LAO
70 YEARS OF SERVICE

February 27, 2014

Budget Reserve Proposals

LEGISLATIVE ANALYST'S OFFICE

Presented to:
Senate Budget and Fiscal Review Committee
Hon. Mark Leno, Chair

LAO 70 YEARS OF SERVICE

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?
- How would the proposals affect the balance of power between the Legislature and the Governor?
- What are some other alternatives?
- At the conclusion of this handout, we provide simplified summaries of the current rainy-day fund procedures, ACA 4, and the Governor's proposal.

LAO
70 YEARS OF SERVICE

California's Budget Process: Key Issues

☑ Significant Revenue Volatility

- Not only capital gains.
- In general, volatile income sources are concentrated among taxpayers paying the highest income tax rates. These sources also include bonus and other compensation for financial and technology industry staff, as well as business income.

☑ Complex Proposition 98 Formula a Major Factor in Spending Decisions

- Above-average revenue increases sometimes result in large Proposition 98 increases (due to maintenance factor payments).
- Can make building a budget reserve difficult.

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

- Instead, a tendency to commit to ongoing spending or tax relief commitments when times are good.
- State has two reserves now: the Special Fund for Economic Uncertainties and the reserve created by Proposition 58 (2004). From 2008-09 through 2011-12, these combined reserves had multibillion-dollar *negative* balances.

LAO
70 YEARS OF SERVICE

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 a 20-year regression estimate or the prior year's spending adjusted for population and inflation.
- Required deposits would stop when reserve reaches 10 percent of 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.

The Two Budget Reserve Proposals

(Continued)

☑ **Governor's Proposal**

- Focuses on revenue volatility caused by annual changes in capital gains taxes.
- Sets aside portion of required school spending in strong capital gains years to give to schools later during weak years. (This Proposition 98 reserve could grow to 10 percent of the Proposition 98 guarantee—totaling about 6 percent of General Fund revenues.)
- After funding Proposition 98 and optional payments on certain state debts, a portion of taxes in strong capital gains years would go to a separate rainy-day reserve. Required deposits would stop when this reserve reaches 10 percent of General Fund tax revenues.
- Governor must declare fiscal emergency in order to use rainy-day reserve funds.
- Allows use of no more than 50 percent of the main rainy-day reserve in first year of a fiscal emergency.

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 could grow to about 6 percent of revenues.
- ***Both Aim to Limit Use of Reserve in First Year of Downturn.*** Both proposals limit the use of the main rainy-day reserve 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, therefore, aim to reduce the likelihood that ongoing spending commitments will outpace revenues during future economic downturns.

LAO
70 YEARS OF SERVICE

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.

☑ **Capital Gains Formulas Require Subjective Judgment**

- The Governor has emphasized how poorly equipped the state is to estimate capital gains revenues. We agree.
- Yet, his measure 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 measure includes such a calculation, a higher or lower threshold percentage could be considered.

LAO
70 YEARS OF SERVICE

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 or paying down bond debt.
  - 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.

☑ **Interactions With Proposition 98**

- Proposition 98 requirements could minimize the amount able to be set aside to the main rainy-day reserves of both measures in some strong revenue years.
- At the same time, the Legislature will want to consider how any reserve measure could affect Proposition 98 school funding—as well as non-Proposition 98 funding—in strong, average, and weak revenue years.
  - For example, the Governor's measure—by emphasizing the funding of enrollment and cost-of-living growth for schools in weak capital gains years—could drain the Proposition 98 reserve quickly during a downturn.

The Balance of Power

☑ **"Power of the Purse" a Primary 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 both have to declare a "fiscal emergency" and ask for the Legislature to transfer rainy-day reserve funds to the General Fund before such a transfer 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.

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

- To limit suspensions or reductions of deposits in the future, Proposition 58 could be amended to limit the number of suspensions and reductions to a fixed number in every rolling ten-year period.
  - Such limits would facilitate suspensions or reductions in future budget crises, such as those that caused the current and prior Governors to suspend transfers into the Proposition 58 reserve recently.

LAO
70 YEARS OF SERVICE

An Alternative: Amendments to Proposition 58 *(Continued)*

☑ **Restrict Reserve Withdrawals**

- Similarly, Proposition 58 could be amended to limit the number of 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]

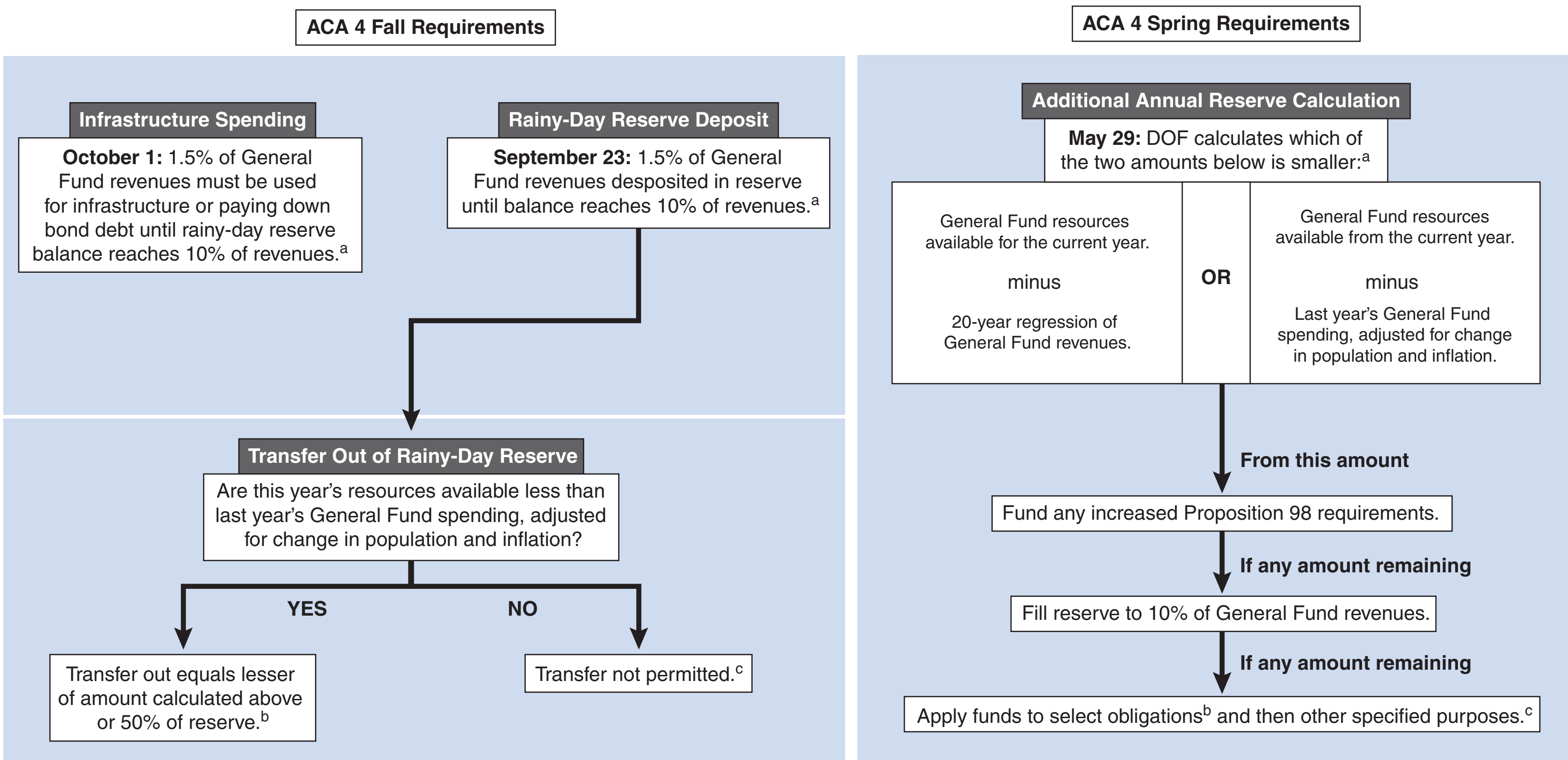
September 30: Based on Governor's decision, deposit—if any—is transferred to rainy-day reserve.

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.

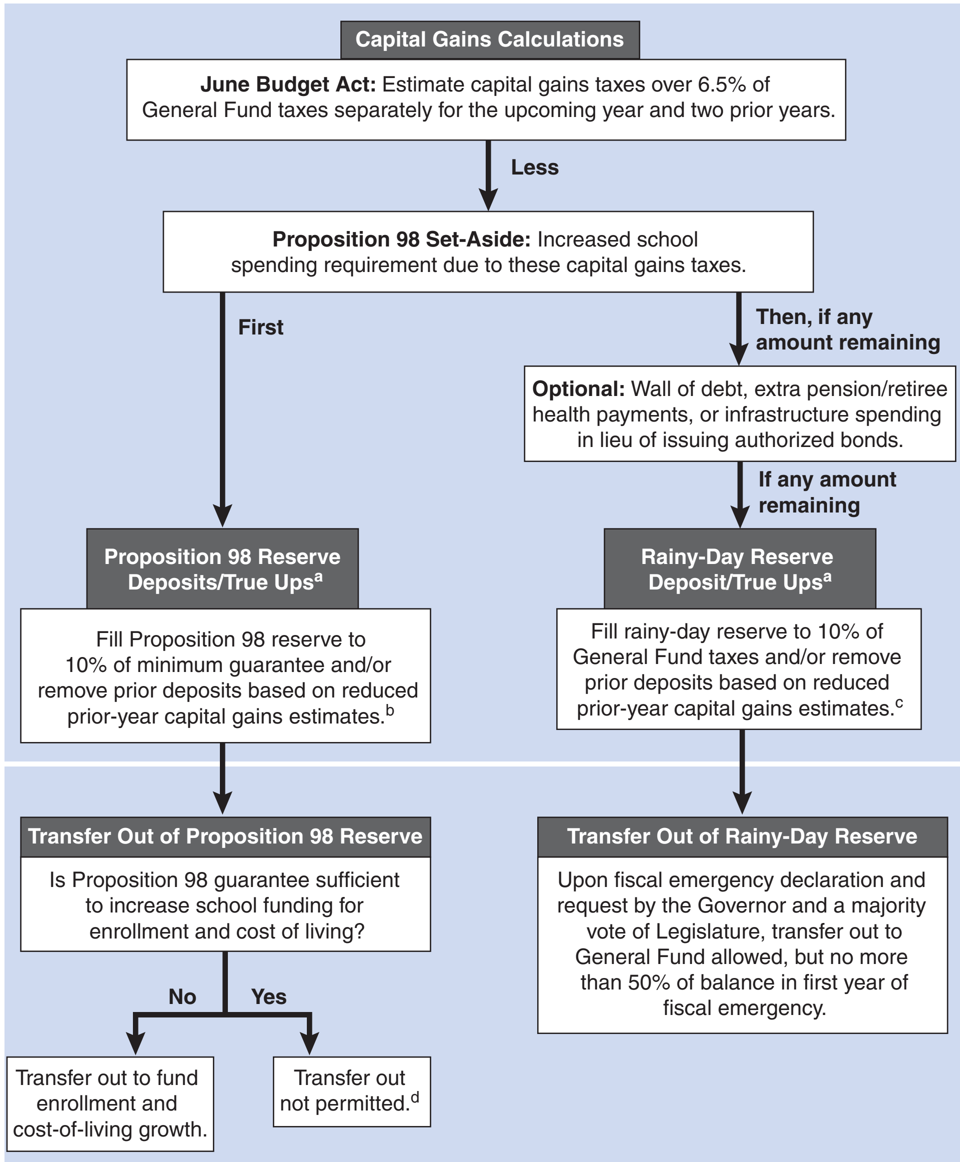
[c] Upon executive order of the Governor declaring an emergency under Article XIII B of the Constitution, any amount needed to respond to the emergency can be transferred out of the reserve.

[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 Governor's fiscal emergency request and majority vote of Legislature, deposit 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 the Proposition 98 reserve reaches 10 percent of the minimum guarantee, increased school funding related to these capital gains taxes flows to schools.

[c] Once this reserve reaches 10 percent of General Fund tax revenues, capital gains taxes over 6.5 percent of General Fund tax revenues may be spent for one-time purposes to be defined in statute.

[d] Upon Governor's fiscal emergency request and majority vote of Legislature, transfer out for school funding purposes allowed.