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The Challenge Of Establishing A State Budget Reserve: The California Example

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For state governments that are subject to balanced-budget requirements, harnessing periods of relatively stronger revenue growth to build up a reserve makes intuitive sense. In Standard & Poor's Ratings Services' view, states that are capable of consistently doing this are better positioned when the next revenue downturn strikes. Indeed, under our state sector criteria, we assign a stronger budget management score to states that have a reserve policy that they can likely follow. Nevertheless, this and the other benefits of following a reserve policy do not ensure that it will actually come to fruition.

In California, a tendency to make long-term spending commitments in flush times without setting much aside for a rainy day, combined with a heavy reliance on capital gains taxes, has led to volatile fiscal performance. Lawmakers are considering replacing the currently proposed reserve policy before it goes to voters, scheduled for November. As the concept for a new policy has evolved from the abstract to the more tangible, several technical issues related to its potential implementation have emerged. It's possible that, in response, policymakers will decide to make some adjustments to the governor's reserve proposal, ACA X-2 1. But if these technical obstacles stymie lawmakers, and the state fails to advance the cause of strengthening its reserve, it could prove to be a missed opportunity.

Overview

- Much of California's revenue volatility arises from its reliance on capital gains taxes.
- A revision of a reserve proposal would fund the reserve through excess capital gains tax revenue.
- We believe, depending on the details, that such a measure could help improve the state's credit quality.

California legislators recently convened in a special session called by Gov. Jerry Brown to consider his budget reserve proposal. The governor's recommendation, Assembly Constitutional Amendment X-2 1 (ACAX2-1), would replace an existing "rainy day" fund proposal, ACA 4, currently scheduled to go before voters in the November 2014 election. Before making it to the ballot, however, ACAX2-1 requires the approval of two-thirds of each house of the state legislature. If the legislature sends it forward and a majority of voters support it, ACAX2-1 would replace Proposition 58, the state's current rainy day fund policy.

In our view, California's credit quality could benefit from a more robust budgetary reserve. Not only do we view the consistency of deposits under its existing reserve policy (Proposition 58) as weaker than those of numerous other states, but we have also cited California's revenue volatility as a limiting rating factor. These two attributes of California's finances -- a weak or absent reserve fund mechanism combined with a volatile revenue base -- have undermined the state's credit quality over the years. Therefore, we believe a policy requiring more regular deposits, especially if it involves setting aside a portion of the state's tax collections when they spike, could help on both fronts. That is what proponents of ACAX2-1, including the governor, assert the amendment would do. In fact, curbing the effects of California's revenue volatility on its finances is central to the design of the policy proposal, according to the

Department of Finance (DOF).

As drafted, the amendment would attempt to tame revenue volatility by linking the requirement for a reserve deposit to the performance of capital gains-related tax receipts. But importantly, in our view, the threshold level would be set low enough to require a deposit in most years, according to the DOF. Specifically, the amendment calls for deposits into the reserve whenever capital gains tax receipts equal or exceed 6.5% of general fund tax revenues. Despite the financial market and budgetary turmoil of the past 10 years, capital gains tax receipts have cleared this hurdle seven times.

Key Provisions Of ACAX2-1

- Links requirement for reserve deposits to capital gains-related tax revenue performance
- Increases maximum balance to 10% from current 5% of general fund revenue
- Allows for certain debt repayment in-lieu of making deposits
- Withdrawals and suspensions of deposits require governor's fiscal emergency declaration and majority agreement from legislature
- Restricts withdrawals to 50% of reserve balance in first year
- Enshrines in constitution requirement for multiple-year general fund budget forecast
- Establishes provisions for a separate Proposition 98 (school) reserve

Reserve Comparison

	Proposition 58	**ACA 4**	**ACAX2-1**
Status	In effect	Currently scheduled for November 2014 election	Would replace ACA 4 on November 2014 ballot if approved by two-thirds of legislature
How is it funded?	Three percent of general fund revenue (half used for repayment of economic recovery bonds until they are retired)	1.5% of general fund revenue plus revenue in excess of 20-year trend or prior-year revenue once adjusted for population and inflation	Amount of capital gains revenue above 6.5% of general fund tax revenue. Split into Proposition 98 portion versus the remaining amount for the budget stabilization account (non-Proposition 98).
Funding level target (% of general fund revenue)	Greater of $8 billion or 5%	10% of GF revenues	10% of general fund tax revenue in budget stabilization reserve; 10% of Proposition 98 allocation held in separate Proposition 98 reserve.
May deposits be suspended?	Yes, at governor's discretion	By executive order only in years when withdrawals would also be permitted	Yes, if governor declares fiscal emergency and majority of legislature consents
Conditions for use of reserve	None	If revenue falls short of prior-year spending once adjusted for inflation and population	Governor must declare fiscal emergency; majority of legislature approval
Limits on withdrawals?	None	Maximum transfer out of 50% of balance if there is a current year budget shortfall.	Fifty percent of balance in first year of budgetary emergency

GF--General fund.

Will The Funding Mechanisms Work?

California's Legislative Analyst's Office (LAO) has articulated some practical challenges with the governor's reserve-fund proposal. Primary among them is the difficulty inherent to estimating personal income taxes (PIT) on net capital gains. The policy, by linking deposits to performance of capital gains-related taxes, could therefore suffer from the same uncertainty that it aims to address. Furthermore, final actual tax receipts attributed to net capital gains remain in flux for up to two years. To address this, the proposal includes a true-up mechanism, so that initial deposits may be increased or decreased through the two subsequent years. But such a process gives rise to the possibility that transfers in or out of the reserve may be necessary at later points that are out of step with the then-prevailing economic conditions.

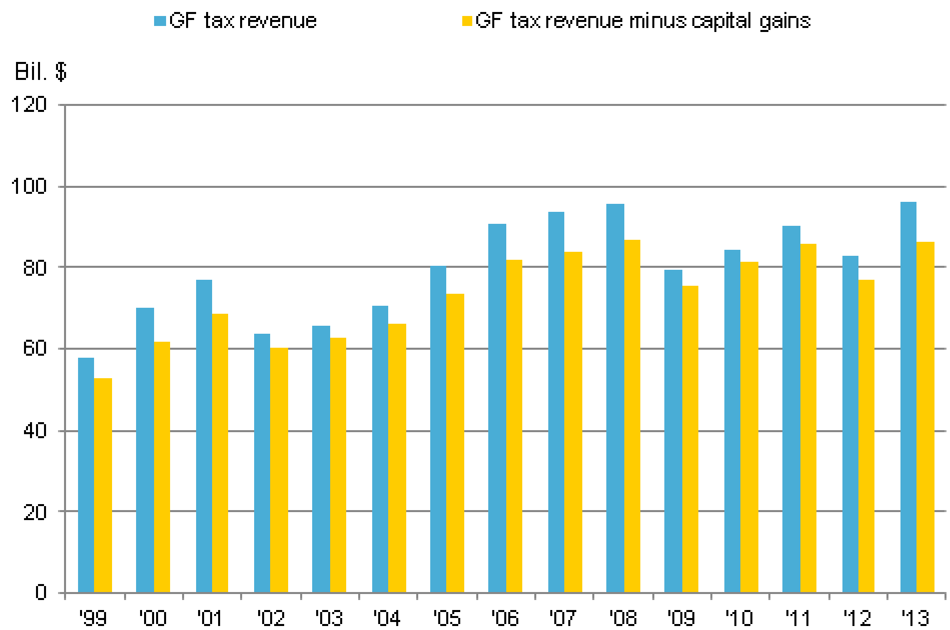
For instance, if capital-gains revenue came in above the state's initial projection, the state could need to make a deposit in a subsequent year. At that point, it's possible that economic conditions may have deteriorated.

Proponents of the measure argue that the provision establishing a Proposition 98 reserve would help smooth out the amount of state funding that goes to education. In some years when the Proposition 98 formula calls for a large increase in state funding to schools, instead of being disbursed, a portion of the funding would be retained in a separate reserve. Funds held in the Proposition 98 reserve would be unavailable for non-Proposition 98 purposes. Instead, they would be held until a year in which weaker general fund revenue performance allows the state to reduce funding for education. Withdrawals would also be allowable even if the formula increased school funding but not by enough to accommodate enrollment growth or cost-of-living increases.

In our view, a mechanism to level-out fluctuations in spending required by Proposition 98 could benefit the state's budgetary performance. However, the specific conditions necessary to trigger a deposit, particularly general fund revenue growth rates as measured in Proposition 98's formulas, have occurred only infrequently in past years. As we understand it, however, rather than looking to past performance, the Proposition 98 reserve proposal reflects the DOF's expectation of how general fund revenue will perform in the future. In our view, the key question is whether a more progressive and PIT-reliant tax structure would result in frequent enough deposits to generate a meaningful balance. If so, this reserve feature could help the state with managing spending-side volatility. But there is no way to know the answer to this prior to the proposal's implementation.

On a related note, the LAO has pointed out that capital gains are not the state's only source of revenue volatility. By our calculations, from one year to the next, state general fund tax revenues have increased as much as 20.3% and declined as much as 17.2% during the past 15 years. But when we exclude capital gains-related PIT from the state's general fund tax revenue, the range -- from 16.6% on the upside to negative 12.9% on the downside -- is somewhat narrower. And two-thirds of the time during these 15 years, the swings in tax revenues have been more pronounced when capital gains are included than when we exclude them.

California Revenues



GF--General fund.

Assessing The Reserve Proposal

Deposits are linked to capital gains

In our view, no perfect way to neutralize revenue volatility exists. California's tax regime, as well as its demographic and income distribution characteristics, probably makes a certain amount of revenue volatility unavoidable. By setting the threshold low enough to require deposits in most years, as the proposal appears to do, it could significantly strengthen the state's institutional commitment to a budget reserve. It could also, in our view, help to partly mitigate the effects of the state's underlying revenue volatility on its finances.

Flexibility to repay debt is mostly favorable

In years when capital gains-related tax receipts would otherwise trigger a deposit to the reserve, the proposal allows the governor and legislature to instead repay certain types of debt. In our view, some of the alternative uses of funds that would be allowed under the amendment are more consistent with the concept of a budget reserve than others. In particular, we view the ability of the governor and legislature to retire budgetary debts, such as internal loans or payment deferrals, as most aligned with a rainy day fund. The state incurred these debts to fund its operating budget; reversing them likewise restores fiscal capacity.

The policy would also allow the state to make supplemental payments against unfunded pension or retiree health care benefit liabilities in lieu of making a deposit. Similarly, it would permit using revenues to finance infrastructure investment instead of making a deposit if doing so would supplant the issuance of previously authorized bonds. We view paying down unfunded retiree benefit liabilities and avoiding additional debt as having merit from a credit perspective. However, neither serves the same purpose as a budgetary reserve, which is to stabilize a state's finances through a one- to three-year revenue slump.

That said, insofar as required contributions to the California State Teachers' Retirement System (CalSTRS) continue to remain below the actuarially recommended level, any supplemental contributions are better than none. But allowing these types of payments shouldn't be mistaken for a real solution to the state's underfunding problem related to CalSTRS.

Recent Experience Demonstrates The Need For A Stronger Reserve

As the LAO has pointed out, the state has a track record of committing to new ongoing spending commitments during years of stronger revenue growth. For example, we calculate that general fund tax revenues, in a reflection of the technology boom, surged 69% between fiscal 1996 and 2001. General fund expenditures more than kept pace, however, growing by 72% during the same period. But whereas tax revenues fell 17% in fiscal 2002, expenditures ratcheted down by just 1.7%. In other words, the state had built the temporary higher revenues into its ongoing spending base.

Had a reserve policy been in place that required saving a portion of the extraordinary revenue growth, it may have lessened the state's mid-decade budget problems in two ways. First, the funds put in reserve would not have been available to fund new spending commitments. Second, the state would have had more of a fiscal cushion to absorb the fiscal 2002 tax revenue downturn. Instead, several fiscal policy decisions actually worsened the state's budget situation.

In fiscal 2004, the state transitioned to a revenue structure that relied on cyclical PIT revenues by sharply reducing the more stable motor vehicle license fee (MVLF). After the state confronted a $38.2 billion projected deficit heading into fiscal 2004, the MVLF rate reduction in November 2003 exacerbated the fiscal strain. Whereas in May 2003 the state estimated its structural gap for fiscal 2005 would be $7.9 billion, by January 2004 it had revised the structural deficit to $14 billion. Ultimately, the state would finance much of its deficit problem with voter-approved debt without successfully solving its underlying structural problems. Thus, rather than being flush from strengthening revenue in the mid-decade years leading up to the Great Recession, the state was still contending with the fiscal hangover left from the prior downturn. Then the Great Recession struck, and the state's structural gap ballooned to more than $20 billion. By early 2011, the state faced a nearly $27 billion projected shortfall between revenues and spending. And, in addition to having no budgetary reserve, it was carrying nearly $35 billion in budgetary debts. These obligations included school aid deferrals, internal loans, and the bonds that had been issued beginning in 2004 solely to finance the state's budget deficit. They were also distinct from its other long-term bonded debt obligations and liabilities for retiree benefits.

A reserve with the teeth to require deposits in better revenue years could have facilitated the creation of a fiscal cushion while also having a disciplining effect on spending. Both would likely have benefited the state's credit quality throughout the late 1990s and into the 2000s.

Mobilizing Support

When it comes to reaching a legislative supermajority on fiscal matters, California has a weak track record. Given this, we cannot rule out the possibility that ACAX2-1 won't move forward. With its current composition, passage of the amendment would require at least some bipartisan accord. On one side, the Republican minority caucus has suggested that it may prefer more onerous restrictions on the state's ability to make withdrawals from the reserve. Conversely, from the governor's own party, and in a demonstration of what we have termed "austerity fatigue," some policy advocates have expressed reservations about putting funds in a reserve rather than deploying them for programs. Sorting through these tensions, as well as refining the measure in light of the technical issues the LAO has raised, represents a test of sorts for the state. But if the legislature succeeds in assembling the consensus necessary to move the measure forward, it could mark another step in California's ongoing journey toward a more sustainable fiscal structure.