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Proposition 2: Should California Prioritize Paying Down Debt and Significantly Change State Budget Reserve Policies?

Prop. 2, which will appear on the November 4, 2014 statewide ballot, would amend the state Constitution to substantially revise the rules for the state's existing rainy day fund, require state policymakers to pay down certain state liabilities each year for 15 years, and create a new state budget reserve for K-12 schools and community colleges. This *Issue Brief* provides an overview of this ballot measure and the policy issues it raises. The California Budget & Policy Center neither supports nor opposes Prop. 2. [Note: California voters overwhelmingly approved Prop. 2, with 69.1% supporting the measure and 30.9% opposed.]

What Would Prop. 2 Do?

Prop. 2 would amend the California Constitution to change certain state budgeting practices.¹ The measure would substantially revise the rules for the state's existing Budget Stabilization Account (BSA), a rainy day fund that the voters created by approving Prop. 58 in 2004.² Prop. 2 also would require the state to set aside revenues each year – for 15 years – in order to pay down specified state liabilities. In addition, Prop. 2 would establish a new state budget reserve for K-12 schools and community colleges called the Public School System Stabilization Account (PSSSA). If a number of conditions were met, the state would deposit into this new reserve a portion of General Fund revenues owed to K-12 schools and community colleges under California's Prop. 98 funding guarantee.³ Furthermore, Prop. 2 would place into the state Constitution an existing *statutory* requirement that the Governor provide spending and revenue projections as part of each year's state budget process.

Prop. 2 Would Set Aside 1.5% of General Fund Revenues Each Year to Build a State Reserve and Reduce Certain State Liabilities

The state Constitution currently requires that 3% of estimated General Fund revenues be deposited into the BSA each year.⁴ Prop. 2 would instead require an annual transfer equal to 1.5% of estimated General Fund revenues. For 15 years – from 2015-16 to 2029-30 – half of these funds would be deposited into the BSA, and the other half would be used to reduce certain state liabilities. Specifically, as determined by the Legislature and the Governor, state debts would be reduced through the allocation of funds to one or more of the following five purposes:

- Making certain payments that were owed to K-12 schools and community colleges as of July 1, 2014;⁵
- Repaying dollars that were borrowed – prior to 2014 – from various state funds and used to pay for services typically supported with General Fund dollars;

- Reimbursing local governments for state-mandated services that they provided prior to 2004-05, but for which the state has not yet provided payment;
- Reducing unfunded liabilities associated with state-level pension plans; and
- Prefunding other retirement benefits, such as retiree health care.

Starting in 2030-31, the entire amount of the annual transfer would be deposited into the BSA. However, state policymakers could allocate up to half of each year's deposit toward one or more of the five purposes listed above.

Prop. 2 Would Set Aside Additional Revenues in Some Years to Further Build Reserves and Reduce State Liabilities

In some years, Prop. 2 would require that additional revenues – on top of those included in the fixed annual transfer – be set aside in order to further build reserves and reduce state liabilities. With respect to the BSA, this requirement would be 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 tax revenues.⁶ If this were to occur, then a portion of these “excess” capital gains revenues – specifically, the share that *is not* owed to schools and community colleges under the state's existing Prop. 98 funding guarantee – would be used as follows:

- For 15 years – from 2015-16 to 2029-30 – half of these revenues would be deposited into the BSA and half would be allocated to reducing state debts in one or more of the five ways specified in the measure.⁷
- Starting in 2030-31, all of these dollars would be deposited into the BSA, with an option for state policymakers to allocate up to half of each year's deposit to reducing state debts in one or more of the five ways specified in the measure.

The other portion of any “excess” capital gains revenues – specifically, the amount that is owed to

K-14 education – would be deposited into a new Prop. 98 reserve (the PSSSA).⁸ However, this deposit would occur *only if* the following conditions were met:

- Prop. 98 is not suspended in the fiscal year in which a deposit would be made;⁹
- Prop. 98's Test 1 is operative (as opposed to Test 2 or Test 3);¹⁰
- All “maintenance factor” obligations created prior to the 2014-15 fiscal year have been repaid;¹¹
- A maintenance factor obligation is not created in the fiscal year in which the deposit would be made; and
- The Prop. 98 funding level is higher than in the prior fiscal year, adjusted for the percent change in attendance and the change in the cost of living.¹²

Unless all of these conditions were met, any “excess” capital gains revenues owed to K-14 education under the Prop. 98 minimum funding guarantee would have to be provided to schools and community colleges rather than set aside in the PSSSA. Moreover, even if all of these conditions were met, a deposit to the PSSSA could not exceed the difference between the Prop. 98 Test 1 and Test 2 funding levels.

Prop. 2 would establish a process for revising – up or down – prior calculations of “excess” capital gains revenues as updated revenue estimates become available. This process, which is often referred to as “truing up,” would apply to both the BSA and the PSSSA, but would not apply to dollars used to reduce state liabilities. With respect to the BSA, the Governor's Department of Finance (DOF) would recalculate the amount – if any – that should have been deposited into the reserve for each of the two prior fiscal years.¹³ The difference between these updated deposit calculations and prior deposits would be settled by a transfer between the BSA and the General Fund.

The true-up process for the PSSSA also would be based on the DOF's recalculations for two prior

fiscal years, although with some key differences relative to the process used for the BSA. If the DOF's recalculations determine that a prior-year deposit to the PSSSA was greater than required, the state would transfer dollars from the PSSSA to support school districts and community colleges. However, if the recalculations determine that a prior-year deposit to the PSSSA was insufficient, the state would transfer dollars from the General Fund to the PSSSA to satisfy prior-year Prop. 98 obligations.

Prop. 2 Would Increase the Maximum Size of the BSA to Approximately 10% of General Fund Revenues

The state Constitution limits the size of the BSA to 5% of estimated General Fund revenues or \$8 billion, whichever is greater.¹⁴ If this cap were reached, state policymakers could allocate *for any purpose* the dollars that would otherwise be required to go into the BSA.¹⁵ Prop. 2 would increase the maximum size of the BSA to approximately 10% of estimated General Fund revenues.¹⁶ Moreover, if this limit were reached, any dollars that otherwise would have gone into the BSA would have to be spent on infrastructure, including spending related to deferred maintenance.

Prop. 2 Would Limit the Size of the PSSSA to 10% of the Prop. 98 Minimum Funding Guarantee

Prop. 2 would cap the size of the PSSSA at 10% of the estimated Prop. 98 minimum funding guarantee for schools and community colleges. If this limit were reached, state policymakers would be required to use the dollars that would otherwise have been deposited into the PSSSA to instead support schools and community colleges.

Prop. 2 Would Allow Transfers to the Reserves to Be Suspended or Reduced Under Certain Conditions

The state Constitution allows the Governor to *unilaterally* suspend or reduce – for any reason – the annual transfer to the BSA.¹⁷ Prop. 2 would change this process in two ways. First, the measure would

limit the circumstances under which a transfer to either the BSA or the PSSSA could be suspended or reduced.¹⁸ Specifically, the Governor would have to declare a “budget emergency,” which the measure defines as resulting from either:

- A disaster or extreme peril, as currently defined in Article XIII B of the state Constitution;¹⁹ or
- 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.²⁰

Second, Prop. 2 would provide a role for state legislators in deciding whether to suspend or reduce the required transfer to the reserves. Specifically, after the Governor has declared a budget emergency, a transfer to the BSA or to the PSSSA could be suspended or reduced only through a bill passed by a majority vote of each house of the Legislature.

Prop. 2 Would Limit the Conditions Under Which Funds Could Be Withdrawn From the Reserves

The state Constitution allows funds to be transferred out of the BSA – for any reason – through a bill passed by a majority vote of each house of the Legislature.²¹ Prop. 2 would instead require the Governor to first declare a budget emergency (as defined above), at which point the Legislature could pass a bill, by majority vote, to withdraw funds from the BSA.²²

Similarly, Prop. 2 would allow funds to be transferred out of the PSSSA to support schools and community colleges if the Governor declared a budget emergency and lawmakers passed legislation approving a withdrawal. However, the measure would *require* funds to be withdrawn from the PSSSA – even without a declaration of a budget emergency – in any year in which the Prop. 98 minimum funding guarantee would be less than the prior year's funding level adjusted for the percent change in school districts' attendance and the change in the cost of living.²³

Prop. 2 Would Generally Limit the Amount of Funds That Could Be Withdrawn From the Reserves

The state Constitution does not restrict the amount of funds that may be withdrawn from the BSA in a single fiscal year.²⁴ Prop. 2 would change this by allowing policymakers to withdraw only the amount needed to “address the budget emergency” declared by the Governor – that is, to address a disaster or insufficient state revenues (as described above). In addition, policymakers could transfer out no more than half of the funds in the BSA, unless funds had been taken out in the previous fiscal year, in which case subsequent withdrawals would not be limited.

Prop. 2 also would limit the amount of funds that could be withdrawn from the PSSSA in years when such withdrawals would be required.²⁵ Specifically, in any year in which the Prop. 98 minimum funding guarantee would be *less than* the prior year’s funding level – adjusted for the percent change in school districts’ attendance and the change in the cost of living – the required withdrawal would be limited to the amount of that shortfall.²⁶ In contrast, in the event of a budget emergency, Prop. 2 would place no limit on the amount of funds that could be withdrawn from the PSSSA.

Prop. 2 Would Add to the State Constitution an Existing Requirement for the Governor to Provide Revenue and Spending Projections

Under current state law, the Governor must provide the Legislature with estimated General Fund resources and recommended General Fund expenditures for the upcoming fiscal year (beginning July 1) as well as projections of General Fund resources and spending for the subsequent three fiscal years.²⁷ This information must be submitted following the release of the Governor’s proposed budget in January, the release of the Governor’s revised budget in May, and the signing of the budget bill. Under Prop. 2, these current statutory requirements would generally be added to the state Constitution.²⁸

If Passed by the Voters, Prop. 2 Could Be Amended Only by a Subsequent Vote of the People

The state Constitution requires that voters approve any amendments to the Constitution itself, whether proposed by the Legislature or by the public through an initiative.²⁹ Consequently, if the voters pass Prop. 2, the measure’s provisions could be amended only by a subsequent vote of the people.

What Would the New PSSSA Mean for K-14 Education Funding?

While Prop. 2 would create a state budget reserve for schools and community colleges – the PSSSA, described earlier – transfers to this reserve are unlikely because the measure would limit the circumstances under which they could occur. Moreover, Prop. 2 would restrict the amount that could be transferred to the PSSSA, but would not limit the amount that could be withdrawn from the PSSSA in a budget emergency. Prop. 2 would not change the state’s existing Prop. 98 funding guarantee for schools and community colleges, which requires the state to provide a minimum level of funding for K-14 education each year. However, to the extent that Prop. 2 impedes transfers to the PSSSA, it would not provide additional protection for education funding during tough budget years.

Deposits Into the PSSSA Are Unlikely Until At Least 2020-21 – and in Most Years Thereafter

Prop. 2 would limit the circumstances under which transfers to the state budget reserve for schools and community colleges could occur. As detailed in a prior section, various conditions would have to be met before dollars would be transferred from the state General Fund to the PSSSA. For example, transfers to the PSSSA could only occur in so-called “Test 1” years under Prop. 98, which have been rare historically. Test 1, which guarantees schools and community colleges a percentage of General Fund revenues, has only been operative in three of the 26 years since 1988-89,

the first year that Prop. 98 was used to calculate K-14 education funding.

Even in years when Test 1 is operative, Prop. 2 would prevent transfers to the PSSSA unless several other conditions are met. Prop. 2 specifies that no deposits into the PSSSA could be made until Prop. 98 “maintenance factor” obligations created prior to the 2014-15 fiscal year have been repaid.³⁰ The state will not repay its current outstanding maintenance factor obligations until at least 2020-21, according to the latest forecast from the Legislative Analyst’s Office (LAO).³¹ Prop. 2 would also prevent transfers to the PSSSA in years when the Prop. 98 funding level is lower than in the prior fiscal year, adjusted for the percent change in attendance and the change in the cost of living. Moreover, no deposits into the PSSSA could be made in years when the Prop. 98 guarantee is suspended by the Legislature or in years when maintenance factor obligations are created.

In short, by narrowly limiting the circumstances under which transfers to the PSSSA could occur, Prop. 2 makes it unlikely that the state would set aside revenue that could be used for K-14 education funding in future years. On the one hand, this means the state generally would provide schools and community colleges funding that otherwise could have been transferred to the reserve. On the other hand, funding for K-14 education would have less protection during tough budget years if dollars are not set aside in the PSSSA.

Prop. 2 Would Restrict the Amount That Could Be Transferred to the PSSSA

Even under the limited circumstances when Prop. 2 would require a transfer to the state budget reserve for schools and community colleges, the measure would cap the *amount* of this deposit. Prop. 2 specifies that transfers to the PSSSA may not exceed the difference between the Test 1 and Test 2 funding levels under Prop. 98. Moreover, the measure would also limit transfers to the PSSSA by prioritizing funding for K-14 education cost-of-living adjustments over deposits to the reserve. By limiting the amount that could be transferred to the PSSSA in any year, Prop. 2 would prioritize providing dollars to schools

and community colleges over setting aside revenues to support K-14 education in future years.

Prop. 2 Would Not Limit Withdrawals From the PSSSA During a Budget Emergency

Proponents of Prop. 2 contend that placing money in a budget reserve for schools and community colleges will protect K-14 education funding in difficult budget years.³² However, Prop. 2 would allow the Legislature to withdraw *all* of the PSSSA funds to support schools and community colleges in the first year of a budget emergency, a provision that could impede the PSSSA from offsetting – at least in part – cuts to K-14 education in subsequent years.

During the Great Recession, Prop. 98 funding for K-14 education fell by more than \$7 billion between 2007-08 and 2008-09, and annual funding under the Prop. 98 guarantee remained more than \$6 billion below the 2007-08 level until 2012-13. In order for the PSSSA to provide dollars to school districts and community colleges beyond just the first year of an economic downturn, the Legislature and Governor would likely need to limit the amount of dollars withdrawn from the PSSSA at the outset of a budget emergency. To the extent that state policymakers spread out withdrawals across two or more years, less money would be available for K-14 education in the initial year of a budget emergency. However, even if policymakers chose to withdraw all funds from the PSSSA in the first year of a budget emergency, these dollars could still be insufficient to offset all potential cuts to schools and community colleges that year.

Approval of Prop. 2 Would Cap the Amount That School Districts Could Keep in Local Reserves

State regulations require K-12 school districts to keep a minimum level of funds in local budget reserves, and many school districts maintain reserves at significantly higher levels than the state requires.³³ If voters approve Prop. 2, a new state law would take effect that limits the amount that school districts could keep in their budget reserves in the year after a transfer is made to the PSSSA.³⁴ Under this new state law, the cap for most local school district reserves

would range from 3% to 10% of a district's annual spending.³⁵

While this cap on school districts' budget reserves would not take effect until the year after a transfer to the PSSSA, approval of Prop. 2 would likely result in some school districts spending down their reserves to bring them closer to the future cap. To the extent this occurred, local school districts would have fewer dollars available for economic uncertainties, such as tough budget years. If a difficult budget year occurred before the state transferred dollars to the PSSSA, it could leave schools and community colleges with fewer funds to withstand budget shortfalls.

What Would the New BSA and Debt Payment Policies Mean for the State Budget?

Prop. 2 would rewrite the rules governing deposits into and withdrawals from California's rainy day fund, the Budget Stabilization Account (BSA), and would require policymakers to pay down certain state liabilities for 15 years. As described above, BSA deposits and debt payments would come from a fixed annual transfer equal to 1.5% of estimated General Fund revenues as well as a share of capital gains revenues in years when those revenues are estimated to be particularly strong. Prop. 2 could have a significant impact on a range of public systems and services funded through the state budget, including child care, health care, state universities, and assistance for low-income seniors and people with disabilities.³⁶ To a large extent, the measure's effects in any given year would depend both on state revenue collections and on actions taken by future lawmakers and governors. Still, some potential impacts can be outlined.

Prop. 2 would not allow debt payments to be suspended or reduced – even if the state faced a severe budget shortfall – during the 15-year period in which these payments would be mandated by the measure. The measure also would make it harder to suspend or reduce annual deposits into – and withdraw funds from – the BSA than under current law. While this change could allow the state to build up a larger reserve prior to the onset of an economic

downturn, it also could diminish policymakers' ability to effectively respond to some challenging budget situations. Moreover, if the BSA ever reached its maximum size, Prop. 2 would require revenues diverted from the reserve to be spent only on infrastructure or deferred maintenance. While the total annual revenue transfer required by the measure could be *larger than* would be required under the current policy, this transfer also could be *smaller* under certain circumstances. Finally, Prop. 2 would prohibit state policymakers from taking out all the reserve funds in a single year, thereby increasing the likelihood that BSA dollars would be available to support public services for at least two consecutive years during an economic downturn.

Prop. 2 Would Not Allow Debt Payments to Be Suspended or Reduced

Under Prop. 2, half of each year's required revenue transfer – the portion not deposited into the BSA – would go toward paying down specified state liabilities. These include loans from state special funds as well as unfunded liabilities for state employee pensions and retiree health care. This requirement would remain in effect for 15 years, from 2015-16 to 2029-30. Following this period, the entire amount required to be set aside by Prop. 2 each year would be deposited into the BSA, with state policymakers having the option to allocate up to half of each year's deposit to reduce state debts.

During the 15-year period in which debt payments would be mandatory, Prop. 2 would not allow these payments to be suspended or reduced *for any reason*, including if the state faced a natural disaster or a severe budget shortfall. This policy stands in stark contrast to how Prop. 2 treats annual deposits into the BSA, which could be suspended or reduced in the event of a "budget emergency."³⁷ A budget emergency, as defined by Prop. 2, would include both a natural disaster and a situation in which an economic downturn significantly reduces state revenues, resulting in a substantial budget gap.

On the one hand, by not providing an option to suspend or reduce the annual set-aside for debt payments, Prop. 2 could make it harder for

policymakers to effectively respond to a state budget shortfall caused by an economic downturn. The debt payments required by the measure could range from \$800 million to \$2 billion or more in any given year, depending on the strength of capital gains revenues, according to the LAO.³⁸ By allocating limited state revenues to debt payments in the midst of a recession – and providing no opportunity for policymakers to suspend or reduce these payments – Prop. 2 would reduce the amount of resources available to support public services and thereby make spending cuts and/or tax increases more likely.

On the other hand, requiring annual debt payments could mean that the state pays down these liabilities faster than otherwise would be the case. For example, unfunded liabilities for state employee pensions exceed \$40 billion, and they surpass \$60 billion for state retiree health benefits.³⁹ Generally speaking, reducing state liabilities more quickly “means that the state could spend less on its debts in future decades, freeing up money for other things in the state budget over the long term,” according to the LAO.⁴⁰

Total Annual Revenue Transfers Would Not Necessarily Be Larger Under Prop. 2 Than Under Current Law

Similar to current law, Prop. 2 would require a portion of state revenues to be set aside each year for specific purposes. However, the amount of the annual revenue transfer required by Prop. 2 could differ from that under current law for two key reasons:

- First, under the current policy the state is required to set aside a fixed share of estimated General Fund revenues – 3% – each year.⁴¹ Under Prop. 2, this fixed annual transfer would be reduced to 1.5% of estimated General Fund revenues. However, Prop. 2 would require *additional* dollars to be set aside when capital gains revenues – which can vary substantially from year to year – are estimated to be particularly strong. As a result, annual revenue set-asides under Prop. 2 could fluctuate significantly, sometimes exceeding the 3%

transfer required by current law and sometimes falling below it.

- Second, under the current policy annual deposits into the BSA are not required once the balance reaches a fixed amount – \$8 billion.⁴² In contrast, Prop. 2 would require deposits to the BSA until the balance reaches approximately 10% of General Fund revenues, a level that would equal about \$11 billion in 2015-16 and could rise to roughly \$12 billion by 2017-18.⁴³ Moreover, for the first 15 years, Prop. 2 would require only half of each year’s total revenue transfer to be deposited in the BSA, with the other half used to repay state debts. In short, under Prop. 2 the BSA cap would be higher and annual deposits, at least initially, could be smaller, compared to the current policy. Consequently, reaching the maximum BSA balance would likely take longer under Prop. 2, with annual deposits continuing for longer than under current law.

As a result of these factors, the annual revenue transfer required by Prop. 2 would not necessarily be larger than would be the case under current law. For example, under the current policy \$3.4 billion could be set aside in 2015-16, all of which would be deposited in the BSA to save for a rainy day (Table 1).⁴⁴ In contrast, Prop. 2 is projected to require a total revenue transfer – both to build the BSA and to pay down state liabilities – of \$1.9 billion in 2015-16, or \$1.5 billion *less* than the amount required under current law.⁴⁵ In other words, if voters approve Prop. 2, an additional \$1.5 billion could be available in 2015-16 – relative to current law – to support a range of state priorities. In contrast, this scenario could be reversed just two years later. Current estimates suggest that the state could have *no* obligation to make a BSA deposit in 2017-18 – due to reaching the maximum BSA balance in the prior year – whereas Prop. 2 could require a total revenue transfer of \$2.2 billion that same year.⁴⁶ In other words, if voters approve Prop. 2, state policymakers could have \$2.2 billion *less* in 2017-18 – relative to current law – to support various state priorities.

TABLE 1

Total Annual Revenue Transfers Would Not Necessarily Be Larger Under Prop. 2 Than Under Current Law (Dollars in Billions)

Fiscal Year	Current Law: Full Amount Deposited Into the Budget Stabilization Account (BSA)*	Prop. 2: Half Deposited Into the BSA and Half Used to Pay Down Certain State Liabilities**	Revenues Set Aside Under Prop. 2 Would Be Less Than (-) or Greater Than (+) Revenues Set Aside Under Current Law
2015-16	\$3.4	\$1.9	-\$1.5
2016-17	\$3.0	\$2.0	-\$1.0
2017-18	\$0.0	\$2.2	+\$2.2

* Budget Center calculations based on General Fund revenue projections from the Department of Finance (DOF). This scenario assumes (1) there is no suspension or reduction of the BSA transfer through 2017-18, and (2) the BSA balance reaches \$8 billion in 2016-17, at which point no further deposits would be required under current law. The BSA balance is \$1.6 billion as of 2014-15.

** DOF projections.

Source: DOF; Budget Center analysis of California Constitution and DOF data

Suspending or Reducing Deposits Into, and Withdrawing Funds From, the BSA Would Be Harder Under Prop. 2 Than Under Current Law

Prop. 2 would make it more difficult for state policymakers to suspend or reduce the annual deposits into the BSA and to withdraw funds from the reserve. Contrary to current law, the measure would require the Governor to declare a “budget emergency” in order to begin the process of suspending or reducing the BSA transfer and/or withdrawing dollars from the reserve. Prop. 2 narrowly defines a budget emergency as resulting from either (1) a disaster or extreme peril or (2) lack of sufficient resources to meet a specific General Fund spending threshold: 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.⁴⁷ In contrast, under current law the Governor can suspend or reduce BSA deposits and dollars can be taken out of the reserve *for any reason*.

On the one hand, by narrowing the circumstances under which BSA deposits could be suspended and reserve funds withdrawn, Prop. 2 could allow the state to build up a larger reserve prior to the onset of an economic downturn. This, in turn, would help to reduce the magnitude of spending reductions and/

or tax increases in response to a significant decline in state revenues.

On the other hand, the changes proposed by Prop. 2 could diminish policymakers’ ability to effectively respond to some challenging budget situations, including:

- **When revenues are rising more slowly than anticipated.** If General Fund revenues are projected to rise more slowly than previously anticipated, causing a budget gap to emerge, the Governor could declare a budget emergency *only if* General Fund spending were estimated to fall *below* the spending threshold determined by Prop. 2. If the state were able to meet this threshold – the highest recent General Fund spending level adjusted for population growth and inflation – the Governor would have no cause to declare a budget emergency in response to the projected budget gap. As a result, the state would not be able to “free up” additional resources to support public services by using funds from the reserve and/or suspending the annual BSA deposit. In short, by putting in place a spending threshold that reflects inflation and changes in population – neither of which provides an

adequate benchmark against which to gauge the need for public services – Prop. 2 would reduce policymakers’ options for addressing an emerging budget shortfall in a year in which revenues were rising slower than anticipated.⁴⁸ This, in turn, would increase the likelihood that state policymakers would need to implement spending cuts and/or tax increases in order to close the estimated gap.

- **When the state is emerging from a recession.**

Prop. 2 could reduce – relative to current law – the number of consecutive years that the BSA deposit could be suspended or reduced during and after an economic downturn that causes a decline in General Fund revenues. This is because, as noted above, Prop. 2 uses a three-year spending “look back” to determine if the state has sufficient resources to support public services – and thus whether a budget emergency could be declared. In the early stages of a downturn, this three-year look-back would capture pre-recession General Fund spending levels, adjusted for population growth and inflation. Due to declining revenues, state spending going into a recession would likely fall short of these earlier spending levels, thereby meeting the requirements of a “budget emergency” and allowing policymakers to suspend the annual BSA deposit and withdraw funds from the reserve.

Moving forward, however, the lower, recession-era spending levels would become the new “yardsticks” against which future expenditures would be compared. If the state began to experience a modest recovery a couple of years after a recession began, revenue growth could soon boost General Fund spending *above* these recession-era levels – even after adjusting these earlier expenditures for population growth and inflation. As a result, the Governor would be prohibited from declaring a budget emergency and the BSA deposit would resume – possibly as soon as four years after the downturn began and likely well before the recovery had reached most Californians. In contrast, under current law the Governor may suspend or reduce

the deposit into the BSA for any number of years that is deemed fiscally prudent. In fact, during the Great Recession and its aftermath, Governors Schwarzenegger and Brown used their executive authority to suspend the BSA deposit for six consecutive years, from 2008-09 through 2013-14, even though the national recession officially ended in 2009. It is unlikely that Prop. 2 would allow state policymakers to make similar choices.

Prop. 2 Would Ensure That BSA Dollars Are Available to Help Offset Cuts to Public Services for At Least Two Consecutive Years

Prop. 2 would limit the amount of funds that could be withdrawn from the BSA in a single fiscal year. In general, state policymakers would be allowed to withdraw only the amount needed to address a budget emergency. Moreover, no more than half of the dollars in the BSA could be taken out unless funds had been withdrawn in the previous fiscal year. In other words, even if a comprehensive response to a budget emergency required withdrawing 60% or 90% of the reserve funds, policymakers would have to spread out these withdrawals beyond a single fiscal year, a limitation that does not apply under current law. On the one hand, such a change would mean that – relative to the current policy – a smaller share of BSA funds could be used to help support public systems and services during the initial year of a budget emergency. On the other hand, by limiting the amount of reserve funds that could be withdrawn initially, Prop. 2 would ensure that such funds are available to help offset cuts to public services for at least two consecutive years.

If the BSA Ever Reached Its Maximum Size, Prop. 2 Would Strictly Limit How Revenues Diverted From the Reserve Could Be Used

Similar to current law, Prop. 2 would establish a cap beyond which deposits to the BSA would no longer be required.⁴⁹ However, in contrast to the current policy, Prop. 2 would strictly limit how state policymakers could spend the dollars that would otherwise go into the reserve if this maximum balance were ever reached. Specifically, under Prop. 2, any

revenues diverted from the BSA due to it reaching the cap could be used only to pay for infrastructure or deferred maintenance. Prop. 2 would prohibit policymakers from using these dollars to support other public systems and services, such as state preschool, higher education, or assistance for seniors and people with disabilities. In contrast, under current law, if the BSA ever reached its maximum size, state policymakers could allocate *for any purpose* the dollars that otherwise would have to be deposited into the reserve.

Prop. 2 Would Increase the Complexity of the State Budget Process

California's budget process is complex, often making it difficult for many Californians – including longtime budget observers – to understand how the state's annual spending plan is crafted. Many of the complexities of the process are the result of voter-approved ballot measures that locked complicated rules and formulas into the state Constitution.

Prop. 2 would make the state budget process even more complex due to the true-up process the measure would use to calculate "excess" capital gains revenues. As described above, under Prop. 2 deposits into the reserves could occur in years when capital gains revenues – based on initial estimates – are particularly strong.⁵⁰

However, revenues from capital gains taxes are among the most difficult to accurately estimate at a given point in time. The state typically is unable to provide an accurate accounting of capital gains revenues until a couple of years after the fact. To address this issue, Prop. 2 would require capital gains revenue estimates to be *recalculated* in each of the two years after the initial estimate is made.⁵¹ Following this true-up, the state would be required to make changes to prior years' rainy day fund contributions if the most recent calculations differ from prior estimates. As a result, deposits into the BSA and the PSSSA could be subject to significant corrections in later years.

Given the difficulty in estimating capital gains revenues, Prop. 2's true-up process would serve a valuable purpose by ensuring that the state's estimates of capital gains revenues would be updated to reflect the revenues collected. However, true-ups would also add complexity to the state budget process. For example, the state could be required to transfer General Fund dollars to the BSA two years after a determination was made that such a deposit was *not* required. Conversely, deposits to the BSA could be transferred back to the General Fund two years after they were made. The uncertainty produced by these adjustments would further complicate the annual state budget process. In addition, the interaction between these true-ups and the complexities of meeting the state's existing Prop. 98 funding guarantee for schools and community colleges could produce unintended consequences.

Moreover, because Prop. 2's complex true-up provisions would be placed in the state Constitution, they could not be changed without voter approval. As a result, if state policymakers later determined that these true-up provisions needed to be modified, a two-thirds vote of each house of the Legislature would be required in order to put a new constitutional amendment before the voters.

What Do Proponents Argue?

Proponents of Prop. 2, including Governor Brown and former Assembly Speaker John A. Pérez, argue that the measure "will force the Legislature and the Governor to save money when times are good, pay down debts and protect schools from devastating cuts." Prop. 2, they argue, "will require politicians to live within their means" and "will make sure that we don't repeat [the] cycle of boom and bust budgeting."⁵²

What Do Opponents Argue?

Opponents of Prop. 2, including Katherine Welch and Hope Salzer of Educate Our State, argue that school districts would have "to reduce their local reserves whenever *anything* is paid into Proposition 2's 'Public School System Stabilization Account.' ... Built up over

decades, these reserves would have to be dumped just because one good capital-gains year moved educational funds away from funding schools and into the State-controlled stabilization account.”⁵³

Conclusion

To a large extent, California’s annual state budget deliberations reflect competing perspectives on how to ensure that adequate funding is available for investing in public systems and services, saving for a rainy day, and paying down debts. Current law provides state lawmakers and the Governor with discretion to decide what this balance should be each year. Prop. 2 would reduce this discretion, particularly with respect to debt payments and the use of revenues allocated to the BSA, the state’s rainy day fund.

Prop. 2’s mandate to pay down debt – along with the new rules for the BSA – could have a significant impact on state budget decisions. For example, Prop. 2 would not allow annual debt payments to be suspended or reduced *for any reason* during the 15 years that these payments would be mandatory. As a result, fewer resources would be available to support public services during a recession, making spending cuts and/or tax increases more likely. At the same time, however, *requiring* annual debt payments could mean that the state pays down these liabilities faster, thereby reducing the cost of these debts and “freeing up” dollars for public services over the long term. Moreover, Prop. 2 would make it harder to suspend

or reduce annual deposits into – and withdraw funds from – the BSA than under current law. Over time, this change could allow the state to build up a larger reserve prior to the onset of an economic downturn. Yet, increasing the difficulty of suspending or reducing deposits could diminish policymakers’ ability to effectively respond to some challenging budget situations.

In contrast, Prop. 2’s impact on overall funding for K-14 education in any year would likely be negligible. Although Prop. 2 would create a new state reserve for K-14 education – the PSSSA – the measure narrowly limits the circumstances under which revenues could be transferred to this new reserve. As a result, the state generally would provide schools and community colleges with funding that otherwise could have been deposited into this new account. However, this means that funding for K-14 education would have less protection during tough budget years because there likely would be no dollars set aside in the PSSSA.

At its core, Prop. 2 poses a fundamental question: Should California scale back state policymakers’ role in certain budget decisions, such as how fast to pay down state debts and when reserve funds are needed to support public systems and services? By making significant changes to state budget reserve and debt payment policies – and placing them in the California Constitution – Prop. 2 would likely have a substantial impact on the state’s budget process for years to come.

Scott Graves and Jonathan Kaplan 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 Legislature placed Prop. 2 on the ballot through passage of Assembly Constitutional Amendment 1 (John A. Pérez, Resolution Chapter 1, Statutes of 2013-14 Second Extraordinary Session).
- 2 The Legislature placed Prop. 58 on the ballot through passage of Assembly Constitutional Amendment 5 (Oropeza, Resolution Chapter 1, Statutes of 2003-04 Fifth Extraordinary Session). For an analysis of Prop. 58, see California Budget & Policy Center, *What Would Propositions 57 and 58 Mean for California?* (February 2004).
- 3 Prop. 98, approved by California voters in 1988, was placed on the ballot through the initiative process. Prop. 98 amended both the California Constitution and state law and was itself subsequently amended by Prop. 111 of 1990. For an explanation of the Prop. 98 guarantee, see California Budget & Policy Center, *School Finance in California and the Proposition 98 Guarantee* (April 2006).
- 4 California Constitution, Article XVI, Section 20(b)(3). Under current law, half of each year's deposit remains in the BSA and the other half is used to accelerate repayment of bonds that California voters authorized in 2004 to address the state's accumulated General Fund deficit as of June 30, 2004. These bonds will be paid off in the current fiscal year (2014-15), according to the Department of Finance (DOF). As a result, under current law, the state will no longer redirect half of each year's BSA deposit to debt payments beginning in 2015-16. Instead, the entire amount of each year's deposit will remain in the BSA absent a suspension of this annual transfer, which is described in a subsequent section of this *Issue Brief*.
- 5 These payments would go toward unfunded prior-year Prop. 98 obligations, including so-called "settle-up" obligations, which reflect the reconciliation of estimates of the annual Prop. 98 minimum funding level and the actual Prop. 98 guarantee.
- 6 As used in this calculation, capital gains would reflect "net capital gains" and total revenues would be based on "General Fund proceeds of taxes," which are estimated for the purpose of calculating the existing State Appropriations Limit and tend to differ slightly from total General Fund revenues and transfers. Capital gains "are profits from the sale of a capital asset, such as shares of corporate stock, a business, a parcel of land, or a piece of art." Tax Policy Center, "Capital Gains and Dividends: How Are Capital Gains Taxed?" *The Tax Policy Briefing Book* (June 22, 2011).
- 7 The Legislature and Governor would determine how the dollars for debt payments would be allocated each year.
- 8 A deposit to the PSSSA would count toward the Prop. 98 funding level in the year the deposit is made as opposed to the year that a withdrawal from the PSSSA is used to fund schools and community colleges.
- 9 The Legislature can suspend Prop. 98 for a single year by a two-thirds vote of each house.
- 10 Prop. 98 states that K-14 education is guaranteed a funding level that is the greater of a fixed percentage of state General Fund revenues (Test 1) or the amount that K-12 schools and community colleges received in the prior year, adjusted for enrollment and changes in the state's economy (Test 2 and Test 3). Test 1 has been operative only three times since the Prop. 98 guarantee was established in 1988-89. For an explanation of the Prop. 98 guarantee, see California Budget & Policy Center, *School Finance in California and the Proposition 98 Guarantee* (April 2006).
- 11 Following a suspension of the Prop. 98 guarantee or a Test 3 year, the Legislature must increase funding over time until funding returns to at least the level it would have reached absent a suspension or had Test 3 not been operative. The overall dollar amount needed to return funding to this level is called the "maintenance factor," which is adjusted annually for changes in enrollment and in California per capita personal income from the preceding year.
- 12 In this situation, 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.
- 13 In 2016-17, the "true-up" process would apply only to the prior fiscal year. Starting in 2017-18, this process would include the two prior fiscal years.
- 14 California Constitution, Article XVI, Section 20(c).
- 15 State policymakers could deposit some or all of these dollars into the BSA – in excess of the constitutional limit – but such a transfer would not be required.
- 16 Specifically, the amount transferred to the BSA in any fiscal year could not result in a BSA balance that exceeds 10% of estimated General Fund "proceeds of taxes." Proceeds of taxes are estimated for the purpose of calculating the existing State Appropriations Limit and tend to differ slightly from total General Fund revenues and transfers.
- 17 California Constitution, Article XVI, Section 20(e). In order to suspend or reduce the annual transfer, the Governor must issue an executive order on or before June 1 of the preceding fiscal year (for example, by June 1, 2015 for the 2015-16 fiscal year, which begins on July 1, 2015).
- 18 Contrary to the proposed rules for the BSA and the PSSSA, Prop. 2 would not allow the transfer for debt payments to be suspended or reduced under any circumstances.
- 19 In Article XIII B, Section 3(c)(2), "disaster" and "extreme peril" include "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."

- 20 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.
- 21 California Constitution, Article XVI, Section 20(f)(2).
- 22 However, the amount that could be withdrawn would be limited, as described in a subsequent section of this *Issue Brief*.
- 23 In this situation, 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.
- 24 California Constitution, Article XVI, Section 20(f)(2).
- 25 The requirement to withdraw funds from the PSSSA under certain conditions is described in the prior section.
- 26 In this situation, 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.
- 27 California Government Code, Section 13308(a). The DOF has interpreted the phrase “General Fund resources” to include (1) General Fund revenues and transfers, (2) any balance carried forward from the prior fiscal year, and (3) any deposit to the BSA. See Department of Finance, *General Fund Multi-Year Forecast at 2014 Budget Act* (June 20, 2014).
- 28 The current statutory requirements would not be repealed by Prop. 2, but could be repealed in a bill passed by the Legislature. There is one key difference between Prop. 2 and current law with respect to these requirements. Prop. 2 would require the Governor to provide estimates of “General Fund revenues,” whereas current state law requires the Governor to provide estimates of “General Fund resources.” As explained in endnote 27, the term “resources” has been interpreted to include not only annual revenues, but also any balance carried forward from prior fiscal years and any deposits to the BSA.
- 29 California Constitution, Article XVIII, Sections 1, 3, and 4.
- 30 Following a suspension of the Prop. 98 guarantee or a Test 3 year, the Legislature must increase funding over time until funding returns to at least the level it would have reached absent a suspension or had Test 3 not been operative. The overall dollar amount needed to return funding to this level is called the “maintenance factor,” which is adjusted annually for changes in enrollment and in California per capita personal income from the preceding year.
- 31 Legislative Analyst’s Office, *The 2014-15 Budget: California’s Fiscal Outlook* (November 2013), p. 34.
- 32 “Argument in Favor of Proposition 2,” in Secretary of State’s Office, *California General Election Tuesday, November 4, 2014: Official Voter Information Guide*, p. 18.
- 33 While the exact percentage of funds that a local school district must keep in reserve depends on its size, for most school districts current state regulations require minimum reserves that range from 1% to 5% of their annual budgets.
- 34 The provisions of Senate Bill 858 (Committee on Budget and Fiscal Review, Chapter 32, Statutes of 2014) that limit budget reserves for local school districts would not apply to community colleges. Unlike the provisions of Prop. 2, the provisions of Senate Bill 858 could be changed by the Legislature without voter approval.
- 35 Senate Bill 858 allows county offices of education to exempt school districts from the cap on local budget reserves for up to two consecutive years.
- 36 Prop. 2 would allow dollars withdrawn from the BSA – as well as dollars that become available due to suspending or reducing the BSA deposit – to be used to support K-14 education under the Prop. 98 guarantee. To the extent that this occurred, however, other dollars would likely be freed up to support public systems and services that are not funded through Prop. 98. The potential impact of the PSSSA on K-14 education funding was analyzed in the previous section.
- 37 As previously noted, the Governor would have to declare a budget emergency – as defined by Prop. 2 – and the Legislature would have to pass a bill in order for the annual deposit to be suspended or reduced.
- 38 Legislative Analyst’s Office, “Proposition 2. State Budget. Budget Stabilization Account. Legislative Constitutional Amendment. Analysis by the Legislative Analyst,” in Secretary of State’s Office, *California General Election Tuesday November 4, 2014: Official Voter Information Guide*, p. 15.
- 39 In early 2014, the Governor reported unfunded liabilities of \$45.5 billion for state employee pensions and \$63.8 billion for state retiree health benefits. See Department of Finance, *Governor’s Budget Summary 2014-15* (January 2014), p. 4. Under Prop. 2, payments to reduce unfunded liabilities for state employee pensions and retiree health benefits would have to be in addition to any payments already required by law. On this point, see Legislative Analyst’s Office, “Proposition 2. State Budget. Budget Stabilization Account. Legislative Constitutional Amendment. Analysis by the Legislative Analyst,” in Secretary of State’s Office, *California General Election Tuesday November 4, 2014: Official Voter Information Guide*, p. 15.
- 40 Legislative Analyst’s Office, “Proposition 2. State Budget. Budget Stabilization Account. Legislative Constitutional Amendment. Analysis by the Legislative Analyst,” in Secretary of State’s Office, *California General Election Tuesday November 4, 2014: Official Voter Information Guide*, p. 17.

- 41 Under current law, half of each year's deposit remains in the BSA and the other half is used to accelerate repayment of bonds that California voters authorized in 2004 to address the state's accumulated General Fund deficit as of June 30, 2004. These bonds will be paid off in the current fiscal year (2014-15), according to the DOF. As a result, under current law, the state will no longer redirect half of each year's BSA deposit to debt payments beginning in 2015-16. Instead, the entire amount of each year's deposit will remain in the BSA absent a suspension of this annual transfer.
- 42 The BSA balance is \$1.6 billion as of 2014-15. Under current law, the \$8 billion BSA cap will remain in effect until annual General Fund revenues exceed \$160 billion, at which point the BSA cap will be equal to 5% of annual General Fund revenues. As a point of comparison, General Fund revenues and transfers are estimated to be \$107.1 billion in 2014-15. See Department of Finance, *General Fund Multi-Year Forecast at 2014 Budget Act* (June 20, 2014).
- 43 These figures are based on projected General Fund revenues and transfers in Department of Finance, *General Fund Multi-Year Forecast at 2014 Budget Act* (June 20, 2014).
- 44 Budget Center analysis of DOF data and the California Constitution. This projection assumes there is no suspension or reduction of the BSA transfer for 2015-16.
- 45 The \$1.9 billion transfer is a DOF projection. See Department of Finance, *Governor's Budget May Revision 2014-15* (May 2014), p. 8.
- 46 The \$0 deposit in 2017-18 under current law is a Budget Center projection that assumes (1) there is no suspension or reduction of the BSA transfer through 2017-18, and (2) the BSA balance reaches \$8 billion in 2016-17, at which point no further deposits would be required under current law. The projected \$2.2 billion transfer in 2017-18 under Prop. 2 is from Department of Finance, *Governor's Budget May Revision 2014-15* (May 2014), p. 8.
- 47 The change in the "cost of living" would be measured by the California Consumer Price Index (CPI).
- 48 Prop. 2 would require the state to use the California CPI to adjust General Fund spending in the three most recent fiscal years. CPI is designed to measure changes in purchasing power by households, not governments. As such, it does not accurately measure the year-to-year increase in the cost of delivering the same level of public services. Moreover, state population growth – the population change indicator specified in Prop. 2 – does not accurately reflect the demand for public services. The state projects that the total number of Californians will increase by 19% between 2010 and 2030, while the number of Californians age 65 or older will increase by 96%. As a result, demographic factors can be expected to increase the cost of services that primarily assist seniors at a rate that exceeds the growth in the cost of other services.
- 49 As described above, Prop. 2 would increase the maximum size of the BSA to approximately 10% of estimated General Fund revenues. Under current law, the maximum BSA balance is 5% of estimated General Fund revenues or \$8 billion, whichever is greater. The limit is \$8 billion in 2014-15, the current state fiscal year.
- 50 Any deposits into the PSSSA would be based entirely on "excess" capital gains revenues owed to K-12 schools and community colleges. In contrast, only a portion of deposits into the BSA would be based on "excess" capital gains revenues.
- 51 In 2016-17, the true-up process would apply only to the prior fiscal year. Starting in 2017-18, this process would include the two prior fiscal years.
- 52 "Argument in Favor of Proposition 2," in Secretary of State's Office, *California General Election Tuesday November 4, 2014: Official Voter Information Guide*, p. 18.
- 53 "Argument Against Proposition 2," in Secretary of State's Office, *California General Election Tuesday November 4, 2014: Official Voter Information Guide*, p. 19.