Commission on the
21ST Century Economy

MEMORANDUM

Date: March 12, 2009

To: Commissioners
From: Staff, Commission on the 21st Century Economy
Re: Budgetary Reserves

This memorandum responds to the Commission's expressed interest in budget management options in conjunction with potential changes in the tax structure. Specifically, this memorandum addresses current and proposed policies for establishing and maintaining a budget reserve The California Constitution requires the establishment of a prudent state reserve fund. California has long contributed to a reserve with mixed results. The size of these reserves has generally been insufficient to compensate for the increasing volatility in California's revenues. In addition, restrictions on withdrawals have not been stringent enough to maintain the reserve for the times when it is most needed. We have provided additional detail on current and proposed reserve requirements below.

I. The Current System: Proposition 58 and the Budget Stabilization Account

Proposition 58, passed by the voters in the March 2004 elections, created a Budget Stabilization Account (BSA) within the General Fund, required that the Legislature pass and the Governor sign a balanced budget, and prohibited most future borrowing to cover budget deficits. Half of each year's Proposition 58 transfers were slated to pay off debt. In 2006-2007, $472 million paid debt while an equal amount was directed to the BSA. In 2007-2008, $1.023 billion went to the reserve and the same amount went towards repaying incurred debt. Subsequently, in the same year, the entire balance of the reserve ($1.494 billion) was transferred out of the reserve and back to the General Fund. The Governor suspended the transfer to the BSA in 2008-09.

II. Proposed Alternatives: Proposition 1A State Finances and the Budget Stabilization Fund

In the May 2009 special elections voters will face a ballot initiative that will change the way that California creates and manages its prudent reserve. The proposed budget reform prevents the state from spending revenue above the long-term trend line (as defined by the initiative) and by creating a more substantial Rainy Day fund, or Budget Stabilization Fund (BSF).

Propositions 1A:

- Restricts the ability of the Governor to waive the annual transfer into the reserve. The governor can currently suspend or reduce the annual transfers into the BSA by an executive order.
- Restricts the purposes for which funds can be withdrawn from the reserve. Currently, funds can be transferred out of the BSA and into the General Fund by a majority vote of the Legislature and approval of the Governor.
- Limits the amount of money that can be withdrawn from the reserve. Money from the Rainy Day fund can only be used when revenue is insufficient to fund population-and-inflation-based growth in spending.
- Limits state expenditures based on revenue growth over the previous ten year period.
- Requires revenues above a decade-long trend to be deposited into the fund.
- Raises the target cap on funds in the BSF (from 5 percent or $8 billion under Proposition 58) to 12.5 percent of revenues.

III. What If This Proposal Had Already Been In Place?

According to modeling done by the Department of Finance, if this proposal had been in effect since 1998-99:

- General Fund, the Rainy Day Fund would have had a balance of $10.6 billion in 2007-08
- Spending in 2008-09 would have been $92.2 billion, which is only $1.7 billion more than it will be after all the current cuts. This represents an annual growth rate of 5.2 percent.
- It is also possible that if this proposal had been in place the state would benefit financially from higher credit ratings and lower debt-service costs.

Commissioners may also want to refer to the analysis of the initiative by the Legislative Analyst's Office. A copy of this analysis was included in the Commission binders for the March 10 hearing in Berkeley.