CALIFORNIA FORWARD ACTION FUND ✓ YES ON PROP 2

Proposition 2 Fact Sheet

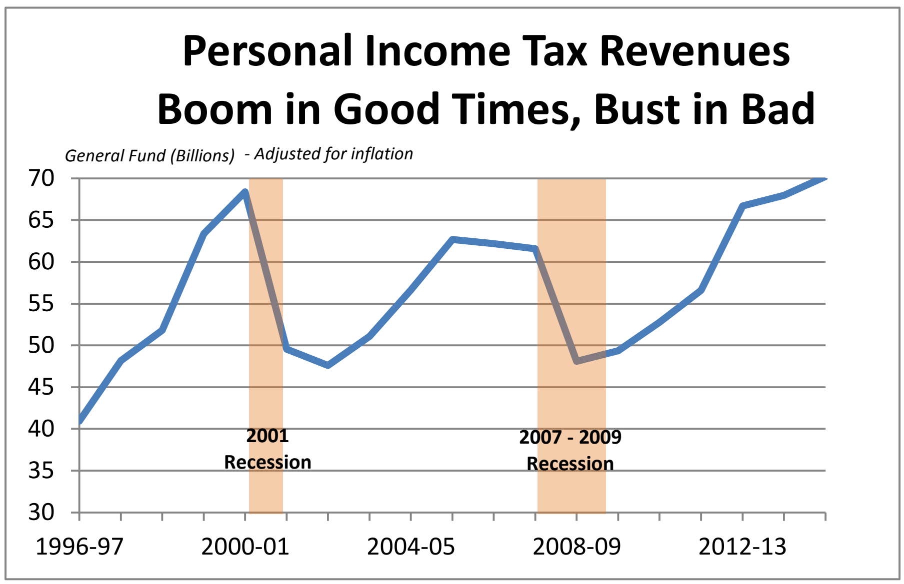
THE PROBLEM: A Budget That Booms…And Busts

As California bounces back from deep recession, state government also is getting back on solid fiscal ground. Learning from this difficult past, the Governor and Legislature have placed a measure on the November ballot – Proposition 2 – that would improve fiscal management and stabilize funding for critical public services during economic downturns.

Why does California need Proposition 2?

Even before the Great Recession, California suffered from booms and busts in state expenditures that exaggerated the impacts of the business cycle on public services. In the last 15 years, two major economic booms created surges in revenue – much of it committed to ongoing programs. Between 2004 and 2006, for example, General Fund revenues – and spending – jumped by over $20 billion.

The recessions that followed left the state facing multi-year deficits that climbed past $40 billion, crippling public services – especially safety net programs – frustrating economic investments, and contributing to California's reputation as a poorly managed state.



SOURCE: Legislative Analyst's Office

The source of the problem

Much of problem can be traced to two factors: California's General Fund is supported by one of the most volatile state revenue streams in the nation, and California's reserve requirement does not adequately manage that revenue.

Over time, California's General Fund has become more dependent on a highly progressive income tax – in some years, *65 percent* of revenues. This progressivity, exaggerated by California's dynamic entrepreneurial economy, creates surges in revenue at the peak of the business cycle.

Prop 2 does not change this volatility, but it would establish rules for managing the volatility. The measure would require minimum deposits in most years and capture the spikes in really good years – disciplining the growth in spending and saving money for inevitable downturns.

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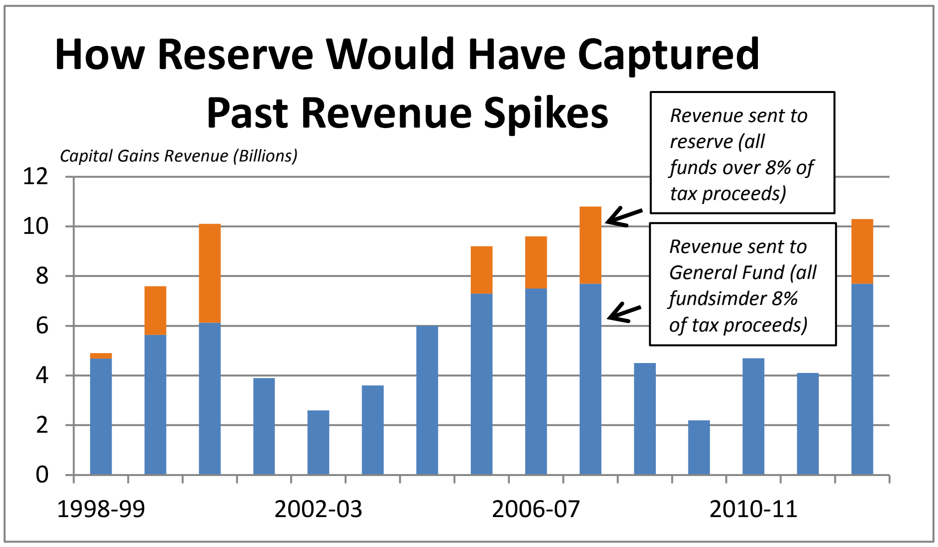
THE SOLUTION: Putting Aside Revenue Spikes for a Rainy Day

When a bipartisan coalition of lawmakers crafted Prop 2 earlier this year, they had three objectives: Capture spikes in revenue, build a bigger reserve to stabilize funding in economic downturns, and give the state a regular way to pay down its debts. Proposition 2 will do all three:

1. **Prop 2 captures spikes in volatile revenues.** Proposition 2 will require the state to set aside unusual, one-time spikes in revenue from capital gains. All capital gains revenue that exceeds 8 percent of that year's tax proceeds would go into the reserve. During economic booms, these spikes can produce as much as $4 billion in one-time revenue in a single year.

2. **Prop 2 builds a bigger reserve to stabilize spending.** The measure also will require 1.5 percent of all General Fund revenues to be deposited into the reserve each year. It will increase the size of the reserve, requiring deposits until the reserve is at 10 percent of the General Fund (or almost $11 billion in 2014).



SOURCE: Franchise Tax Board

Prop 2 also creates stricter rules around depositing and withdrawing funds than the current reserve mechanism, which has been rarely used since its adoption in 2004. Under Prop 2, to avoid making a deposit, a governor would be required to declare a fiscal emergency – and demonstrate that the state was bringing in fewer revenues than the prior year. Prop 2 also limits withdrawals in the first year of a recession to half of the reserve's balance to ensure the State does not exhaust the account in one year.

3. **It requires debt payments.** For the first 15 years Prop 2 would *require* half of the set-aside to pay off budget-related debt and half to the reserve. In subsequent years half would pay off long term liabilities, including pension related costs and half in the reserve.

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THE FUTURE: Prop 2's Impacts on Public Spending

So what will Prop 2's long-term benefits be? Will the reserve be able to provide stability and support the state's vital safety net programs during the next recession?

Predicting state fiscal conditions is always a difficult task, but a look back at the last 15 years of state budgets provides some indication that the reserve will get the job done. Voters should vote yes on Proposition 2 to strengthen this vital budget backstop.

How much more money would Prop 2 put into the reserve?

If Proposition 2 had been in place over the last 15 years, the state would have transferred 1.5 percent of General Fund revenues about seven times depending on budgetary conditions. This would have added up to an average annual $1.3 billion deposit into to the reserve.

How much spike revenue would Prop 2 capture?

In the last 15 years, the state has had six years where revenue from capital gains taxes exceeded 8 percent of General Fund tax proceeds. These transfers would have resulted in an average annual deposit during those years of $2 billion – one-time revenues that could have been used to protect programs during the downturns that followed.

How big will the Prop 2 reserve be in 5 years?

There's no telling when the next recession will come, but this year's state budget made the first deposit into the reserve ($1.6 billion) since before the Great Recession. The State Department of Finance estimates that by 2018 the state will have set aside $4.6 billion in revenues – with half going into the reserve and half available to pay down debt. This would give the state a way to completely pay off the remainder of the $34.7 billion in budget-related debt accumulated during the recession.

How Prop 2 Will Change State Budgeting

- **More stability for priority programs** like education.
- **A stronger safety net** when it is needed most.
- **Keeping California out of the international headlines** for being a failed state.
- **Helping to prevent fiscal crises** that trigger intergovernmental raids that divide Californians
- **Reduce borrowing to sustain programs**, which costs millions in interest and puts pressure on the budget during recoveries.

Will Prop 2 protect the state from the next recession?

Recessions come in many lengths and degrees, but the Prop 2 reserve will be strong enough to support major state programs in all but the worst economic downturn. A CA Fwd analysis found that if the state had this type of reserve mechanism in place over the last 15 years, programs dependent on the state budget would have avoided the fiscal impacts of the dot.com bust and the multi-billion deficits of the Great Recession would have been half that size.