

## Assembly Constitutional Amendment 1

*July 2014*

**SDCTA SUPPORTS Assembly Constitutional Amendment 1** because it will help California budgeting by strengthening its “rainy day fund.” It also establishes procedures to pay down debt. The Budget Stabilization Account or the states “rainy day fund,” is currently capped at a level below the best practice for state reserves of 15 percent of annual spending. It is currently empty because transfers to it have been suspended and existing funds were withdrawn. This measure addresses these issues by increasing the cap from five percent to ten percent and limiting withdraws.

- Assembly Constitutional Amendment 1 is a legislatively initiated constitutional amendment dealing with state budgeting and saving. It is supported by Governor Brown and a two-thirds majority in both houses of the state legislature as a way to improve California’s finances.
- Throughout its past, California has been hit hard by economic recessions due to its highly progressive state tax system that is dependent upon high-income earners. ACA 1 addresses this issue through modification of the Budget Stabilization Account - the state’s “rainy day fund.”
- California’s revenues vary dramatically with the state of the economy. When in expansion, the state sees rapid revenue growth followed by huge declines during recessions.
- ACA 1 would increase the cap on the Budget Stabilization Account from five percent of General Fund Revenues to ten percent and put in place restrictions on when the money can be withdrawn to make sure it is only used in times of need. These savings would help offset the budget shortfalls caused by economic recessions.
- ACA 1 requires a transfer of money from the general fund yearly, and also relies on a supplementary transfer from any excess capital gains revenues the state has. This is meant to ensure excess revenue is saved.
- For the first fifteen years, half of any transferred money would be used to pay down state debt. This is intended to help the state manage its long-term obligations.
- ACA 1 specifies that transfers can only be suspended if the governor declares a state of emergency in the event of a disaster, or if state spending in the current year cannot keep pace with the high of the last three years.
- In addition, ACA 1 proposes a savings fund specifically for education spending. This is aimed at preventing cuts in education funding during future recessions, and to help the state cover its mandatory education liabilities under proposition 98.
- This measure does not require any new taxes or spending. The intent is to reduce rapid swings in state spending through more prudent fiscal planning.
- ACA 1 is designed to help ensure a more stable economic growth path for California by preventing excess spending in good economic times and creating a savings account to cushion the blows from future recessions. It is also designed to help the state pay off its long-term debt obligations.



## Assembly Constitutional Amendment 1

*July 2014*

**SDCTA Position:**                    **SUPPORT**

### **Rationale for Position:**

This initiative will help California budgeting by strengthening its “rainy day fund.” It also establishes procedures to pay down debt. The Budget Stabilization Account or the states “rainy day fund,” is currently capped at a level below the best practice for state reserves of 15 percent of annual spending. It is currently empty because transfers to it have been suspended and existing funds were withdrawn. This measure addresses these issues by increasing the cap from five percent to ten percent and limiting withdraws.

**Title:** Assembly Constitutional Amendment 1

**Jurisdiction:** State

**Type:** Initiative Constitutional Amendment

**Vote:** Simple majority of voters

**Status:** Qualified for November 2014 ballot

**Issue:** State finance reform

**Description:** Modifies the state “rainy day fund” by increasing the cap size of the existing Budget Stabilization Account. The proposal makes it more difficult to rapidly spend money in the account, and half of funds transferred to this account in the first fifteen years would be required to be spent on debt reduction. In addition, a savings fund for education established to ensure that in future recessions education funding does not need to be cut.

**Fiscal Impact:** The measure should help California get through future recessions with less reactionary spending cuts or revenue increases due to the increased state savings. This measure would also result in the state beginning to pay down its long-term obligations by mandating that half of transferred funds be used for that purpose each of the first fifteen years.

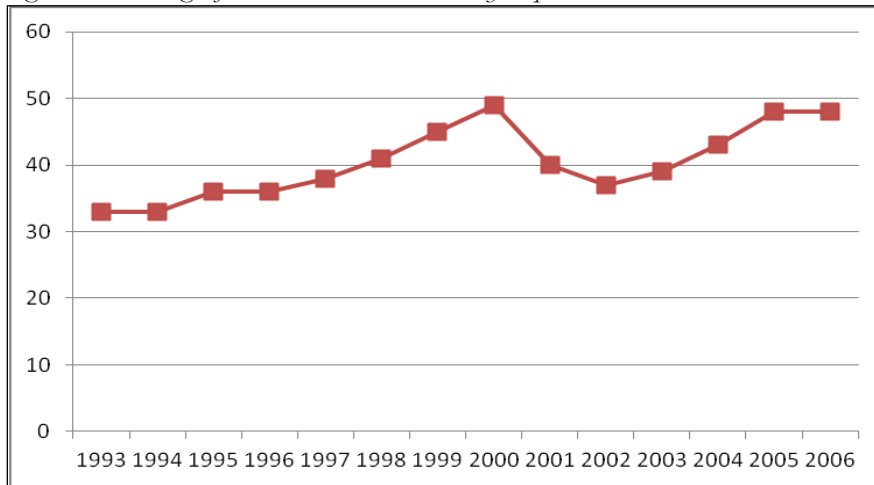
### **Background:**

Assembly Constitutional Amendment 1 is a legislatively proposed amendment to the California State Constitution introduced by Assembly Member John Perez. It was passed during a special session of the legislature by Governor Brown last month to address the issue of reforming the state’s “rainy day fund.” ACA 1 represents a compromise between the “rainy day fund” reform plan proposed by Governor Brown in his preliminary 2014-2015 budget released in January, and previously passed Assembly Constitutional Amendment 4, which was set to appear before voters this November. Assembly Constitutional Amendment 1 will now replace Assembly Constitutional Amendment 4 on the November ballot and requires approval of a simple majority of voters in the election. Each of these efforts were designed to help the state smooth spending levels through economic expansions and recessions. The proposal would change existing provisions in the California Constitution regarding state saving and the Budget Stabilization Account, or the state’s “rainy day fund.”

*California Tax Revenue Volatility*

California has a progressive state income tax rate, meaning the highest earners are paying a higher income tax rate than lower earners.<sup>1</sup> Recently, high-earners have accounted for approximately 40 percent of total personal income tax revenues as shown in Figure 1.<sup>2</sup> More recently, in 2011 the top one percent of earners accounted for 41 percent of state tax revenues.<sup>3</sup>

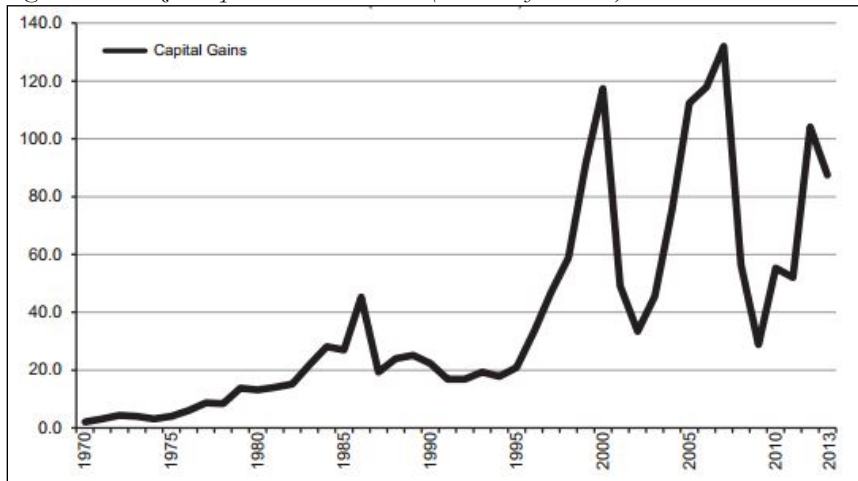
*Figure 1: Percentage of State Tax Revenue Paid by Top One Percent*



Source: Final Report of the Commission on the 21st Century Economy, SDCTA

Top income earners tend to rely more on non-wage income (real estate, stocks, investments), which is more volatile year to year and depends on the general economic climate and stock market. Figure 2 below from the proposed 2014-2015 California Budget displays the volatility in one major source of state revenues dependent upon the stock market, the capital gains.<sup>4</sup>

*Figure 2: Realized Capital Gains Revenue (Billions of Dollars)*



Source: Governor's Proposed 2014-2015 Budget

<sup>1</sup> California Franchise Tax Board. "[2013 California Tax Rates and Exemptions.](#)"

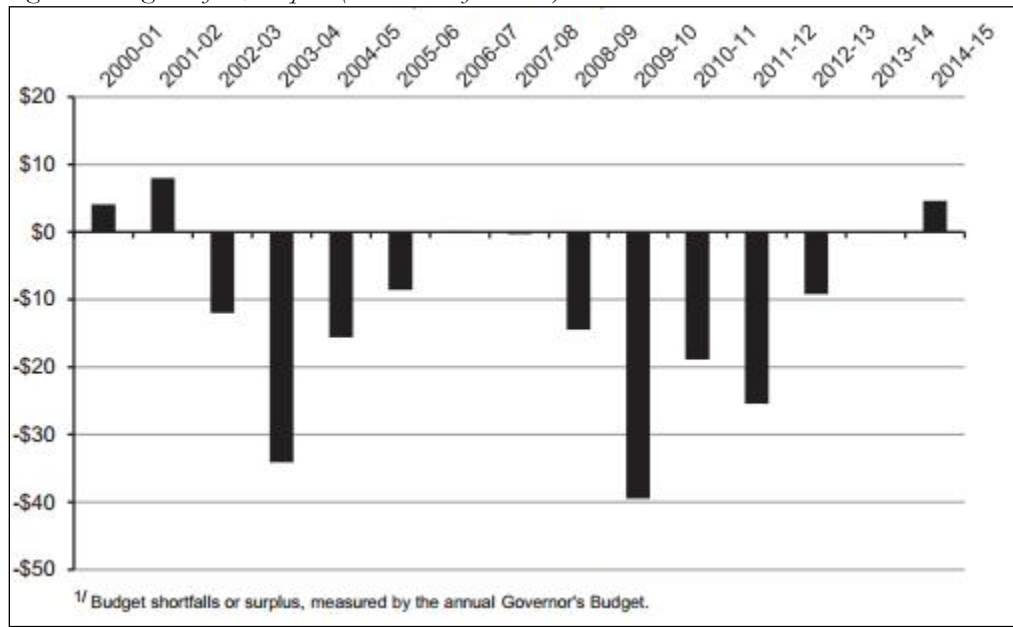
<sup>2</sup> Chart compiled using data from Commission on the 21st Century Economy. "[Final Report of the Commission on the 21st Century Economy.](#)" September 2009.

<sup>3</sup> Pemder, Kathleen. SFGate. "[State Leaders Closely Watching Migrating Millionaires.](#)"

<sup>4</sup> Office of the Governor. "[Governor's Proposed Budget 2014-15 Summary Revenue Estimates.](#)"

Figure 3 shows the massive increase in California deficits after the 2001 and 2007 recessions.<sup>5</sup> Large revenue and budgetary swings like these are problematic for government programs that provide a continuous service. A fiscally responsible reserves program could help alleviate the effects of this budgetary stress.

Figure 3: Budget Deficit/Surplus (in Billions of Dollars)



Source: Governors Proposed 2014-2015 Budget

#### “Rainy Day Fund” Best Practices

One of the most important aspects of a “rainy day fund” is its size relative to state spending. Currently California’s Budget Stabilization Account is capped at five percent of general fund revenues. According to the Government Finance Officers Association (GFAO) best practice guide:

*“The adequacy of unrestricted fund balance in the general fund should be assessed based upon a government’s own specific circumstances. Nevertheless, GFAO recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.”<sup>6</sup>*

The National Association of State Budget Officers also agrees with the need for larger reserves stating in their most recent report:

*“Before the Great Recession, a very informal rule-of-thumb was to hold approximately five percent of expenditures in total balances; however, states are now rethinking how much should be held in reserve, with some states recognizing that higher amounts are essential”*

<sup>5</sup> Office of the Governor. [“Governor’s Proposed Budget 2014-15 Summary Introduction.”](#)

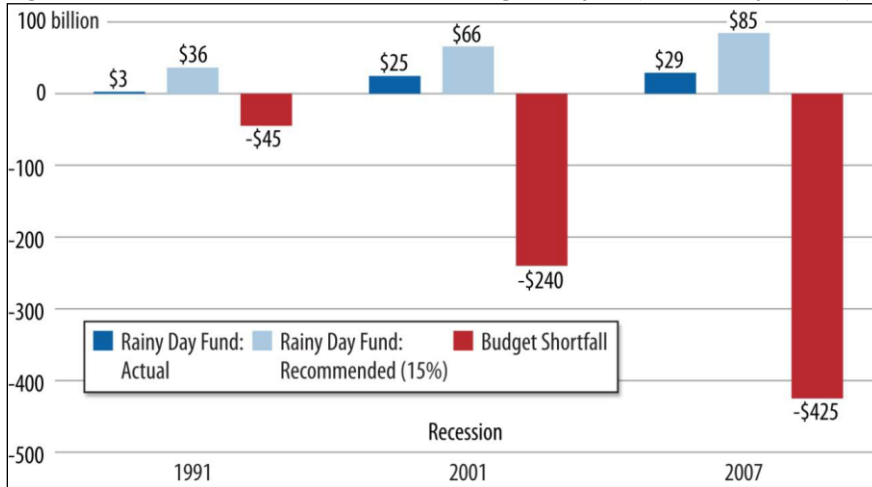
<sup>6</sup> Government Finance Officers Association. [“Best Practice Appropriate Level of Unrestricted Fund balance in the General Fund \(2002 and 2009\).”](#) October 2009.

<sup>7</sup> National Association of State Budget Officers. [“State Budgeting and the Lessons Learned from the Economic Downturn.”](#) Summer 2013.

When applying the GFOA best practice to the state’s budget, approximately 16 percent of general fund revenues would be held in reserve. In a 2011 report, the Center for Budget and Policy Priorities came to a similar conclusion about the necessary size of a state’s “rainy day fund,” about 15 percent of state annual spending.<sup>8</sup>

Figure 4 compares actual aggregate funds in all states “rainy day” accounts with the aggregate budget shortfalls associated with the past three recessions. It is clear that even “rainy day” accounts holding 15 percent of annual revenues are dwarfed by budget shortfalls created during the last three recessions. However, actual state savings pale in comparison even with the 15 percent figure. States in general have not been as prepared as they should have been for the last three recessions.

Figure 4: Peak Reserves Balance vs. Recession Budget Shortfalls (in Billions of Dollars)



Source: Center for Budget and Policy Priorities

### California History of Reserves

The idea of a “budget stabilization fund” goes back to Governor Earl Warren.<sup>9</sup> The former Governor recognized surpluses as temporary tax revenues created by the defense and manufacturing industries’ involvement in World War II. He urged caution in squandering these resources and advocated for setting up a state savings fund however was not successful in establishing one. The excess revenues were spent during the 1950’s and not replenished, leaving the state vulnerable to decreases in revenue caused by economic downturns.

More recently, there has been a renewed push to establish a “rainy day fund” in California. After being hit with a recession in 2001 and seeing state deficits grow, Californians voted with a 71 percent majority to pass Proposition 58 in 2004.<sup>10</sup> Proposition 58 created a “rainy day fund” in the state constitution and now, in-part as a response to the deficits after the 2008 recession, additional changes to this framework are being proposed.<sup>11</sup>

<sup>8</sup> McNichol, Elizabeth; Boadi Kwame. Center for Budget and Policy Priorities. “[Why and how States Should Strengthen Their Rainy Day Funds](#)” February 2011.

<sup>9</sup> California Taxpayers Association. “[Assembly Constitutional Amendment 4 of 2010 \(on November 2014 Ballot\) Strengthens California’s Rainy Day Fund.](#)”

<sup>10</sup> Smartvoter.org. “[Proposition 58 The California Balanced Budget Act.](#)”

<sup>11</sup> Section 20 Article XVI California State Constitution

### *SDCTA Past Position*

SDCTA supported proposition 58 and the creation of the current system back in 2004 as an effective way to address some of the systemic issues contributing to state budget deficits.

### *Current Law*

In March 2004, California voters passed Proposition 58 to create the basis for today's state government reserve fund. Proposition 58 included

- **A requirement for a balanced budget** by prohibiting the state legislature from signing or the governor from sending a budget where projected expenditures exceeded projected General Fund Revenues.
- **A defined procedure for the Governor to declare a fiscal emergency.** This process allows for midyear changes in the budget if the governor feels that the estimated funds or expenses that the budget is based on are significantly different from reality
- **The creation of a Budget Stabilization Account** (a “rainy day fund”) and sets a requirement for the state to transfer 3% of general fund revenues every year to this account.
- **A cap on required contributions if the account exceeds the smaller of 5% of general fund revenues or \$8 billion.** The governor can also suspend transfer of funds to this account. The legislature can transfer funds back to the general fund with a simple majority vote.
- **A Deficit Recovery Bond Retirement Sinking Fund is created.** This fund takes half the money transferred to the budget stabilization account and uses it solely to pay off state Economic Recovery Bonds passed under Proposition 57 in the same year. This account is capped at \$5 billion.

### **Proposal:**

ACA 1 is a legislatively referred constitutional amendment appearing on the November 2014 ballot after the California State Assembly and State Senate voted for it with a two-thirds super majority. If passed, ACA 1 would make the following changes to the above framework governing the states accumulation of cash reserves:<sup>12</sup>

- **1.5% of General Fund revenues will be transferred to the Budget Stabilization Account each year.** In addition, if capital gains tax collections exceed 8% of General Fund revenues, then the excess is transferred to this account.
- **Maximum size of the Budget Stabilization Account will increase to 10% percent of General Fund Revenues in a given year.** This is opposed to the 5% percent of General Fund revenue or eight billion dollar level used previously. If a transfer would cause the account to exceed that amount, then the money must be used on infrastructure appropriations instead.
- **Specifies the conditions under which the governor can declare a fiscal emergency.** Specifically transfers can be suspended if it is found that revenues are not sufficient to keep General Fund expenditures at least as high as the peak of the past three years after adjusting for inflation and population growth. In addition, disaster situations are grounds for suspending transfers.

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<sup>12</sup> ACA 1 text



- **Specifies new conditions on transferring money out of the Budget Stabilization Account including a maximum 50% transfer the first year such a transfer is made.** The legislature can only move to transfer money out of the account if the governor has declared a fiscal emergency.
- **Earmarks some of the money transferred to the Budget Stabilization Account to go towards deficit reduction.** Until 2030, half of all transfers to the account must be spent on retiring state obligations. After 2030, up to 50 percent could be for this purpose based on legislative discretion.
- **A new “Public School System Stabilization Account” would be created as a reserve for education spending under Proposition 98.** This fund is capped at ten percent of the obligated spending on education due to Proposition 98 in a given year and is drawn from capital gains revenues in excess of eight percent of general fund revenues. Money from this account can be used to support Proposition 98 spending in the event that the minimum spending required by Proposition 98 exceeds the allocation of General Fund revenues property tax revenues and other sources. Any funds deposited in the account are counted towards Proposition 98 spending in the year they are transferred to the reserve account and not the year they are actually appropriated.

### **Policy Implications:**

Assembly Constitutional Amendment 1 proposes to set resources aside from economic expansions to offset budget shortfalls during recessions. However, deficit reduction provisions reduce the growth of the Budget Stabilization Account by diverting funds to debt reduction. This is especially problematic given the state’s low cap on the reserve fund.

As noted in the background section, there seems to be a consensus that an effective “rainy day fund” should be somewhere near 15 percent of a state’s total expenditures. ACA 1 caps the “rainy day fund” at ten percent, a level that is below this best practice standard. However, California is not likely to see even that lower level of savings over the next 15 years, because half of all transfers to the Budget Stabilization Account are earmarked for debt reduction, and the transfers are partly dependent upon capital gains taxes (which as discussed above) are a volatile source of revenue. While reducing the state debt is not necessarily a bad thing, it does take away from the effectiveness of ACA 1 in its primary purpose of helping California smooth spending during economic downturns.

### **Fiscal Impact:**

No new spending or revenue changes are involved, but the new regulations of ACA 1 can have an important impact on state spending and saving patterns. If the state is successful in increasing its “rainy day” reserves, then California will be better positioned to avoid tax increases and spending cuts during the next economic downturn.

Raising the reserve cap for the Budget Stabilization Account from five percent of General Fund revenues or eight billion dollars to ten percent of General Fund revenues should result in the state saving more money to offset future recessions. The new rules that prevent the legislature from drawing the money back out immediately and restrict withdrawals to 50 percent of the fund in the first year of drawing on the fund mean that the money in the Budget Stabilization Account will be more likely to be available for its intended purpose.

In addition, the requirement that the state use half the transferred funds to pay down debt for the first fifteen years should result in meaningful debt reduction. Figure 5 from the 2014-2015 revised budget submitted in May shows estimates of savings and debt repayment under the new plan for the

next three years.<sup>13</sup> Approximately three billion dollars are expected to go towards retiring debt in the next three years alone.

Figure 5: Calculation of Rainy Day Amounts at 2014-2015 May Revision (Dollars in Millions)

	Fiscal Year		
	2015-16	2016-17	2017-18
Annual 1.5% of General Fund Revenues	\$1,698	\$1,773	\$1,854
Capital Gains Tax Revenues in Excess of 8% of General Fund Taxes <sup>14</sup>	\$174	\$233	\$341
<b>Total Rainy Day Amount</b>	<b>\$1,872</b>	<b>\$2,005</b>	<b>\$2,195</b>
Debt Repayment (50%)	\$936	\$1,003	\$1,097
Deposit to Rainy Day Fund (50%)	\$936	\$1,003	\$1,097

<sup>14</sup> Net of amount of revenues attributable to Proposition 98.  
Note: Numbers may not add due to rounding.

Source: Governor's Proposed Budget 2014-2015 May Revision

### List of Proponents:

- Governor Jerry Brown
- Kern County Superintendent of Schools
- California Forward<sup>14</sup>

### Proponent Arguments:

- State needs to better manage revenues to avoid reactionary spending cuts during recessions and to protect key programs.
- Making part of the reserves come from excess capital gains revenues is an attempt to end the boom and bust cycle and prevent the state from spending that excess on unsustainable new programs. In addition, having a component of savings from the General Fund as a more stable source allows the state to insure it is saving in most average years.

### List of Opponents:

- Riverside County Superintendent of Schools
- California Federation of Teachers<sup>15</sup>

### Opponent Arguments

- Support for the idea of a rainy day fund, but at a later date after spending for health and services programs have been restored. Paying down debt early when people are suffering due to state spending cuts does not seem right.

<sup>13</sup> Office of the Governor. "[Governor's Revised Budget 2014-2015 Introduction](#)." May 2014.

<sup>14</sup> California Forward. "[Testimony Submitted to the Assembly Budget Committee](#)." April 28, 2014

<sup>15</sup> California Federation of Teachers. "[The May Revision of the State Budget](#)." May 13, 2014.