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Assembly
California Legislature

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Agenda

Tuesday, August 6, 2024

1:30 P.M. – State Capitol, Room 437

Oversight of Budget Reserves

Panelists

Panel 1: Overview of State Reserves

- Ann Hollingshead, Legislative Analyst's Office

Panel 2: How Can We Improve Our Reserves?

- Jason Sisney, Budget Director for Speaker Rivas
- Ann Hollingshead, Legislative Analyst's Office
- Brian Brennan, 21st Century Alliance
- Scott Graves, California Budget and Policy Center
- Lisa Mierczynski, Department of Finance

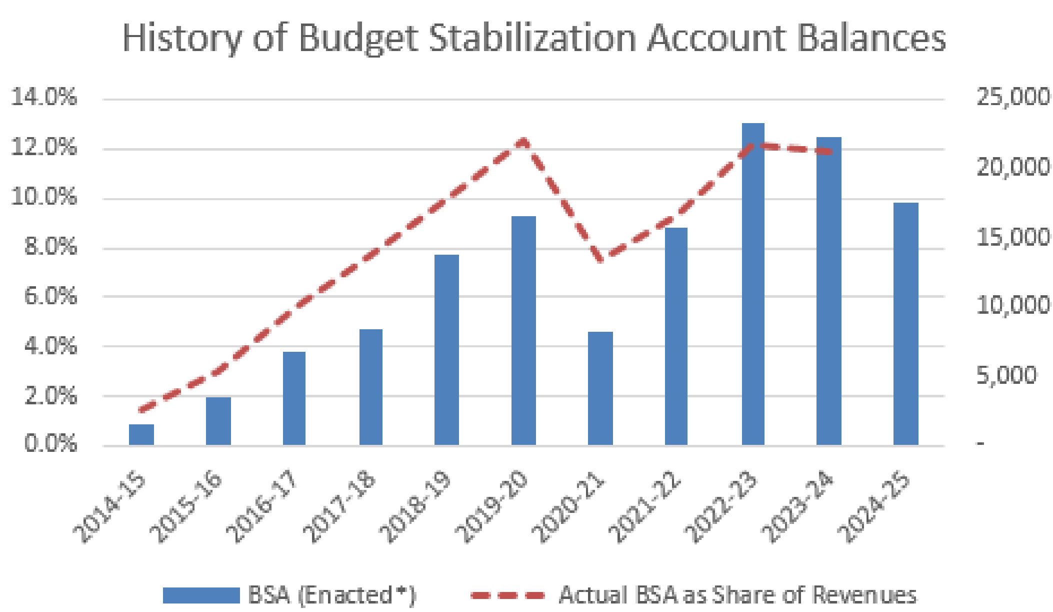
Attachment links:

- How to Effectively Use State Rainy Day Funds, March 12, 2020
- State Reserves Cover Record Level of Spending as Budget Conditions Tighten, December 7, 2023

Background

During the Great Recession, the State of California was functionally bankrupt - it had run out of cash and was no longer able to pay contractors for services rendered. The traditional institutions that had helped the state in such situations were unable to because of the depths of the recession, and the federal government moderated its response to the state, which made the recovery much more difficult. It became clear to California leaders that it could not count on others to help mitigate such economic catastrophes, the State would need to find a way to help itself.

After the Great Recession mostly receded, policymakers came together to craft Assembly Constitutional Amendment (ACAX1 2) authored by Speaker Emeritus John A. Pérez that would later be approved by voters as Proposition 2. This measure set aside state revenue and spiking capital gains into a rainy-day fund, called the Budget Stabilization Account that could be used in cases where state revenues declined. After voters approved this plan, this rainy-day fund would begin building this protective nest egg for the State in 2014 and sit untouched and growing for six fiscal years, accumulating a balance of $17.4 billion, 12.4 percent of General Fund Revenue.



2020 and the COVID-19 pandemic was the first test of the rainy-day fund, as the economic shock from the quarantine shut downs was unprecedented on both state revenues and expenditures. In the 2020 budget, half of the rainy-day fund was used to close the projected budget gap. But then something unexpected happened, unlike the Great Recession, the federal government came to the rescue of California, and the rest of the country, with a robust and sizable recovery effort that forestalled the expected recession from the pandemic.

The resulting stimulus from the federal government response resulted in one of the largest booms in revenue growth in California history. 2021 was one of the best years for personal income growth in United States history. That year alone, over 1 million US taxpayers would become millionaires, reflecting the dramatic increase in income and net worth from the pandemic recovery. Again, the State was in uncharted territory as the State was able to immediately rebuild the rainy-day fund to a historic $23.2 billion.

But the State also faced a new challenge in reserve building, the Gann limit, a 1979 ballot measure that was intending to cap state expenditures. The way the Gann limit was written, it treated all reserves as “expenditures”. The 2022 revenue forecast suggested that the State would exceed the Gann limit without some intervention, yet there was also great uncertainty of how much of the 2021 revenue growth would continue in future years. Policymakers chose to use tax rebates and infrastructure investments to avoid exceeding the Gann limit but were limited in how much they could add to reserves because of the limit.

When the 2022-23 actual revenues were revealed to be quite lower than expected in late 2023, it created the budget gap that the recent 2024 state budget had to bridge. This led to reflection about how the rainy-day fund and reserves work, and if there were changes to the Budget Stabilization Account that could be made to better work in the situation the state just experienced. In addition, the Department of Finance suggested trailer bill language to delay the appropriation of surplus funds, to further reduce volatility in the future.

How California’s Reserves work

The State has five major General Fund reserve accounts:

1. Special Fund for Economic Uncertainties (SFEU): This is the normal, unencumbered General Fund reserve that is sometimes referred to as “the reserve” because it is a true measure of the state’s available uncommitted funding. When the State collects unexpected General Fund revenue, it accumulates automatically to this account.

   In the 1990s and 2000s, prior to the majority-vote budget constitutional amendment, various compromises were needed to achieve two-thirds legislative majorities for budget agreements, including tax measures related to those budget agreements. Two such compromises—from SB 169 (Alquist) of 1991 and AB 426 (Cardoza) of 2001--effectively impose limits on the size of the state’s basic reserve, the Special Fund for Economic Uncertainties (SFEU). Those limits on the size of the SFEU remain in place today in Sections 6051.4, 6051.45, 6201.4, and 6201.45 of the Revenue and Taxation Code. These measures turn off a quarter-cent (0.25%) portion of the sales and use tax temporarily if the size of the SFEU otherwise would surpass a certain level—generally 3% or 4% of General Fund revenues, as specified. SB 169 resulted in a temporary reduction of the state sales tax in 2001. The 0.25% portion of the sales tax currently generates about $2.2 billion of General Fund revenue per year.

2. Safety Net Reserve: This General Fund reserve that was established to offset the impact of a revenue downturn or economic impact on health and safety programs. Deposits and withdrawals from this account are made as part of the annual budget process.

3. Budget Stabilization Account (Rainy-Day Fund): As mentioned earlier, this is the special account established by Proposition 2 of 2014 that requires the state to set aside funding for revenue downturns.

4. Public School System Stabilization Account: Also a component of Proposition 2, this account is a companion to the Rainy-Day fund and sets aside funding for Proposition 98 purposes.

5. Budget Deficit Savings Account: The Budget Deficit Savings Account (BDSA) was created in 2018, as proposed by Assemblymember Tom Daly, to provide a supplemental discretionary reserve. It only received a small amount of funding in 2018, but otherwise has not been funded. Deposits to the discretionary Safety Net Reserve Fund are able to be used for health and human services programs, while the BDSA could be used to stabilize funding for any state program. This account does not have a balance at this time.

The General Fund Update below provides the latest levels of these reserves, as adopted as part of the 2024 budget act:

2024 Budget Act
General Fund Budget Summary
(Dollars in Millions)

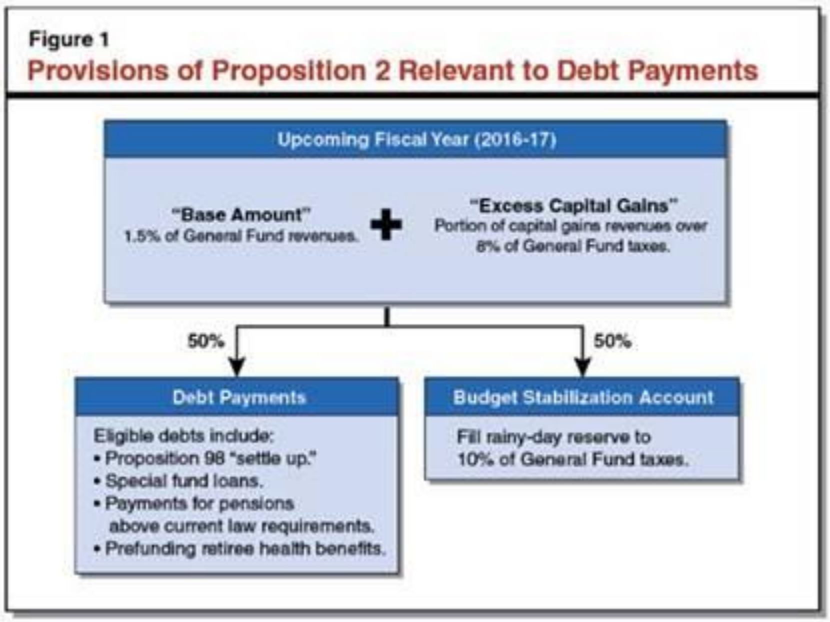
	2023-24	2024-25
Prior Year Balance	$47,119	$13,443
Revenues and Transfers	$189,399	$212,139
Total Resources Available	**$236,518**	**$225,582**
Non-Proposition 98 Expenditures	$155,042	$128,892
Proposition 98 Expenditures	$68,033	$82,612
Total Expenditures	**$223,075**	**$211,504**
Fund Balance	**$13,443**	**$14,078**
Reserve for Liquidation of Encumbrances	$10,569	$10,569
Special Fund for Economic Uncertainties	$2,874	$3,509
Public School System Stabilization Account	-	**$1,054**
Safety Net Reserve	**$900**	-
Budget Stabilization Account/Rainy Day Fund	**$22,559**	**$17,633**

Note: Numbers may not add due to rounding.

How Does Proposition 2 Work?

Deposits

Proposition 2 created a set of formulas that specified minimum annual amounts the state must deposit into the rainy-day fund and use to pay down certain debts. Under the measure, the state must set aside two amounts: (1) 1.5 percent of General Fund revenues and (2) a portion of capital gains revenues that exceed a specified threshold. From these two amounts, the state must allocate half to increase the balance of the rainy-day fund and the other half to pay down debts. The table below illustrates how this works:



Withdrawals

Under the rules of Proposition 2, the Legislature can only make a withdrawal from the rainy-day fund if the Governor has first called a budget emergency. The Governor may only call a budget emergency if one of two conditions holds: (1) estimated resources in the current or upcoming fiscal year are insufficient to keep spending at the level of the highest of the prior three budgets, adjusted for inflation and population (a "fiscal budget emergency"), or (2) in response to a natural or man-made disaster. In the case of a fiscal budget emergency, the Legislature may only withdraw the lesser of: (1) the amount needed to maintain General Fund spending at the highest level of the past three enacted budget acts, or (2) 50 percent of the rainy-day fund balance.

10 Percent Cap and Additional Deposits

Under Proposition 2, the state must make deposits into the rainy-day fund until its balance reaches a threshold of 10 percent of General Fund taxes. Each year that General Fund tax revenues grow, this 10 percent threshold also grows. As such, in each of these years, the State is required to make deposits into the rainy-day fund to bring the fund to the revised estimate of 10 percent of General Fund taxes. Any additional required deposits that would bring the rainy-day fund above 10 percent of General Fund taxes must be spent on infrastructure.

The Legislature has elected to deposit additional amounts into the rainy-day fund—above the constitutionally required minimums. In particular, the Legislature deposited an additional $2 billion into the BSA in 2016-17 and an additional $2.6 billion in 2018-19.

<u>True Up</u>

Under Proposition 2's true-up provisions, the state reevaluates each year's rainy-day fund deposit twice: once in each of the two subsequent budgets. The state does this because initial estimates of future capital gains revenues are highly uncertain. This process attempts to align those original estimates of required deposits with actual revenues. Under these reevaluations, the state revises the rainy-day fund deposit up (down) if excess capital gains taxes are higher (lower) than the state's prior estimates.

Administration Proposal on Surplus Deferral

The Department of Finance has proposed August budget clean up language to delay recognizing surplus budget revenue above a historic threshold. The intent of this delay is to reduce the risk of revenue uncertainty during periods of economic boom, such as what occurred in 2021.

How Reserves Work in Other States

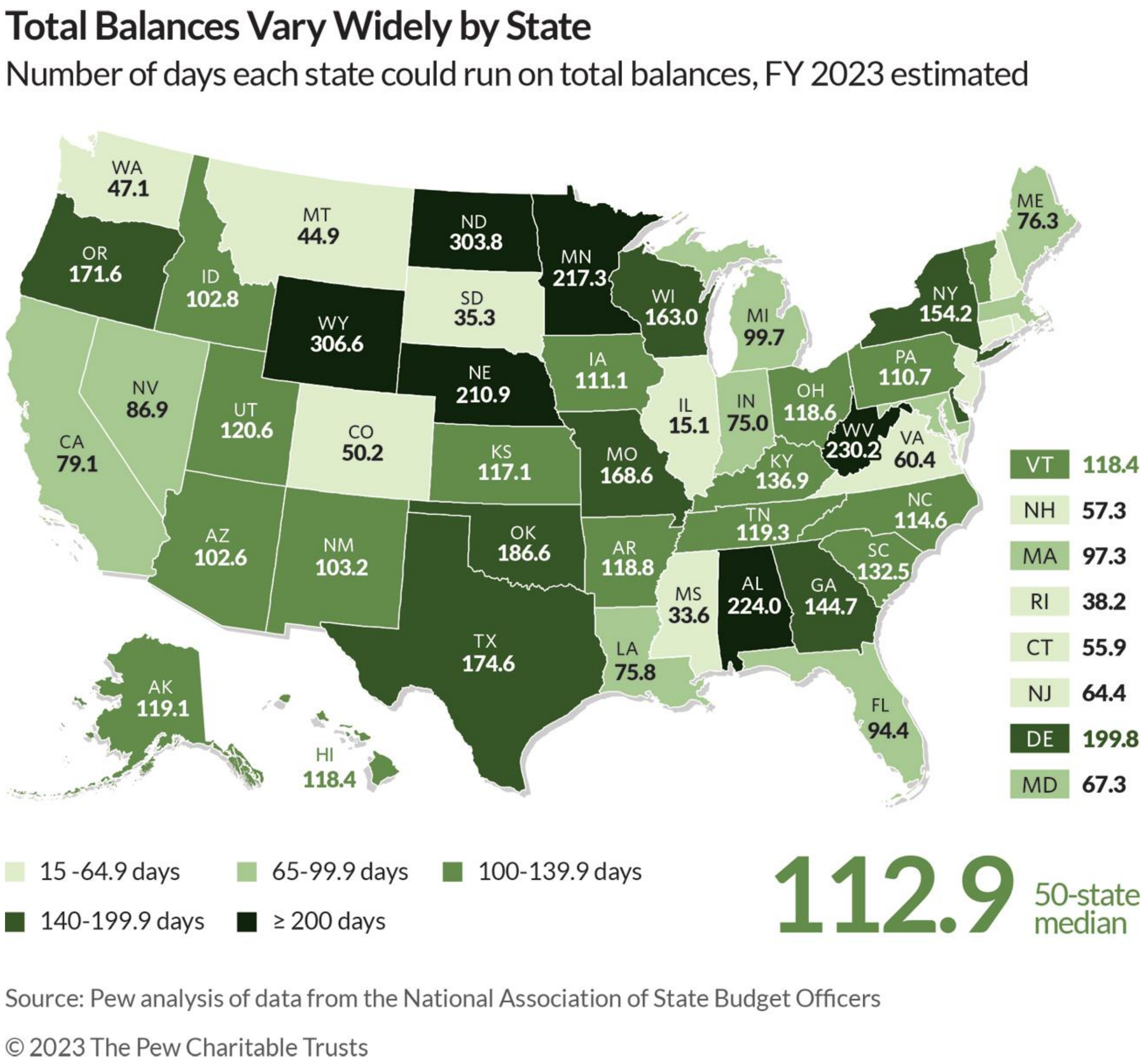
Two reports from the Pew Charitable Trusts are attached to this agenda that provide some context to reverses in other states.

The first, "How to Effectively Use State Rainy Day Funds," March 12, 2020, provides some nation context for reserves.

In this publication, Pew defines the following best practices for rainy-day funds:

1. Maintain at least one reserve account specifically for budget stabilization.
2. Deposit extraordinary revenue, including above-average tax revenue and one-time collections, into the rainy day fund.
3. Define clear withdrawal conditions.
4. Calculate a risk-based cap or savings target.

In the second publication, “State Reserves Cover Record Level of Spending as Budget Conditions Tighten,” December 7, 2023, Pew compares states total balances based upon how many days of operations they would sustain. In this measurement, California was below the national median. However in a separate comparison of just reserves, California was in a better position than most states.



Staff Comments

Staff suggests the members consider the following five questions and they advance the conversation about potential changes to our reserve policies:

1. What is the policy problem the reserve is trying to solve?

Reserves provide protection against risk and volatility, but the size, rules and design of the policy will vary depending on the risks involved. For example, the Safety Net Reserve was designed to specifically hedge against the increase in state costs from rising caseloads, while the Budget Stabilization Account was more tied to reducing impact of volatile personal income tax revenue fluctuations. Like and insurance policy, a reserve policy can reduce the risk to the budget against many threats, but will be more effective if specific risks are articulated.

2. How big should the reserve be?

In addition to considering the risk the reserve is designed to hedge against, the expected use of the reserve should be considered. For example the Special Fund for Economic Uncertainty has been used to fully cover unexpected state emergency costs, like disaster response, while the Budget Stabilization Account has been used more as a buffer against revenue declines, providing temporary funding to allow the state time to work out of a budget imbalance.

3. How restricted should deposits and withdrawals from the reserve be?

Currently, the State has both a very flexible general reserve and a restrictive rainy-day fund. Should annual required deposits to the rainy-day fund be increased? Alternatively, should more frequent and larger discretionary deposits to other reserves be a focus?

4. Should there be different reserves?

With five existing reserves, it is worth reflection on whether the state needs a variety of reserves.

5. What is the opportunity cost of having big reserves?

In early July, the State Controller reported that the State had over $103 billion in cash available in state accounts. The State’s strong cash position give California additional flexibility and tools to address risk. But it also raised questions about what value the state derives from adding additional reserve cash to the giant bank account. While there is value in having a robust reserve to reduce risk to the State, that reserve itself generates growth that, at best, is in line with inflation. The members should consider the tradeoffs of having larger reserves, as compared to other opportunities to improve the state’s overall financial balance sheet. For example, CalPERS posted a 9.3 percent return on investments last fiscal year, which is almost 5 percent more than the return on the state’s cash assets. If the state wanted to improve its balances sheet, investing $10 billion in reducing pension liabilities could generate almost $500 million more in return than having the same cash on hand in a reserve account.