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What Are California's State Budget Reserves and How Can They Be Used During the COVID-19 Crisis?

California is facing significant costs related to the immediate public health response to the COVID-19 crisis. In addition, the state will likely spend more on services such as health care and cash assistance for Californians whose incomes have fallen sharply in the wake of the statewide stay-at-home order. At the same time, the state's primary revenue sources – income taxes and sales taxes – will be lower than anticipated due to increased unemployment, stock market declines, and reduced consumer purchases. These factors – higher spending and lower revenues – have put the state on the cusp of a substantial budget shortfall.

California is in a much better position to address a budget gap compared to previous recessions because state policymakers prudently set aside billions of dollars for a rainy day. These reserve funds will help to soften the impact of the COVID-19 crisis on the state budget. However, these funds – which total nearly \$18 billion as of April 2020 – may be used up quickly depending on the severity and duration of the recession and the extent to which the state receives federal fiscal relief. This *Issue Brief* describes California's state budget reserves and explains how the funds can be accessed and used to help support key public systems and services during the uncertain economic times that lie ahead.

Budget Stabilization Account (BSA): California's Largest Reserve

With a balance of \$16.5 billion, the BSA is California's largest state budget reserve (Table 1).¹ Deposits into and withdrawals from this "rainy day fund" are based on complex rules that were added to the state Constitution by Proposition 2 of 2014.² Key rules include the following:

- **An annual deposit is required.** Prop. 2 requires that 1.5% of General Fund revenues be set aside every year, with half of these revenues going into the BSA and the other half used to pay down certain state debts.³ In some years, the state must set aside *additional* General

Fund revenues, which also are split equally between the BSA and debt payments.⁴

- **The annual deposit may be reduced or suspended in the event of a budget emergency.** If the Governor declares a budget emergency, the state may reduce or suspend the required BSA deposit with a majority vote of each house of the Legislature.⁵ Prop. 2 allows the Governor to declare a budget emergency when:
 - Conditions of disaster or extreme peril are present;⁶ or
 - The state has insufficient resources to maintain General Fund expenditures at

the highest level of spending in the three most recent fiscal years, adjusted for state population growth and the change in the cost of living.⁷

- **BSA funds may be withdrawn in the event of a budget emergency, but the entire balance cannot be removed at once.** If the Governor declares a budget emergency and the Legislature agrees with a majority vote of each house, funds may be taken out of the BSA.⁸ However, the entire balance cannot be removed immediately. Only the amount needed to address the budget emergency may be withdrawn, subject to the additional limitation that a withdrawal may not exceed 50% of the BSA balance in the first year of a budget emergency. In the second consecutive year of a budget emergency, all of the funds remaining in the BSA may be withdrawn.⁹

Funds that are taken out of the BSA may go toward any purpose determined by the Legislature. For example, these dollars could be used for health care services, subsidized child care for working families, cash assistance for people with low incomes, K-12 schools, and any number of other public services and systems.

Public School System Stabilization Account (PSSSA): The Reserve for K-12 Schools & Community Colleges

Prop. 2 also established the PSSSA, the state's budget reserve for California's K-12 schools and community colleges, which has a balance of \$377 million.¹⁰ Prop. 2 does not require an annual deposit into the PSSSA. Moreover, Prop. 2 restricts the circumstances under which transfers to the PSSSA can occur. In fact, no deposits were made until enactment of the 2019-20 budget last year. For a PSSSA deposit to be required *all* of the following conditions must be met:

- General Fund revenues that come from personal income taxes on capital gains are relatively strong;¹¹

- Growth in General Fund revenues leads to relatively strong growth in the state's annual minimum funding guarantee for K-12 schools and community colleges;¹² and
- The Legislature does not suspend the annual K-14 education minimum funding guarantee.

Even under these restricted circumstances, Prop. 2 limits the size of the deposit to the schools reserve when such a deposit is required.¹³ As a result, the \$377 million transfer to the PSSSA made last year amounted to less than 1% of state spending on K-12 schools and community colleges.

Deposits to the PSSSA may be reduced or suspended in the event of a budget emergency under the same rules that govern reductions or suspensions of deposits to the BSA (see the prior section of this *Issue Brief*). Similarly, funds may be withdrawn from the schools reserve if the Governor declares a budget emergency and the Legislature agrees with a majority vote of each house.¹⁴ In contrast to the rules governing the withdrawal of funds from the BSA, however, all of the PSSSA funds may be withdrawn in one year. Moreover, funds withdrawn from the PSSSA must be used to support K-12 schools and community colleges.

Safety Net Reserve: Funds to Protect the Medi-Cal & CalWORKs Programs

The Safety Net Reserve, which has a balance of \$900 million, was created in 2018 to set aside funds to help cover the costs of two programs that often see increases in enrollment during recessions: Medi-Cal and California Work Opportunity and Responsibility to Kids (CalWORKs).¹⁵ Both of these programs serve Californians with low incomes – with Medi-Cal providing health coverage, and CalWORKs providing modest cash assistance to families with children. During economic downturns, more people become unemployed and temporarily rely on these programs to cover their basic needs, increasing state costs.

The Safety Net Reserve is not a constitutional reserve, so there are no binding requirements governing deposits or withdrawals. As a result, funds can be transferred into and withdrawn from the reserve at the discretion of the Legislature. Additionally, while state law specifies that the funds are to be used only for Medi-Cal and CalWORKs costs during economic downturns, state policymakers could decide to modify this language and use the funds for other purposes. However, in establishing this reserve, policymakers clearly recognized the need to protect critical services for Californians with low incomes from budget cuts – cuts that would undermine Medi-Cal and CalWORKs at the very time that these programs are needed most.

Special Fund for Economic Uncertainties (SFEU): The Discretionary Reserve

The SFEU is the state’s discretionary General Fund budget reserve, meaning policymakers have a great deal of latitude in spending the funds in the reserve.¹⁶ The amount of money in the SFEU is equal to the difference between General Fund resources and General Fund spending in a given fiscal year.¹⁷ The SFEU serves as a buffer against unanticipated revenue shortfalls or spending increases. Due to the state’s constitutional balanced-budget requirement, which requires the state to enact a budget each year in which spending does not exceed available resources, the projected SFEU balance cannot be less than zero at the time the budget is adopted. However, if revenues come in lower than projected and/or spending unexpectedly rises, the SFEU balance will decline, and may become negative as spending begins to exceed revenues.

The Legislature can appropriate funds from the SFEU at any time and for any purpose. Additionally, in the event of a disaster, the Governor can allocate funds from the SFEU without the prior approval of the

Legislature. Specifically, when the Governor declares a state of emergency, the Department of Finance (DOF) can transfer funds from the SFEU into a subaccount called the Disaster Relief-Emergency Operations Account (DREOA).¹⁸ These funds are allocated to state agencies for costs that are “immediate and necessary to deal with an ongoing or emerging crisis.”¹⁹

The 2019-20 budget, which was adopted in June 2019, projected an SFEU balance of \$1.4 billion. However, in March the DOF transferred \$1.3 billion into the DREOA. These funds are being rapidly spent to support the state’s response to the COVID-19 pandemic, including expanding the surge capacity of hospitals and acquiring personal protective equipment and other medical supplies. As a result, the SFEU balance is currently around \$100 million based on the projections included in the 2019-20 budget.²⁰ While the federal government is expected to reimburse the state for a large share of these costs, it’s unclear when the state will receive any such funding.

What’s Next for California’s State Budget Reserves?

Largely due to lessons learned from previous recessions, California policymakers and voters prudently established multiple reserves in recent years in order to better prepare the state for a “rainy day” – a future economic downturn. That day has arrived. The COVID-19 public health and economic crisis presents California with unique challenges and uncertainty. Policymakers will soon need to 1) determine the extent to which the state’s reserves can fill the gap created by declining revenues, and 2) decide how to allocate reserve funds to support critical public systems and services. As state leaders work to finalize the 2020-21 state budget, how they use California’s reserves will be pivotal to addressing the public health and economic consequences of the COVID-19 crisis.

TABLE 1

Understanding California’s State Budget Reserves

	Established in the State Constitution		Established in State Law	
	Budget Stabilization Account (BSA)	Public School System Stabilization Account (PSSSA)	Safety Net Reserve	Special Fund for Economic Uncertainties (SFEU)
How much is in the reserve? (April 2020)	\$16.5 billion	\$377 million	\$900 million	Around \$100 million
Is the state required to make an <i>annual</i> deposit?	Yes	No However, a deposit is required under a restricted set of circumstances. ¹	No	No
Can a required deposit be reduced or suspended – and by who?	Yes A required deposit can be reduced or suspended if the Governor declares a budget emergency and the Legislature approves the reduction or suspension by a majority vote.	Yes A required deposit can be reduced or suspended if the Governor declares a budget emergency and the Legislature approves the reduction or suspension by a majority vote.	Not applicable	Not applicable
When can funds be withdrawn?	Funds may be withdrawn if the Governor declares a budget emergency and the Legislature passes a bill, by majority vote, to withdraw funds. ²	Funds may be withdrawn if the Governor declares a budget emergency and the Legislature passes a bill, by majority vote, to withdraw funds. ³	The Legislature may withdraw the funds at any time by majority vote.	The Legislature may withdraw the funds at any time by majority vote. ⁴
Is there a limit on the amount of funds that can be withdrawn?	Yes The amount that can be withdrawn is 1) limited to the amount needed to address the budget emergency and 2) cannot exceed half of the funds in the BSA, unless funds had been withdrawn in the previous fiscal year.	No ⁵	No	No
How can the funds be used by the state?	Funds may be used for any purpose.	Funds must be used to support K-12 schools and community colleges.	Funds are intended to maintain existing CalWORKs and Medi-Cal benefits and services during an economic downturn, but may be used for any purpose if the Legislature so chooses.	Funds may be used for any purpose.

Note: A “budget emergency” that’s declared by the Governor is defined as either: 1) the existence of “conditions of disaster or of extreme peril to the safety of persons and property within the State, or parts thereof” as currently defined in Article XIII B, Section 3(c)(2) of the state Constitution; or 2) a determination by the Governor that there are insufficient resources to maintain General Fund expenditures at the highest level of spending in the three most recent fiscal years, adjusted for state population growth and the change in the cost of living. Article XIII B, Section 3(c)(2), defines “conditions of disaster or of extreme peril” as being “caused by such conditions as attack or probable or imminent attack by an enemy of the United States, fire, flood, drought, storm, civil disorder, earthquake, or volcanic eruption.”

Sources: California Constitution, California Government Code, California Welfare and Institutions Code, Legislative Analyst’s Office, and State Controller’s Office

Endnotes are on the following page.

TABLE ENDNOTES

- ¹ For example, these circumstances include requirements that deposits only occur when capital gains tax revenues exceed a specific level of total General Fund proceeds of taxes and when growth in the state's minimum funding guarantee for K-12 schools and community colleges is relatively strong.
- ² The withdrawal rules governing the BSA may not apply to some of the funds in the BSA. Specifically, of the \$16.5 billion in the account, \$3.1 billion was either in the reserve before the current BSA rules took effect in 2014 or was added by the Legislature in recent years as an optional (non-mandatory) deposit. The Legislative Analyst's Office argues that the Legislature could appropriate this \$3.1 billion with a majority vote and without a declaration of a budget emergency by the Governor. In contrast, under this interpretation, the various withdrawal rules *would* apply to the remaining \$13.4 billion in the BSA. Separate and apart from this issue, funds *must* be withdrawn from the BSA – without the need for a declaration of a budget emergency – when updated revenue estimates indicate that a prior-year deposit was greater than required.
- ³ Funds *must* be withdrawn from the PSSSA – without the need for a declaration of a budget emergency – when the state's minimum funding guarantee for K-12 schools and community colleges is less than the prior year's funding level, adjusted for changes in student attendance and the cost of living, or when updated revenue estimates indicate that a prior-year deposit was greater than required.
- ⁴ Additionally, the Department of Finance may withdraw funds from the SFEU without legislative approval to cover the cost of state disaster response efforts upon an emergency proclamation by the Governor.
- ⁵ However, in any year when funds must be withdrawn from the PSSSA because the state's minimum funding guarantee for K-12 schools and community colleges is less than the prior year's funding level – adjusted for changes in student attendance and the cost of living – the required withdrawal is limited to the amount of that shortfall.

Scott Graves, Jonathan Kaplan, and Kayla Kitson prepared this *Issue Brief*. The Budget Center was established in 1995 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The Budget Center engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the Budget Center is provided by foundation grants, subscriptions, and individual contributions. Please visit the Budget Center's website at calbudgetcenter.org.

ENDNOTES

- ¹ The BSA balance is likely to be reduced even without any action by state policymakers. This is because certain constitutional provisions that govern the BSA – specifically, the “true-up” provisions – “will automatically adjust the balance of the BSA pursuant to new revenue estimates.” See Legislative Analyst's Office (LAO), *Update on State and School District Reserves* (April 23, 2020). The BSA balance could be reduced by around \$2 billion, according to the LAO. These dollars would return to the state's General Fund and could be used to help close a state budget shortfall. For a discussion of Prop. 2's true-up provisions, see endnote #8.
- ² Prop. 2 was placed on the November 2014 statewide ballot by the Legislature; voters approved the measure by a more than 2-to-1 margin. Prop. 2's rules are found in the California Constitution (Article XVI, Sections 20 to 22). For a comprehensive overview, see Scott Graves and Jonathan Kaplan, *Proposition 2: Should California Prioritize Paying Down Debt and Significantly Change State Budget Reserve Policies?* (California Budget & Policy Center: September 2014).
- ³ Revenues that are set aside for paying down state debts may be used for several types of debt, including reducing unfunded liabilities associated with state-level pension plans and prefunding other retirement benefits, such as retiree health care.
- ⁴ This requirement to set aside additional General Fund revenues is triggered in years when estimated General Fund revenues that come from personal income taxes on capital gains exceed a specified target: 8% of total General Fund proceeds of taxes. The share of these “excess” capital gains revenues that is not owed to K-12 schools and community colleges under the state's Prop. 98 funding guarantee is split equally between the BSA and debt payments. The 50/50 split between the BSA and debt payments will continue until 2029-30, after which *all* revenues set aside each year, including those from the automatic 1.5% transfer, will be deposited into the BSA. However, state policymakers will have the *option* of using up to 50% of each year's BSA deposit to pay down specified state debts starting in 2030-31.
- ⁵ In contrast, the portion of General Fund revenues that is required to be used for debt payments cannot be reduced or suspended under any circumstances.

- ⁶ A budget emergency that is declared in response to a disaster or extreme peril must meet the definition provided in Article XIII B, Section 3(c)(2) of the state Constitution. This section refers to the existence of “conditions of disaster or of extreme peril to the safety of persons and property within the State, or parts thereof” and defines these conditions as being “caused by such conditions as attack or probable or imminent attack by an enemy of the United States, fire, flood, drought, storm, civil disorder, earthquake, or volcanic eruption.”
- ⁷ General Fund expenditures for the prior three fiscal years would be based on the level of spending “estimated at the time of enactment” of the budget bill for each fiscal year. The change in the “cost of living” would be measured using the California Consumer Price Index.
- ⁸ The BSA balance may be reduced for another reason unrelated to a budget emergency. Specifically, Prop. 2 requires revising prior calculations of “excess” capital gains revenues – once in each of the two subsequent years – as updated revenue estimates become available. (As explained in endnote #4, if there are “excess” capital gains revenues in any given year, then the portion of those revenues that is not owed to K-12 schools and community colleges under the state’s Prop. 98 funding guarantee is split equally between the BSA and state debt payments.) If a revision of “excess” capital gains revenues determines that a prior-year deposit to the BSA was *greater* than required, then the amount of funds equal to the over-deposit must be withdrawn from the reserve and returned to the General Fund. Alternatively, if a prior-year deposit was *smaller* than required, then funds must be added to the BSA to make up the difference. This after-the-fact “true-up” process does not apply to the portion of “excess” capital gains revenues that is used to pay down state debts each year. The true-up process also does not apply to the 1.5% of General Fund revenues that are required to be set aside each year.
- ⁹ There is some uncertainty around whether these withdrawal rules apply to the *entire* BSA balance because some of the funds were not deposited under the rules put in place by Prop. 2. The LAO notes that of the \$16.5 billion in the BSA, \$3.1 billion was either in the account before the current BSA rules took effect in 2014 or was added by the Legislature in recent years as an optional (non-mandatory) deposit. The LAO argues that the Legislature could appropriate this \$3.1 billion with a majority vote and without a declaration of a budget emergency by the Governor. In contrast, under this interpretation, Prop. 2’s withdrawal rules *would* apply to the remaining \$13.4 billion in the BSA. See Legislative Analyst’s Office, *Update on State and School District Reserves* (April 23, 2020).
- ¹⁰ The PSSSA balance is likely to be reduced even without any action by state policymakers. This is because the schools reserve level is affected by both 1) revisions to prior-year revenue estimates and 2) year-over-year declines in the Prop. 98 minimum funding guarantee for K-12 schools and community colleges. The fact that California has entered a recession suggests that one or both of these scenarios is likely to occur.
- ¹¹ Specifically, capital gains revenues must exceed 8% of total General Fund proceeds of taxes.
- ¹² A PSSSA deposit can only occur in so-called “Test 1” years under the state’s Prop. 98 minimum funding guarantee for K-12 schools and community colleges, which have been rare historically. Test 1, which guarantees K-14 education a percentage of General Fund revenues, has been operative only four times since 1988-89. However, even in certain Test 1 years the amount of growth in state per capita personal income from the prior year can prevent a deposit to the PSSSA.
- ¹³ For example, Prop. 2 specifies that transfers to the PSSSA may not exceed the difference between the Test 1 funding level under Prop. 98 and the “Test 2” funding level, which is determined by year-to-year growth in state per capita personal income. Prop. 2 also limits the size of the deposits to the PSSSA by prioritizing funding for K-14 education cost-of-living adjustments over deposits to the PSSSA.
- ¹⁴ Prop. 2 *requires* funds to be withdrawn from the PSSSA, even without a declaration of a budget emergency, when prior-year PSSSA deposits were greater than required. Prop. 2 also requires a withdrawal of funds from the PSSSA in any year when the Prop. 98 minimum funding guarantee is less than the prior-year Prop. 98 funding level, adjusted for changes in student attendance and the cost of living. In this case, the required withdrawal would be limited to the amount needed to reach the prior year’s funding level. Prop. 2 defines change in “cost of living” as the higher of 1) the percent change in California per capita personal income from the preceding year or 2) the cost-of-living adjustment applied to school district and community college district general purpose apportionments.
- ¹⁵ The Safety Net Fund is authorized in California Welfare and Institutions Code, Section 11011.
- ¹⁶ The SFEU (originally called the “Reserve for Economic Uncertainties”) was created through the 1980-81 Budget Act and is authorized in California Government Code, Section 16418.
- ¹⁷ Specifically, the SFEU balance is equal to the General Fund balance carried over from the prior year, plus revenues and transfers, minus expenditures and encumbrances. Legislative Analyst’s Office, *The 2020-21 Budget: Structuring the Budget* (February 10, 2020), p. 11.
- ¹⁸ The amount that may be transferred to the DREOA is limited to the amount necessary to cover disaster-related claims that exceed the available balance in the account, which is set at \$1 million at the beginning of each state fiscal year. California Government Code, Section 8690.6(d).
- ¹⁹ The DOF is required to *notify* the Joint Legislative Budget Committee as well as the fiscal committees in each house before any funds may be allocated from the SFEU in response to a disaster. Funds in the DREOA can be spent for disaster response costs that occur within 120 days of the Governor’s emergency proclamation. The DOF can extend this time period in up to 120-day increments upon notifying the Legislature, subject to certain limitations. California Government Code, Section 8690.6.
- ²⁰ However, because General Fund revenues for 2019-20 are expected to fall short of projections, the SFEU balance will likely be depleted or negative by June 30, 2020, the last day of the fiscal year.