrawals are made, pending approval of the legislative body, when revenues are insufficient to meet budget obligations. In 16 states, authorization for a withdrawal requires a supermajority of the legislature. Other states give their governors authority to make transfers from their budget stabilization funds to prevent cash shortfalls that occur during the fiscal year. In a handful of states, withdrawals are triggered when anticipated revenues or other economic indicators fall below specified levels, for example, a withdrawal in order to meet cash flow deficits or when the annual growth rate in personal income is below a certain level. In the event a withdrawal is made, some states have in place a cap, based either on the size of withdrawal or in relation to the fund balance.

Fifteen states require withdrawals to be repaid to their budget stabilization fund. The terms and conditions under which withdrawals must be repaid typically contain a due date for repayment or a statutorily prescribed repayment schedule. For example, in some states, withdrawals must be repaid by the end of the fiscal year in which the withdrawals occurred. In other states, withdrawals must be repaid within a certain number of years of the date the withdrawals occurred. Some outline specific schedules for repayment while others specify that such repayment is to be made only after an upturn in the economy or fiscal position.

The great majority of states limit the size of their budget stabilization funds by capping the funds in relation to state general fund revenues or appropriations. For example, New Jersey limits its reserve to five percent of total anticipated general fund revenues, while Connecticut’s cannot exceed 10 percent of net general fund appropriations for the fiscal year, and Minnesota caps its budget reserve and cash flow accounts at specific dollar amounts. Historically, a reserve capped at five percent of expenditures has been considered the standard recommended level. Among other entities, NCSL and the major rating agencies have suggested or used this as the standard. However, appropriate levels vary according to individual state circumstances, specific economic conditions, revenue profiles, or access to atypical revenue sources. Many analysts caution against "a one-size-fits-all’ approach because of the "heterogeneity among state economic conditions and tax codes.” States with elastic revenue sources, such as California, with its progressive income tax system, might opt for larger balances because revenues from this source tend to display greater fluctuations during economic swings. Since 2000, and especially since the sharp economic downturn, many states have raised the percentage caps on their funds, allowing for their funds to play a larger role in the event of economic and fiscal downturns.

**Use of Budget Stabilization Funds.**
The recent economic and fiscal downturn, from which most states are slowly emerging, provides important lessons regarding design of reserve accounts. Based on surveys by the National Association of State Budget Officers (NASBO), total balances as a percent of General Fund expenditures had reached 11.5 percent in 2006, but plummeted to 5.2 percent by 2010 (and less than half that if Alaska and Texas are excluded). The change in the level of budget reserves is shown in the figure below.




**Source: NASBO Fiscal Survey of States**

Researchers from NASBO, academia, and other organizations have been able to draw several conclusions regarding the role of reserve funds during period of economic decline and fiscal stress. Among the most important of these conclusions are:

- Reserve funds played an essential role in cushioning the effect of revenue downturns. Many states relied on reserve funds to avoid more severe cuts to essential state services and programs.

- Reserve funds were not fully sufficient to withstand the fiscal impacts of the recession. Given the severity of the downturn, this is not surprising, but suggests that larger reserves may be warranted.

- The appropriate level for a reserve fund depends partly on the revenue system. States with more volatile or elastic revenue sources should hold more in a reserve to withstand economic downturns.

- Sources of reserve funds should be considered prior to using them. Using reserves based on required regular contributions, as opposed to one-time windfalls, poses less of a risk of structural imbalance.

- State revenue collections have become more volatile in recent years. States benefit from elastic revenue sources, such as the income tax, but these sources have become more volatile, suggesting that capital gains or other revenues could be used as reserve deposits.

- Budget reductions generally occur along with the use of reserves. Combining the use of budget reductions and reserves can assist in maintaining the most critical areas, while preserving the ability to tap into reserves if a downturn lasts for an extended period.

**California's Budget Reserves**

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).

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) 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, to bring the balance in the BSA to $1.6 billion.

**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, for placement on the June 2012 ballot. This election date was later changed pursuant to SB 202 (Hancock) Chapter 558, Statutes of 2011, to place the amendment on the November 2014 ballot.

The amendment would involve tightening up certain aspects of the BSA account requirements, including the following:

- 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 revenues amounts that are received over the cap, including additional deposits to BSA, debt reduction, or tax rebates.

**Legislative Analyst's Office Perspective**
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, the LAO's views are congruent with many of the changes to BSA that are found in the current version of ACA 4; however, there are certain aspects of the ACA 4 proposal about which it has raised concerns.

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, 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."

## GOVERNOR'S PROPOSAL:

In the budget, the Governor proposes a constitutional amendment to create a new reserve fund—termed the Rainy Day Fund (RDF)—which largely builds off of the existing BSA. In addition, the Governor proposes a payment of three percent to the existing BSA, as a beginning to building the state's reserves. There are no particularly novel concepts in the proposal, as virtually all the components have been discussed and proposed in various permutations since the early

2000s. The proposal is nevertheless a sound contribution that can help frame the discussion of a budget reserve. The Governor's proposal for the RDF includes the following requirements:

- Basing deposits on when capital gains revenues rise to more than 6.5 percent of General Fund tax revenues.

- Creating a Proposition 98 reserve, whereby spikes in funding would be retained for future years of decline, smoothing school spending to prevent damaging cuts, while making no changes to the Proposition 98 guarantee.

- Doubling the maximum size of the Rainy Day Fund from five percent to 10 percent of revenues.

- Allowing supplemental payments to the Wall of Debt, or other long-term liabilities, in lieu of a year's deposit.

- Limiting 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.

The Governor indicates that Proposition 58's BSA has several weaknesses, such as no restrictions on when deposited amounts can be withdrawn and the requirement to make deposits in both lean and abundant years. He also notes that the proposed ACA 4 suffers from other drawbacks, including not giving an option to the state for paying off liabilities, not addressing the sharp ups and downs of Proposition 98 requirements, and basing deposits on the long-term trend rather than capital gains spikes.

LAO's preliminary observations of the Governor's proposal are consistent with its historical views. While generally complimentary of the proposal, LAO notes again the state's complex constitutional budget rules which "are difficult to fathom," likely unintended consequences of formulaic budget requirements, lack of adequate real-time data and other information, counterintuitive interactions with Proposition 98 requirements, and a potential shift in power to the executive branch.

## ISSUES TO CONSIDER:

California's fiscal experience during the sharp economic downturn has highlighted the value of establishing and maintaining an adequate budget reserve. While the experience in other states indicates that a reasonably-sized reserve would be unable to absorb all of the fiscal stress that can result from an extended and severe economic downturn, a reserve can be structured to help provide a cushion for such budget blows. Used in tandem with other budget solutions, a reserve can be a valuable addition to responsible budgeting. In addition, California's particular revenue structure—with its comparatively large reliance on volatile revenue streams—suggests that a significant reserve fund would be of sizeable benefit to the state.

The Governor's proposal to strengthen the state's reserve policy through the establishment of a new RDF is a welcome contribution and provides a reasonable starting point for further discussions relating to the specific structure of a reserve. However, the proposal remains largely conceptual in nature, and as implied by the Governor's discussion regarding the problematic features of Proposition 58 and ACA 4, details matter immensely in this technical area. The particular design characteristics of a reserve are vital considerations in order to ensure that an established fiscal cushion is adequate, accessible and functional. The constitutional nature of the proposal warrants its careful consideration and extensive vetting, especially given the relative difficulty of making alterations in response to changing circumstances. Utilizing Administration's top-level criteria in characterizing of its RDF proposal, the Legislature may want to consider the following questions and issues:

**Source of Fund Deposits**
Under the Administration's proposal, the source of RDF deposits is limited to a slice of personal income tax revenues related to capital gains realizations. Given the volatility and importance of capital gains taxes for the state fisc, this is not unreasonable, but may be too limited as a source of funds. As noted in this discussion, there can be numerous sources of unexpected or volatile revenues.

- Dividends and business income together contributed about as much to the General Fund over the long-term as capital gains income, and in previous years—although not the most recent period—they can be just as volatile. If the federal government were to alter its treatment of dividend income to lessen what some consider its double taxation (at the corporate and the personal income levels), this could increase these volatile income sources relative to capital gains. Similarly, bonus income, which is included in the wages and salaries income component, has also shown significant volatility in the past.

- Corporation tax revenues have become exceptionally difficult to forecast, with substantial variation between expected and actual liabilities. In fact, the DOF has recently acknowledged the large swings in tax liabilities related to this tax. The estimating difficulties have increased in recent years as the relationship between corporate income and tax liabilities has increasingly diverged. Changes in the behavior of multi-state corporations and changes in tax treatment of earnings can result in wide swings in corporation income.[1]

- Legal judgments can result in sizeable revenue or expenditure swings. In recent years, the state has seen increases in expenditures pursuant to legal proceedings related to corrections, various budget cuts, and potential tax refunds. But it is also possible these one-time impacts could work in a positive direction. If the state were to prevail in a significant legal proceeding—perhaps related to the dissolution of redevelopment agencies—this could free up additional unexpected resources or provide General Fund relief that could allow for additional reserve deposits.

[1] As one example, it is estimated that between $1.0 and $2.0 trillion in corporate earnings sits in off-shore holding companies. If the federal government were to institute either a tax 'holiday' or provide a one-time reduction in tax rates that stimulated the repatriation of these earnings, this action would likely trigger a significant upswing in corporation earnings and a corresponding increase in the state tax liability of California corporations.

These and similar issues related to one-time, unexpected or volatile revenue considerations may warrant a consideration of broadening the potential sources of funds required to be deposited to the reserve.

**Capital Gains Deposits**

The Administration's proposal to calibrate fund deposits based on capital gains revenues in excess of 6.5 percent of the General Fund raises a number of complicated issues, specifically:

- The threshold of 6.5 percent is actually below the average contribution of such revenues to the General Fund of about seven percent since the mid-1990s. Given this, the 6.5 percent threshold could have the impact of depressing expenditures below the long-term average. There is also no guarantee that 6.5 percent—or any other specific threshold—will be the 'magic' number in the future. For example, if capital gains were to shrink as a revenue source relative to other forms of alternative income—such as bonuses—the designated threshold might well warrant a similar downward adjustment.

- Using capital gains revenues as a percent of General Fund revenues ignores the role of tax treatment of capital gains realizations. If California were to tax certain such gains preferentially (through some variant of the Qualified Small Business Stock exclusion), this would have an impact on General Fund revenues by driving down the associated tax liability on such gains and potential reserve deposits. Furthermore—and perhaps more important—changes at the federal level (over which the state has no direct control), such as altering what can be considered as 'capital gains,' could substantially alter the capital gains tax base in California.[2]

- Revenues from taxpayers with capital gains are not known until at least 18 months after the state receives such revenues. In fact, most taxpayers with capital gains file extended returns and as a result such information is likely not available until 24 months after the revenues are received. This delay implies that deposits to the fund would need to be estimated, with a 'true-up' mechanism instituted to address shortfalls or excess deposits. The timing problems are easily discernable. If a true-up calculation required additional deposits to the reserve years after an underestimate, and the state was in a fiscally challenging position, the required 'true-up' could add to the fiscal stress. Alternatively, if the estimated deposit to the reserve was too high, this would result in an 'opportunity cost' for not having used those inappropriately reserved funds for a higher and better use.

[2] For example, so-called 'carried interest', representing a portion of the return based on capital investment by private equity firms and hedge funds in an investment fund, is now generally treated as a capital gain and consequently receives preferential tax treatment at the federal level. Many tax analysts indicate that only a portion of carried interest represents a 'true' capital gain, with the larger portion of carried interest representing labor compensation that should be taxed as ordinary income (see, for example, *'The Tax Policy Briefing Book,'* Tax Policy Center of the Urban Institute and Brookings Institution). If proposals to disaggregate the returns directly related to capital contribution from the portion that is ordinary income are adopted, this would likely reduce capital gains and increase ordinary income. Since California generally conforms to federal tax law, this would result in a similar diminution of capital gains and the associated state tax liability.

**Supplemental Payments**
The Administration's proposal allows for supplemental payments to the state's budgetary debt and long-term liabilities, but does not provide any parameters or limitations under which such alternative use of funds could occur.

- Given the Administration's itemization of such liabilities (which includes deferred capital maintenance) it is not clear whether or not capital investment and infrastructure might be allowed under this exception, and if so, what types. One approach might be to develop a hierarchy of priorities that could be funded through this mechanism of supplemental payments.

There are a multitude of other important issues related to the structure of the proposed RDF that warrant close legislative scrutiny, including:

- The flexibility and size of the Proposition 98 reserve, and how this fund would relate to the general reserve and be allocated during periods of fiscal stress.

- The appropriate maximum size of the reserve, especially given that no practically feasible amount would have provided adequate cushioning for the precipitous revenue declines experienced over the last five years.

- How binding would be the limitations on fund withdrawals, including whether emergencies such as natural disasters could result in the release of funds in excess of the 50 percent ceiling.

The issues raised above can certainly be addressed through both policy and additional detailed mechanisms; however, it is important to acknowledge these complex issues 'up-front' and address them in a direct manner. Generally, additional reserve safeguards and mechanisms can reduce the amount of legislative and administrative discretion, but also make the undertaking and eventual approach to establishing a reserve a more complicated endeavor than it otherwise would be. More fundamentally, an unduly prescriptive policy—particularly a constitutional one—can result in constraints that inhibit the state's ability to respond to unexpected and unforeseen fiscal disruptions in the future. In the end, the design of a functional budget reserve should carefully balance legislative discretion and administrative safeguards.

One approach that the Legislature could consider is to work from the foundation established by Proposition 58. The Governor, after all, is facilitating the implementation of the BSA established by the proposition by depositing three percent of General Fund revenues into the reserve (and using half this amount to pay off the ERBs). Certain additional features could be implemented to address the magnitude and frequency of BSA withdrawals, the required process for such withdrawals to occur, as well as the allowable frequency of deposit suspensions. In addition, the Legislature could consider whether the three percent of General Fund is adequate, or should take into account other factors, for example, the receipt of one-time funds through an 'April Surprise.'

Establishing and maintaining a budget reserve is a both a technical and a political exercise that involves balancing demands of current expenditures with the need to set funds aside for a fiscal 'rainy day.' California's spending demands and requirements are substantial, and include restoring various human services programs, rebuilding and enhancing public education, and improving the state's physical infrastructure. Given these competing demands, the Legislature should carefully weigh the appropriate design of a state reserve, and in particular, give careful consideration to how to provide funding for the reserve, the level of such funding, the requirements for withdrawing funds, and the timing and process for replenishing the fund.