Structuring a Functional Reserve Fund: Lessons from California

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Introduction

The steep economic recession had a significant fiscal and budgetary impact on the State of California. Beginning in fiscal year 2007-08 and continuing through 2011-12, the state was forced to embark on a series of *ad hoc* budgetary maneuvers designed to achieve short-term fiscal stability. Lacking a meaningful reserve during the several years of fiscal stress, the state employed 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 the creation of budgetary debt in excess of $30 billion. Each of these approaches to balancing the budget resulted in significant political, economic and fiscal costs.

As the state began to recover—both economically and fiscally—from the downturn, policy-makers displayed increased interest in measures that would cushion against future budgetary stress. Instead of relying on costly approaches, such as those noted above, one alternative means through which greater budgetary stability may be achieved is through the establishment and maintenance of an adequate budget reserve. Such a reserve, once established, could 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 inconsistent funding.

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

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

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

Maintaining a budget stabilization fund is not without its own identifiable drawbacks, including the possibility that such funds could alternatively be deployed for such uses as capital investment or tax reductions. In addition, it is highly unlikely that a reasonably funded reserve would ever be sufficient to completely address fiscal challenges of the magnitude experienced by states 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 for dealing with budgetary uncertainty. The issue for states is the appropriate design of such a budget reserve, given alternative use of funds, the state's revenue system, and political realities.

State Reserve Funds

According to several recent surveys, almost all states have established budget reserve funds. According to a report from the Center on Budget and Policy Priorities, 47 of the 50 states maintain such funds—at least in theory.[†] 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.

Approaches to Budget Reserves

States create budget stabilization funds either through statutory or constitutional authorization. While most states' budget stabilization funds are statutorily created, several states have constitutionally authorized funds. Other states have both statutorily and constitutionally authorized budget stabilization funds, with eight states maintaining 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

[†] Center on Budget and Policy Priorities, "Budgeting for the Future: Fiscal Planning Tools Can Show the Way," February 2014.

statutory language prescribe 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, economic or revenue growth in excess of a specified rate triggers a required deposit to the fund.

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 about 2/3rds of states using such tests. Typically, withdrawals are made, pending approval of the legislative body, when revenues are insufficient to meet budget obligations. In some states, authorization for a withdrawal requires a supermajority of their 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.

Many 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, withdrawals may be required to be repaid by the end of the fiscal year in which the withdrawals occurred. In other cases, withdrawals must be repaid within a certain number of years of the date the withdrawals occurred. Some states 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.

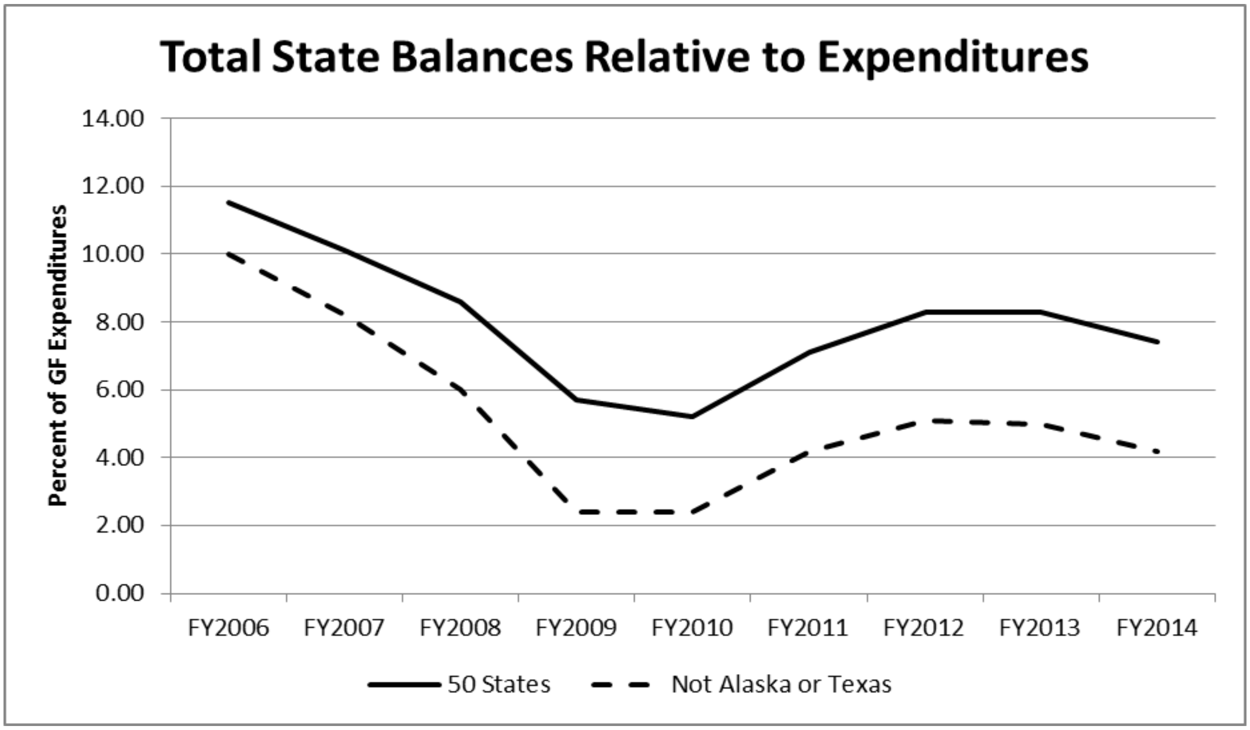
The great majority of states limit the size of their budget stabilization funds by capping the funds in relation to state general fund revenues or appropriations, for example at five percent or 10 percent of the designated base. Others cap their budget reserves and cash flow accounts at specific dollar amounts. Historically, a reserve capped at five percent of expenditures has been considered the standard recommended level. Among other entities, National Conference of State Legislatures 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 existence of atypical revenue sources. Many fiscal 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

[‡] See, for example, The Pew Charitable Trusts, "Building State Rainy Day Funds," July 2014.

funds, allowing for their funds to play a larger role in the event of economic and fiscal downturns.

Uses 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 level 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 government organizations, academia, and other institutions have been able to draw several conclusions regarding the role of reserve funds during this period—and previous periods—of economic decline and fiscal stress. Among the most important of these conclusions are:

- Reserve funds have 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.

[§] National Association of State Budget Officers, "Fiscal Survey of the States," Fall 2013.

- Reserve funds were not fully sufficient to withstand the fiscal impacts of the recent recession. Given the severity of the downturn, this is not surprising, but may suggest that larger reserves are 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 the use of such revenues. 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. While 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 Current Budget Reserves

California budget reserves are established by both constitutional and statutory provisions. 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. This general reserve is known as the Special Fund for Economic Uncertainties (SFEU). For 2014-15, the SFEU is budgeted at $449 million based on the adopted budget.

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.[**] As approved at that time (and through 2013-14), the proposition required 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 were required until the account balance reached $8.0 billion or five percent of General Fund revenues, whichever was greater. The annual transfer requirement was in effect whenever the balance in the BSA fell below either the

[**] Proposition 2, a Constitutional Amendment approved by the voters in November 2014, substantially altered the BSA, as discussed in a later section of this paper.

$8.0 billion or the five percent threshold. During the time the Economic Recovery Bonds (ERBs) were outstanding, 50 percent of the annual transfers to the BSA were to be used to pay off the bonds.

Spending from the fund could 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 existed 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 almost immediately withdrew the funds during each of those years. Up until the current year, the state suspended the transfer of moneys to the BSA since that time and the BSA had a zero balance. The 2014-15 budget approved by the Legislature and signed by the Governor included a deposit of three percent of General Fund revenues, to bring the balance in the BSA to just over $1.6 billion (with half the required deposit amount of $3.2 billion dedicated to repayment of the ERBs).

Previous Proposed Change in California's Reserve

In the midst of the recession, 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. (This proposal, has been replaced with a modified proposal, as discussed in the subsequent section.)

The original amendment would have involved 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 received in excess of the cap, including additional deposits to BSA, debt reduction, or tax rebates.

The proposal involved an elaborate mechanism to establish and fund the reserve, as well as determine what revenues were considered “unanticipated revenues” and subject to restrictions. By placing in the constitution a requirement to estimate a linear regression trend in order to determine expenditure levels, the proposal would have acted as much as a spending cap as a means to fund a functional reserve. Among its other flaws, this approach would likely have: locked-in lower spending levels necessitated during economic downturns, imposed restraints on needed additional spending (such as K-12 education), and limited state responses to unforeseen critical needs.

At once formulaic but concurrently susceptible to manipulation, the measure would have required the Director of Finance to forecast the revenue level for the current year and budget year based upon a linear regression analysis of revenues over the last twenty years, and placed this requirement in the Constitution. Unanticipated revenues were defined as the lesser of: (1) current-year General Fund revenue estimate minus the current-year revenue forecast based on a 20-year revenue regression, or (2) current-year General Fund resources estimate (revenue, transfers and prior-year balances) minus the expenditure forecast of prior year expenditure grown by population and inflation.

The proposed amendment stated:

> *(d) For the 2013–14 fiscal year, and for each fiscal year thereafter, the revenue forecast amount shall be determined as follows:*
> *(1) The General Fund revenues for the current fiscal year shall be forecast by extrapolating from the trend line derived by a linear regression of General Fund revenues as a function of fiscal year for the period of the 20 preceding fiscal years. For purposes of this paragraph, General Fund revenues shall exclude both of the following:*
> *(A) The General Fund revenue effect of a change in state taxes that affects General Fund revenues for less than the entire period of the 20 preceding fiscal years.*
> *(B) Any proceeds of bonds authorized by subdivision (a) of Section 1.3*
> *(2) The amount forecast pursuant to paragraph (1) shall be increased or decreased, as applicable, to reflect the net current fiscal year General Fund revenue effect of a change in state taxes for which General Fund revenue effects were excluded pursuant to subparagraph (A) of paragraph (1).*

The susceptibility of the construct to manipulation—or at least to interpretive differences—is apparent. Would an ‘inherently linear regression’ qualify, for example? While the language does not explicitly allow for other explanatory variable other than time, nor does the wording indicate that the model should be a function ‘solely’ of time. Perhaps most important, the language requires that the effect of state tax changes be excluded. As anyone who has conducted revenue estimates knows, this can be an extremely complex and often subjective task, and reasonable estimates of the effect of tax reductions and increases can vary substantially. Questions of whether such estimates would account only for direct impacts or included indirect (and potentially 'dynamic') impacts constitute only the beginning of the complexity imposed by this requirement.

The California 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 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 were contained in ACA 4; however, there were certain aspects of the ACA 4 proposal about which it raised concerns.

The LAO 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 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 viewed favorably the effort to transfer excess revenues into the BSA, but recommended that a relatively high threshold be reached before such 'excess funds' are directed to the reserve.

However, 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 noted 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 cautioned 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 January Budget Reserve Proposal

In the context of the January budget, the Governor proposed a constitutional amendment to create a new reserve fund—termed the Rainy Day Fund (RDF)—which largely built from the

[††] Legislative Analyst's Office, "The 2014-15 Budget: Overview of the Governor's Budget," January 2014.

existing BSA and was intended to replace ACA 4 on the November 2014 ballot.[‡‡] (In addition, the Governor proposed a payment of three percent to the existing BSA, as a beginning to building the state's reserves.) There were no particularly novel concepts in the new RDF proposal, as virtually all the components had been discussed and proposed in various permutations since the early 2000s. The proposal was nevertheless a sound contribution that can help frame the discussion of a budget reserve. The Governor's proposal for the RDF included the following requirements:

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

- Doubling the maximum size of the Budget Stabilization Account 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.

- 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.[§§]

The Governor indicated that Proposition 58's BSA had 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 noted that the proposed ACA 4 suffered 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 were consistent with its historical views. While generally complimentary of the proposal, LAO noted 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 pertinent

[‡‡] State of California, "Governor's Budget Summary 2014-15, January 2014.

[§§] Proposition 98 refers to the state's constitutionally-established funding requirement for K-14 education, which sets forth the annual minimum guarantee for per pupil funding. Such funding is based on local property tax revenues, with state revenues required to make up the difference between property taxes and the total per pupil requirement.

information, counterintuitive interactions with Proposition 98 requirements, and a potential shift in power to the executive branch.

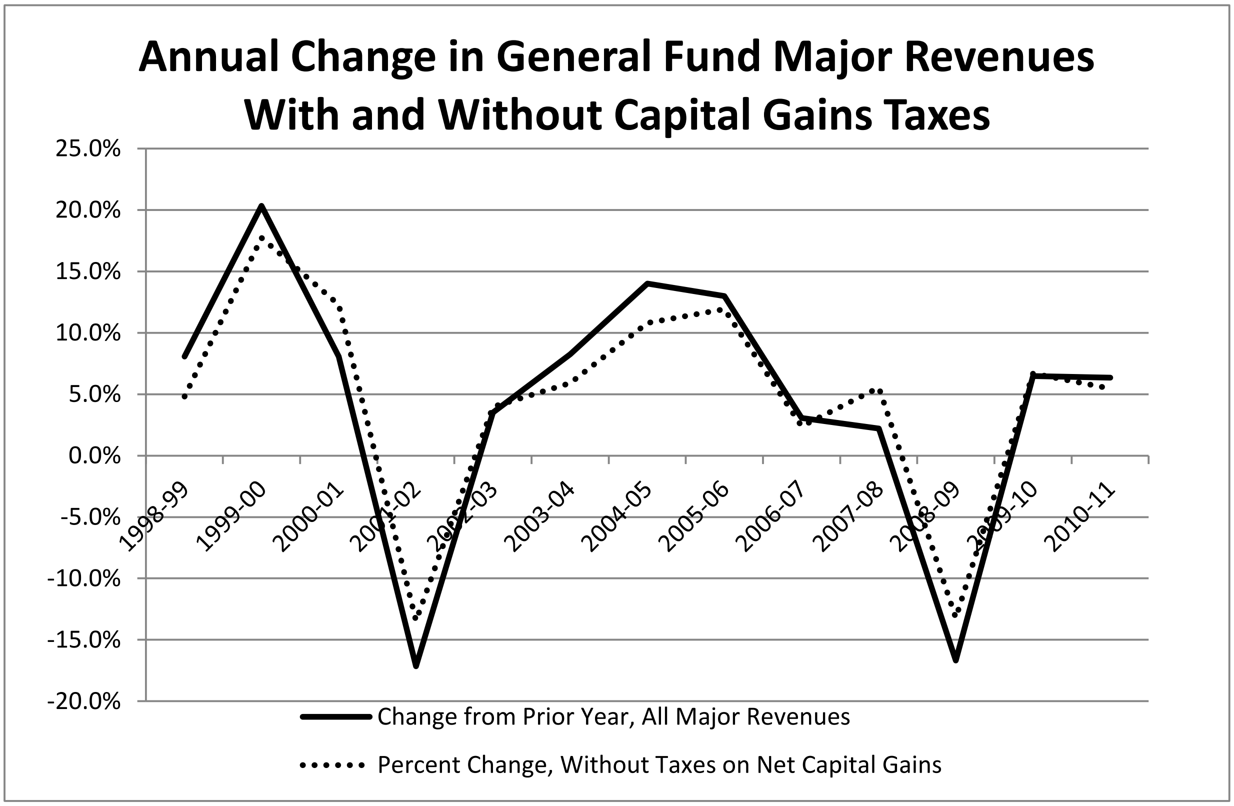
Issues Related to Governor's Reserve Proposal

California's fiscal experience during the sharp economic downturn 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 benefit to the state.

The Governor's proposal to strengthen the state's reserve policy through the establishment of a new RDF was a welcome contribution and provides a reasonable starting point for further discussions relating to the specific structure of a reserve. However, the proposal was 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 warranted its careful consideration and extensive vetting, especially given the relative difficulty of making alterations in response to changing circumstances. The top-level concerns that were raised are discussed below.

Source of Fund Deposits
Under the Administration's initial proposal, the source of RDF deposits was limited to a slice—amounts in excess of 6.5 percent—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 its (arguably) double taxation (at both 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. The chart below depicts a simple measure of volatility (as represented by percentage changes) for revenue with and without capital gains.



Source: California Legislative Analyst's Office and State of California Department of Finance

- Corporation tax revenues have become exceptionally difficult to forecast, with substantial variation between expected and actual liabilities. In fact, the Department of Finance has recently acknowledged the large and volatile 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.[***]

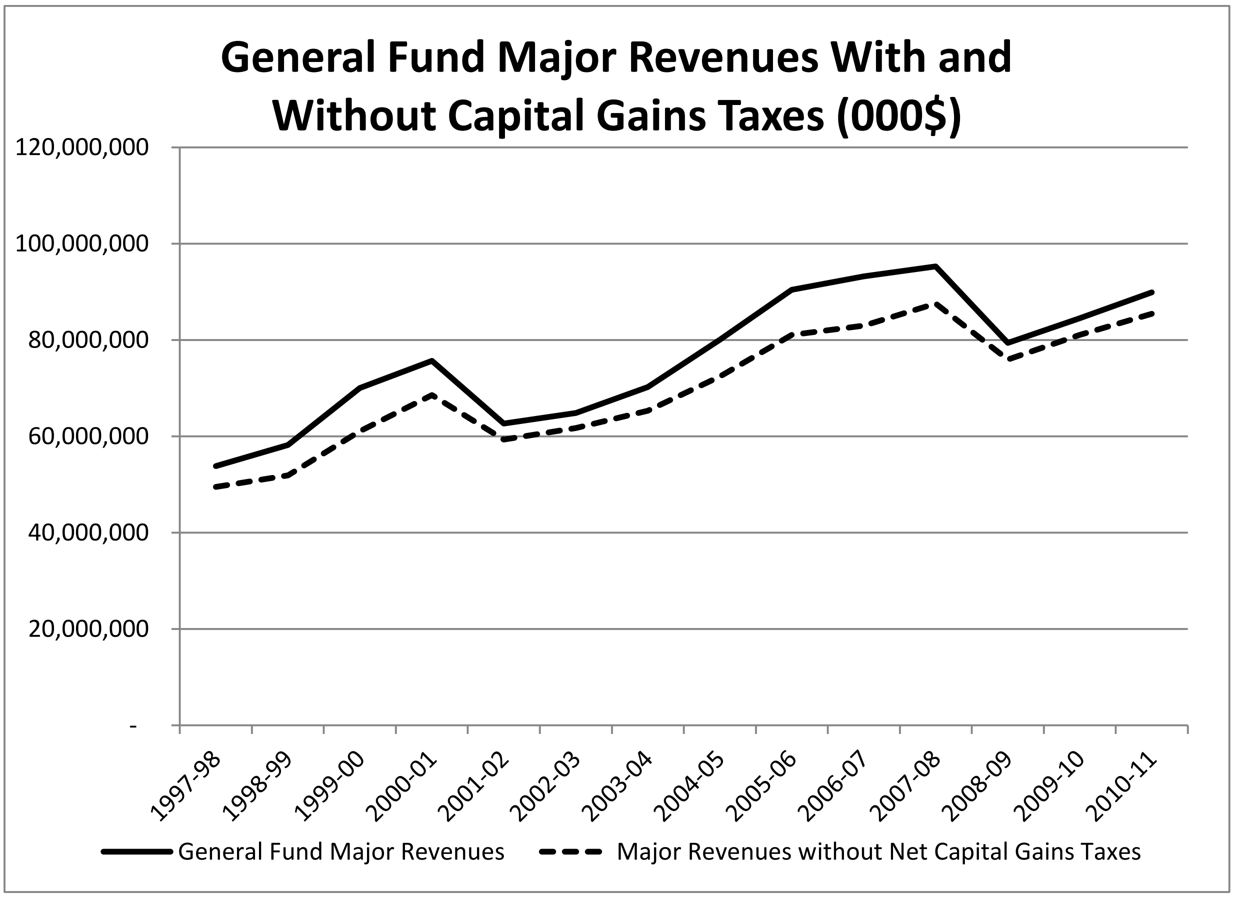
- Legal judgments can result in sizeable revenue or expenditure swings. In recent years, the state has seen increases in expenditures pursuant to legal proceedings related to corrections, various budget cuts, and potential tax refunds. But it is also possible these one-time impacts could work in a positive 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.

[***] 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 would warrant a consideration of broadening the potential sources of funds required to be deposited to the reserve.

Capital Gains Deposits

Taxes on capital gains constitute an important—though variable and erratic—component of the state's General Fund revenues, as shown in the figure below. The Administration proposed to calibrate fund deposits based on capital gains revenues in excess of 6.5 percent of the General Fund. This proposal raised a number of complicated issues, specifically:



Source: California Legislative Analyst's Office and State of California Department of Finance

- 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 state expenditures below the

[†††] Since 2000, the percentage has been even higher. Specifically: 2000-01—10.8%; 2001-02—5.6%; 2002-2003—4.5%; 2003-2004—6.2%; 2004-05—8.8%; 2005-06—10.3%; 2006-07—10.7%; 2007-08—9.4%; 2008-09—4.9%; 2009-10—3.5%; 2010-11—5.0%; 2011-12—6.8%; 2012-13—10.5%; 2013-14—9.7% (est.); 2014-15—9.1% (est.), for a simple average of over 7.5%.

long-term average. There was also no guarantee that 6.5 percent—or any other specific threshold—would 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,' would likely substantially alter the capital gains tax base in California.[‡‡‡]

- 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 consequently such information is 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.

[‡‡‡] 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.

[§§§] The measure relies on various estimation and deposit responsibilities by the Administration. These include an estimate (and notification to the Legislature) of General Fund proceeds of taxes, tax revenue derived from capital gains realizations and subsequent follow-up calculations, and schedules related to debt payments in lieu of deposits to the reserve. Because of the estimation issues related to forecasting tax revenues on capital gains realizations, the Administration would be required to make so-called "true-up" calculations in the two subsequent years following the initial estimate of tax revenues derived from capital gains realizations. Over-estimation or under-estimation amounts would generate debits or credits against the reserve fund, with offsetting debits and credits to the General Fund.

Additional Issues

The Governor's proposal raised additional concerns among legislators, directly relating to the powers of appropriation which are the key to legislative discretion. Given the current Administration's focus on debt repayment, there were significant concerns related to the ability to provide program resources while at the same time aggressively paying-down debt and funding an entirely new reserve. The Administration's proposal allowed for supplemental payments to the state's budgetary debt and long-term liabilities, but did not provide any parameters or limitations under which such alternative use of funds could occur.

In addition, suspending deposits or allow withdraws would require a finding by the Governor of a budget emergency (natural disaster, fiscal emergency, or an inability to fund programs at the current year level accounting for population and cost-of-living changes). There would also be a limit on the maximum amount that could be withdrawn during the first year of a recession to half of the fund's balance, ensuring that the state would not overly rely on the fund at the start of a downturn. This simple test could lock the state into lower levels of spending caused by short-term-downturns.

Legislature's Reserve Fund Approach

The Legislature chose to work from the basic framework as the Governor's January proposal, but incorporate several fundamental modifications. The Legislature's revised budget reserve proposal—ultimately approved by the Legislature and signed by the Governor—addressed a number of issues that had been identified in legislative hearings and over several months of discussion.[****] These modifications were designed to enhance the 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 frequency and magnitude of unanticipated required reserve deposits.

Reserve Fund Deposits

The Legislature's counter proposal largely (but not completely) delinked deposits from receipt of capital gains' related taxes by requiring annual deposits to the reserve fund equal to 1.5 percent of total General Fund revenues. In addition, the altered measure calls for deposits in an amount equal to revenues derived from tax liabilities associated with capital gains realizations if, and only to the extent, such associated revenues are in excess of 8.0 percent of General Fund

[****] The measure was approved by the voters in November 2014, with 69 percent voting in favor of the proposal and 31 percent opposed.

revenues. Deposits to the reserve fund would be made until or unless, the account balance reaches an amount equal to 10 percent of General Fund revenues.[††††‡‡‡‡]

The requirement to deposit 1.5 percent of General Fund revenues in the budget reserve moved away from the problematic concept in the original proposal that relied exclusively on "excess" capital gains revenues. While the measure provides for a supplemental deposit to the reserve of revenues derived from capital gains income in excess of 8.0 percent of General Fund revenues (less amounts deposited to the Proposition 98 Reserve), this source is estimated to be a subordinate component of contributions to the budget reserve, as shown in the Appendix.[§§§§] This revision implicitly recognizes that revenue components other than capital gains income (such as bonuses, stock options, corporation taxes) are also quite volatile by incorporating these revenues in the 1.5 percent deposit.

In addition, the reduced reliance on capital gains as a source for reserve funding—operative only in robust periods of robust capital gains spikes—would eliminate or reduce the impact of a number of technical and fiscal issues that were raised. Specifically, relative to the original proposal, the revised measure would in most years: (1) lessen 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) reduce the impact of inevitable miss-estimations of capital gains tax revenues, thus avoiding large capital gains true-ups and facilitating a more certain budgeting process; and (3) make the selection of the capital gains as a percent of General Fund revenues threshold less significant given the reduced importance of these revenue sources to the funding of the budget reserve.

Reserve Withdrawals and Deposit Suspensions

One of the principal concerns with the Governor's proposal was that state spending would be 'trapped' at a lower than desired level as a result of temporary economic and fiscal downturns. This could occur either because of mandatory deposit rules or restrictions on withdrawals from the reserve fund. One of the tests imposed in the Governor's original plan was that withdrawals

[††††] Thus, compared to the Governor's proposal, deposits to the reserve would be greater in the event capital gains taxes were less than 8.0 percent of the General Fund. If capital gains taxes were 8.0 percent or more of the General Fund, reserve deposits under the two plans would be equivalent.

[‡‡‡‡] In the event the reserve fund reaches a balance equal to 10 percent of General Fund revenues, additional revenues that would otherwise be deposited in the reserve fund may be expended only for infrastructure costs, as defined by Section 13101 of the Government Code, including any associated deferred maintenance.

[§§§§] The proposal also establishes a Proposition 98 Reserve, funded by the portion of tax revenues derived from capital gains realizations that are in excess of 8.0 percent of General Fund revenues. Transfers would occur if the state: has met total school funding requirements as increased for enrollment growth and the higher of two cost-of-living factors. Transfers would be subject to true-up calculations and not result in a balance in the reserve in excess of 10 percent of the Proposition 98 guarantee. Funds would be appropriated from the Proposition 98 Reserve in circumstances when the amount required to be applied by the state for the support of K-14 education exceeds the allocation of General Fund revenues, allocated local property taxes, and other available resources.

would be limited to funding programs at the current year level, raising the possibility of artificially depressed spending.

In the legislative construct, the suspension and withdrawal triggers are based on a three year calculation of spending. This could allow for some recovery to past levels of spending while ensuring that a more long lasting decline in available resources would result in a trimming of spending. Specifically, if the Governor declares a budget emergency, the Legislature may take action to suspend or reduce required deposits to the reserve fund and return and appropriate funds that have been deposited in the reserve fund. No more than 50 percent of the reserve fund balance may be withdrawn for appropriation (unless a withdrawal occurred in the immediately prior year). Under the legislative counter proposal, a budget emergency is defined as:

1. Conditions of disaster or extreme peril, such as a natural disaster, as set forth in paragraph (2) of subdivision (c) of Section 3 of Article XIII B of the California Constitution.

2. A determination by the Governor that estimated resources are inadequate to fund General Fund expenditures equal to the highest amount of such expenditures over the most recent three prior years, after accounting for cost-of-living adjustments and population growth.

The expansion of the reference base from one to three years would lessen the chances of the state being locked into lower spending stemming from short run economic declines. At the same time, it would tend to curtail spending when resources are lower and expected to continue at a lower level (absent the adoption of revenue enhancements).

Diversion for Debt Payments and Excess

The current Administration has been focused on debt reduction since it took office in 2010. In an attempt to put California's finances on a sustainable track—after significant period of time of borrowing to achieve budgetary balance—the Administration has aggressively paid off external borrowing and internal inter-fund borrowing, as well as 'trued-up' billions in deferred payments to local school districts. These efforts have paid off with respect to the budgetary bottom line, but have constrained the rebuilding of public programs.

The Legislature sought to ensure that establishing a reserve and making debt repayments would not totally consume available resources and preclude the restoration and rebuilding of various programs and services. Accordingly, for fiscal years 2015-16 until 2029-30, 50 percent of the revenues that would otherwise be deposited in the budget reserve must be used to pay for unfunded prior year General Fund obligations, budgetary loans to the General Fund, payable claims for mandates incurred prior to 2004-05, and unfunded liabilities of state-level pension plans. After this period, up to 50 percent of revenues that would otherwise be deposited in the reserve fund could be used to pay such specified obligations in lieu of being deposited. Once the fund reaches a maximum size, additional amounts of capital gains related revenues that would otherwise be placed in the reserve may be spent only on infrastructure.

Conclusion

Establishing a functional reserve requires balancing numerous conflicting demands. Demands for current expenditure and capital investment must be balanced against the need for an adequately-sized reserve. Prudent rules for the suspension of deposits and reserve withdrawals must be balanced against budget flexibility in times of fiscal stress. Legislative prerogative must be balanced against administrative controls. It is unlikely that even a resolutely deliberative process could identify and appropriately weigh the different demands; the political environment makes the chances of this even more remote. Nevertheless, informed by the recent brutal fiscal conditions in California, the Governor's proposal and the ensuing compromise with the Legislature on the design of the reserve represents a credible attempt to balance the conflicting goals.

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 have considered was to work more explicitly from the foundation established by Proposition 58. The Governor, after all, facilitated 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 have been 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. Nevertheless, the current proposal seems a reasonable balance of imposed rules and legislative discretion.

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 attempted to devise an appropriate design of a state reserve, and in particular, gave 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.

Appendix

The Department of Finance estimates the following deposits to the proposed budget reserve.

New Reserve Policy
at 2014 Budget Act

(Dollars in Millions)

		2015-16	2016-17	2017-18
	1.5% under Prop 58			
1	General Fund Revenues and Transfers	$113,265	$118,129	$123,379
2	Prop 58 Transfer (1.5% of General Fund Revenues & Transfers)	$1,699	$1,772	$1,851
	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)	$1,873	$2,005	$2,191
11	**Debt Repayment (50%)**	**$937**	**$1,002**	**$1,096**
12	**Deposit to Rainy Day Fund (50%)**	**$937**	**$1,002**	**$1,096**
	Cumulative Balance in Rainy Day Fund [1/]	**$2,543**	**$3,545**	**$4,641**

[1/] Includes balance of $1,606m from 2014-15.

Source: California Department of Finance