California State Assembly

Agenda

Assembly Budget Subcommittee No. 7
on Accountability and Oversight

Assemblymember Gregg Hart, Chair

Wednesday, May 7, 2025

9:00 AM – State Capitol, Room 126

Items To Be Heard

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Items To Be Heard

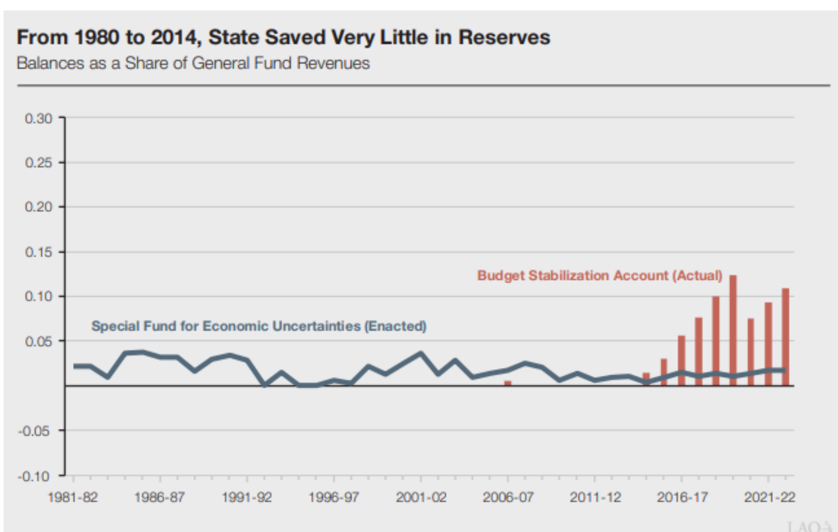
Issue 1: Reserves, Proposition 2 and the Budget Stabilization Account

The first issue provides background on the history and the features of California's existing reserve policy and rainy day fund mechanism.

Proposition 2: A Response to a Period of State Budget Vulnerability

The end of the 1970's marked many changes to California public finance at both the state and local level, but also ushered in an era of low reserves, chronic budget deficits, and heightened budget uncertainty that would last for three decades. During the Great Recession, the state's lack of budget resilience led to actual cash insolvency, requiring the state to delay payments to vendor and employees and to cancel thousands of projects. During that time, the state, led by the Assembly, crafted a ballot measure that was intended to create a Rainy Day Fund. The intent of the measure was to create a dedicated special reserve for really bad years that would grow by mandatory contributions as the State recovered and grew economically. This initiative, Proposition 2, was passed by voters in 2014.

Proposition 2 largely worked as intended, with the Budget Stabilization Account growing above its 10 percent target by 2019-20, benefiting from the help of both mandatory and voluntary contributions into the account.



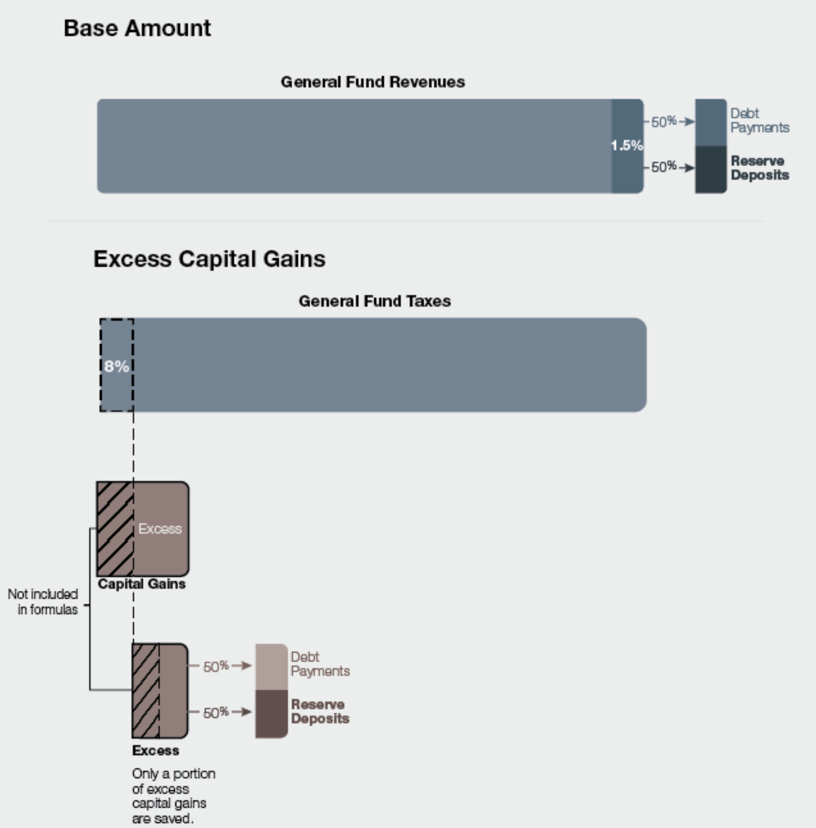
Since the passage of Proposition 2, the state benefited from consecutive years of revenue growth. The state has only used the Budget Stabilization Account twice since that time, once during the short 2020 pandemic recession, and a second time in the current 2024-25 fiscal year. The 2024 Budget Act and the Governor's 2025 budget proposal also assume an additional withdraw from the account in 2025-26.

How Does Proposition 2 Help the State Build Reserves?

Figure 4 shows how Proposition 2 deposit rules work. The measure has two main parts. First, it requires the state to set aside 1.5 percent of total General Fund revenues (we refer to this as the "base amount"). Second, it requires the state to set aside a portion of capital gains revenues that exceed 8 percent of General Fund taxes (this is: "excess capital gains"). Importantly, the state does not set aside *all* capital gains that exceed this threshold, but only a share of them. This share is determined by a complex set of formulas that can lower excess capital gains by anywhere from 0 percent to 100 percent, although reductions around 30 percent have been the most common to date. The state combines the base and excess capital gains amounts and allocates half to pay down debts and the other half to build the rainy day reserve.

Figure 4

How Proposition 2 Works



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

Schools and Community Colleges Have Separate System to Mitigate Revenue Volatility

Schools and community colleges, the main tool in the state's Public School System Stabilization Account (the Proposition 98 Reserve), which requires the state to save more in reserves when revenues - especially those from capital gains taxes - are surging. These funds must be used to supplement, but not supplant, Proposition 98 spending during a downturn. In addition, school and community college districts themselves hold local reserves to manage unexpected cost increases, as well as state funding declines. Finally, the state has used other tools like deferrals, which uses a principle similar to borrowing to help smooth school spending through downturns.

Panel

- Ann Hollingshead, Legislative Analyst's Office
- Lisa Mierczynski, Department of Finance

Staff Comments

This background allows members to ask questions about the existing Rainy Day Fund, which has several complicated features

Staff Recommendation: This item is presented for informational purposes

Issue 2: Rethinking California's Reserve Policy

While the Budget Stabilization Account has helped mitigate the volatility the state has experienced recently, the pandemic and subsequent recovery have uncovered two major limitations to Proposition 2.

1. The current Budget Stabilization Account target of a reserve of 10 percent renders too small a reserve given California's volatile revenue sources. LAO estimates that the reserve only covers one-third of recent downturns, which falls below the level of most state reserves.

2. Contributions to the Budget Stabilization Account are considered expenditures for purposes of the State Appropriations Limit (SAL). The SAL, also known as the Gann Limit, was approved by voters in Proposition 4 of 1979. Recently concerns about exceeding the SAL limited State's ability to make additional deposits during the record surpluses of 2022-23

This issue explores these issues and other input from stakeholders before considering three proposals to change the Budget Stabilization Account in Issue 3.

LAO Recommendation

On April 10, 2025, the Legislative Analyst's Office issued a report *Rethinking California Reserve Policy,* that reviewed reserves and made the following two recommendations:

1. ***Raise the Reserve Cap to 50 Percent by 2055***. We first recommend the cap on constitutional reserve deposits be raised from 10 percent to 50 percent of General Fund taxes. 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.

2. ***Two 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. There are many options for doing this, but given the volatility in the state's revenues, we think it is important to set aside much more funds in years when revenues are surging, rather than setting aside somewhat more in every year. We suggest two alternative mechanisms to accomplish this: (1) create new, more robust and flexible deposit rules, or (2) keep existing rules in place, but change them to set aside more in capital gains revenues in some years.

Panel

- Ann Hollingshead, Legislative Analyst's Office
- Brian Brennan, 21st Century Alliance
- Scott Graves, California Budget and Policy Center

Staff Comments

There are five major questions members should consider when evaluating changes to the Budget Stabilization Account:

1. How big should California's Rainy Day reserve be?

2. Should the 1979 State Appropriation (Gann) Limit apply to BSA funds? What about deposits to other budget reserves?

3. What should the rules be for reserve deposits (voluntary versus mandatory)?

4. What revenues should feed the reserve?

5. Should we change the rules for when the reserve can be used and/or what types of state expenditures could use reserve funds?

Staff Recommendation: This item is presented for informational purposes.

Issue 3: Budget Stabilization Account Reform Proposals

There are two current proposals for reforming the Rainy Day Fund that have been published. For discussion purposes, Assembly staff will discuss additional features and components that could be included in a proposal adopted by the Assembly as part of the 2025 budget package.

Governor Proposes Two Changes to Proposition 2.

The Governor's budget includes proposed trailer bill language that would put a measure before voters to make two changes to Proposition 2. Those are:

1. ***Raise BSA Cap to 20 Percent of General Fund Taxes.*** The Governor proposes raising the reserve cap from 10 percent of General Fund taxes to 20 percent of General Fund taxes. This would not have any impact on the rules that set aside funds each year, but would mean the state would save more cumulatively over time.
2. ***Exclude BSA Deposits From the SAL.*** The Governor also proposes excluding BSA deposits from the SAL. (Reserve withdraws are already excluded and the Governor does not propose changing that.) This proposal does not impact the constitutional deposit rules, but it could make it easier for the state to save more on a discretionary basis in certain years. (It would also somewhat reduce the budgetary constraints created by the SAL in certain years.)

ACA 1 (Valencia)

ACA 1 includes three changes to the BSA:

1. ***Increases the required General Fund contribution to the Budget Stabilization Account.*** Currently, the draft of the ACA does not specify a new amount for this contribution, but has placeholder pending deliberation.
2. ***Raise BSA Cap to 20 Percent of General Fund Taxes.*** Like the Governor's proposal, ACA 1 proposes raising the reserve cap from 10 percent of General Fund taxes to 20 percent of General Fund taxes.
3. ***Exclude BSA Deposits From the SAL.*** Similar to the Governor's proposal, the ACA exempts depositions to the BSA from being counted as expenditure for Gann.

Panel

- Assemblymember Avelino Valencia
- Lisa Mierczynski, Department of Finance
- Jason Sisney, Speaker's Office

Staff Comments

Proposition 2 was a complex measure that included additional provisions around debt repayment, and how the state treated capital gains revenue and Proposition 98 expenditures. In contrast, the two measures that have been proposed make relatively simple changes to the existing law. However, given the rare opportunity to ask voters to revisit state reserves and spending, there are other provisions that the Assembly could consider as part of a package.

These include:

- Assuming there is consensus that the state needs to grow bigger reserves during strong budget times, how much of that growth should be "hard wired" into the Constitution versus growth accomplished via future, discretionary deposits to statutory budget reserves
- Gann Limit changes likely are required to facilitate savings in both constitutional and statutory budget reserves.
  - The Gann Limit helped ensure tax rebates to Californians in 2022, but rarely accomplishes this goal during strong budget times. Should Proposition 2 help provide more regular tax rebates during strong budget periods?
  - Making tax rebates one eligible use for Proposition 2's "debt repayment funds" is one option.
  - Exempting funding set aside for such rebates from the Gann Limit may help provide more regular tax rebates.
- Related to this concept: could similar mechanisms be used to set aside funds to pay down unemployment insurance (UI) loans to the federal government, leading to long-term tax reduction for businesses?
- Should oversight and transparency be increased as reserves grow?
- One option for a rainy day fund constitutional measure is to ask voters to remove the Legislative Analyst's Office from the Legislature's Proposition 140 spending limit.
- Should federal cuts allow a draw from the BSA?
- Proposition 2 could be amended to explicitly allow BSA draws due to significant federal cutbacks in state or local funding, given that the magnitude of cuts now being discussed are beyond those considered

Staff Recommendation: This item is presented for informational purposes only.