CITIZENS'
Budget
2003–05

A 10-Point Plan to Balance the California Budget and Protect Quality-of-Life Priorities

Reason

The Performance Institute

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Part 1

Put Politics and Accounting Gimmicks Aside to Create a Bipartisan and Effective Solution

"This is not a time for a political debate; this is a time to have a business-management approach."

—Steve Peace, Director, California Dept. of Finance

In 2001-2002, the Governor and the legislature realized that the state was facing a serious fiscal crisis. As will be clearly demonstrated in Part 2, spending increases had outpaced revenue increases so much that a huge deficit was opening. Much worse, the state had engaged in three years of over-spending based on unrealistic revenue expectations predicated on the dot.com stock market boom. Yet, instead of correcting the problem, the Governor and legislature resorted to short-term measures such as dipping into tobacco settlement money, restructuring existing debt, implementing transfers, and engaging in accounting shifts and tax deferrals.[3]

This year is a dramatically different scenario. **The gimmicks are gone…the phantom savings won't work…and the problem is much, much worse.**

While most states are facing difficulties, California's fiscal challenge tops the list—with the largest deficit in terms of size and the greatest magnitude of change from the 2000 high. Indeed, California's deficit constitutes half of the entire shortfall of $70 billion for all states combined! Worse still, just a few short years ago, California was actually well-positioned in relation to other states—both in terms of its surplus and its climate for businesses.

California Budget FACTS:



$34.6 Billion

Total deficit predicted by Governor for 2002-03 and 2003-04 fiscal years.

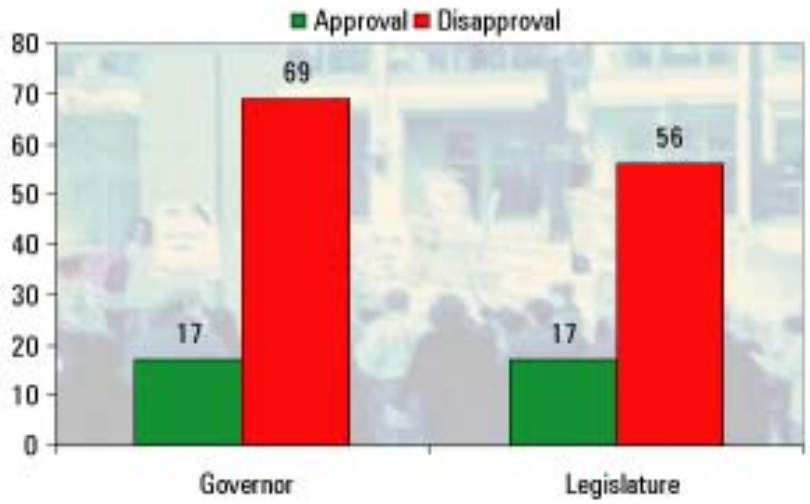
$5.5 Billion

New spending added by the Governor to his $34.6 billion budget shortfall before he proposes tax increases and spending cuts.

$26.1 Billion

Total deficit predicted by non-partisan Legislative Analyst's Office for 2002-03 and 2003-04 fiscal years.

Figure 1: Public Disapproves of Handling of Budget by Governor & Legislature



Source: *Los Angeles Times*, April 10, 2003

Elected leaders in Sacramento (in particular the Governor, Senate and Assembly) are responsible for analyzing the scope and cause of the current fiscal crisis and enacting both short-term and Long-term changes to ensure California can meet its obligations today and tomorrow. Unfortunately, all sides seem (to a greater or lesser degree) to have neglected their responsibilities to constructively address the budget challenge. Politics and the gravity of the crisis faced by California have prevented either party from offering a viable budget plan that will protect California's quality of life.

The Typical Chorus in the Budget Debate

The annual budget debate is always colored by the typical inflammatory rhetoric—with each side jockeying for political advantage over the other. Republicans are painted by Democrats as heartless and uncaring—dead-set on shutting down the government, protecting rich and corporate interests, and ignoring the needs of the poor, the sick, and the elderly. Democrats are portrayed as bureaucracy-building tax-and-spenders looking to expand government intrusion into daily lives, over-regulate business, and build welfare programs for every want, care or desire of needy and special interest populations.

Consider the following quotes from State Treasurer Phil Angelides and former California Republican Party Chairman Shawn Steele:

> *Angelides: "I say if the Republicans want to cut education, let them be the ones to rip the textbooks out of our children's hands."*[4]

> *Steele: "Gross negligence is too soft of a word. It's almost like child molestation that prevents generations of young people from having an equal chance in our society."(Referring to Democrat leadership in California)*[5]

Both positions are extreme. Both yield gridlock. Neither is helpful to solving such important problems as the state budget. Neither protects the quality of life of Californians. What is desperately needed in the budget debate is some serious resolve to find serious Long-term solutions. Instead of a Democrat or Republican perspective on the budget, we should take a citizen's perspective.

Agreeing On the True Size of the Deficit: $34.6 vs. 26.1 Billion

Assuming for the moment that the political parties can put aside the rhetoric and approach the budget debate in a constructive manner, the first step in crafting a sound budget solution is to agree on the magnitude of the problem. Unfortunately, Sacramento cannot even provide a solid number for how big a deficit the state faces! Indeed, there are two competing figures being used in Sacramento—one by the Governor, the other by the non-partisan Legislative Analyst's Office (LAO). Governor Davis has placed the projected deficit for the rest of this year and all of next year at $34.6 billion[6] while the (LAO) estimates the deficit at $26.1 billion.[7]

So why is there such a big difference and, more importantly, who is right? According to Legislative Analyst Elizabeth Hill, about $3 billion of the difference is due to the Governor's more pessimistic economic assumptions, particularly with regard to the revenue forecast. The remaining $5.5 billion is due to "definitional differences" over the baseline level of state spending. In the words of the LAO:

> *Our standard for this baseline is spending that would occur under current law (or, if more applicable, current legislative practice). In contrast, the administration's baseline in some cases reflects additional spending that would be required to achieve the administration's policy goals as well as proposals that have not yet been adopted.*[8]

In other words, Governor Davis is including in his estimate his own wish list of new spending that the legislature has not even approved! By inflating the true size of the deficit, the Governor's approach allows him to suspend the proposed $5.5 billion of funding (that never actually existed) and then claim that he has eliminated 16 percent of the projected budget deficit through these "cuts." The authors believe this approach to be irresponsible and disingenuous, and thus consider the LAO's $26.1 estimate to be more reliable.

California Budget FACTS:



24%

Percentage of Governor's solution to baseline budget shortfall addressed through tax and fee increases

40%

Percentage of Governor's solution to baseline budget shortfall addressed through program savings

15%

Percentage of Governor's solution to baseline budget shortfall addressed through shifts to local governments

$2.2 Billion

Amount of budget Senate Republicans address through the accounting gimmick of switching Medi-Cal to cash accounting basis and deferring Proposition 98 funding

Existing Budget Plans Not Adequate to Solve Budget Challenges

To date, there have been only two complete proposals to address the projected budget shortfall—and only one with concrete details. Governor Davis submitted his 2003-04 Governor's Budget in January, as required by law, complete with concrete details on what reductions would be necessary to achieve balance. In addition, Senate Republicans have submitted their own proposal, which adopts a number of the Governor's suggested cuts, and claims to balance the budget without tax increases. Unlike the Governor's proposal, the Senate Republican plan contains few specifics on what reductions would be necessary. Even worse, the Democrats in the legislature have abdicated their responsibility to put forward a comprehensive plan. A review of what each side has offered provides several positive and negative critiques.

The Governor's Budget

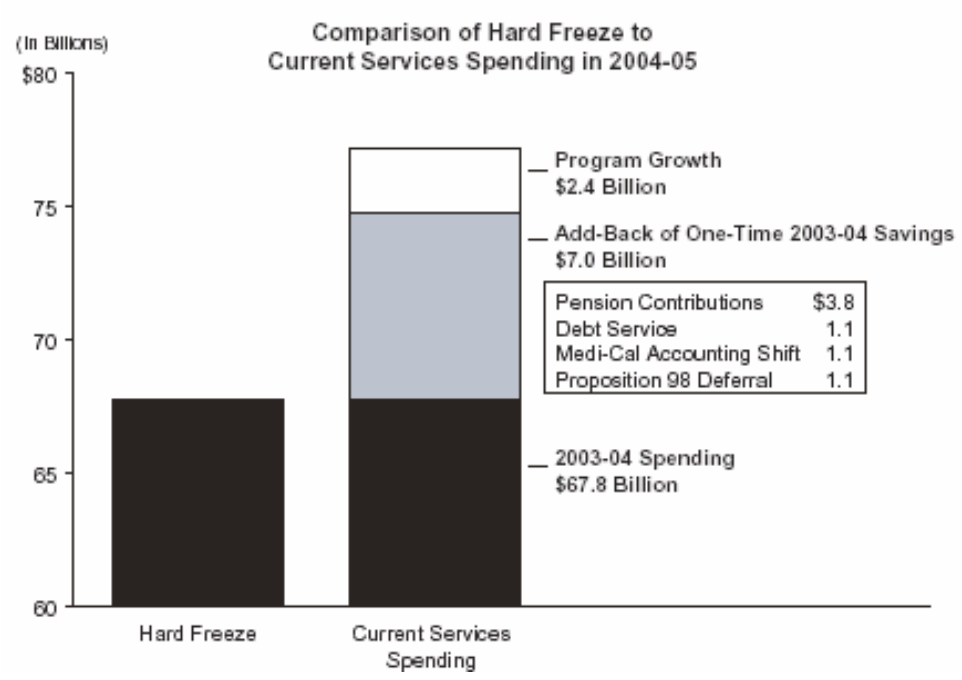
There are several positive features in the Governor's Budget. First, the Governor takes some important first steps in correcting the state's spending problem by proposing spending reductions. When setting aside his phantom savings as defined above, the Governor proposes a total of $8.2 billion in real reductions to programs—representing at this point in the debate the only specific package of reductions offered. Another positive feature of the budget is the realignment of state programs to the local level. As will be discussed in Part 4, many state and local services should be realigned to produce efficiencies and performance improvements. Finally, the Governor is to be commended for correctly calling for systemic reforms in state management and finances.

However, a number of flaws exist in the Governor's Budget making it an inadequate proposal:

- **Incorrect Budget Deficit Figure:** The Governor's Budget proposes to close an estimated two-year budget gap of $34.6 billion. However, as already established, the Governor's numbers are not credible, given that the Legislative Analyst's Office put the figure at $26.1 billion.
- **Phantom Spending Reductions:** The Governor's Budget contains $5.5 billion in *new spending* that is not required by law. His so-called spending reductions of $13.7 billion detailed in his plan actually become $8.2 billion when the "phantom" $5.5 billion in "reductions" are factored in.
- **Inadequate Correction of Spending Binge:** As will be demonstrated in Part 2, the appropriate growth rate on average for state programs should be 21 percent. Unfortunately, the governor does not correct the unsustainable explosion in programmatic spending in any of the budget categories—pushing spending up by 36 percent. Simply put, further reductions are needed before state spending can return to a sustainable level. For example, planned spending for corrections, including a $220 million renovation of death row at the San Quentin facility and an exorbitant new labor agreement with correctional peace officers that will cost hundreds of millions of dollars over the next several years, will actually increase, while virtually every other area of government is made to share in the cost cutting and pain of spending reductions.
- **Across-the-board Cuts:** The Governor does make several specific and targeted reductions in programs, but in many cases his proposal relies on across-the-board cuts. Across-the-board cuts are generally not a good idea, as effective, high-priority programs are forced to suffer equally with those programs that are inefficient and of lower priority. Difficult as it may be, legislators are elected to make tough decisions, such as what government should be doing, in good times and in bad. The focus should thus be on eliminating waste and low-priority programs, not throwing the baby out with the bath water.

- **Excessive and Regressive Tax and Fee Increases:** The Governor's proposal seeks to assess an additional $8.3 billion in taxes and fees on California taxpayers. In doing so, the plan imposes additional strain on California's struggling economy and workers that could drive jobs out of the state.
- **Over-reliance on Bonds and Loans:** The Governor proposes to use loans and bonds to cover $3.3 billion of the shortfall—including a $1.6 billion to cover state contributions to the employee retirement funds. This is exacerbated by bond financing, which costs much more than pay-as-you-go spending and will hit taxpayers harder in the future, as the bonds will have to be paid off somehow (i.e., through taxes).
- **Raiding Local Government:** The Governor's plan eliminates the Vehicle License Fee (VLF) backfill provided to local governments as part of an agreement reached in 1998. By not honoring this agreement (or by not fundamentally reforming state-local finances), the state is imposing severe burdens on local governments that provide the most essential services to citizens.
- **No Plan for Long-term Reforms:** Even though the Governor calls for fundamental reform, his budget fails to articulate a clear package of reforms to address Long-term liabilities and flaws in the current state fiscal structure. In fact, some of his proposals will worsen the volatility of the state's fiscal system. For example, while California increasingly relies on volatile personal income tax revenue, which includes taxes on stock market gains, the Governor has proposed increasing personal income taxes on those in the wealthiest income bracket, who are the very people with the most volatile incomes and who pay the largest share of state taxes. This will only increase the volatility of future tax revenues, and thus increase the likelihood of future budget deficit emergencies.

Figure 2: Senate Republican "Hard Freeze" Doesn't Reflect Mandatory Spending in Second Year



Source: Legislative Analyst's Office

The Senate Republican Plan

The Senate Republicans' plan also has several positive elements. First, it relies on no tax or fee increases. Second, it wisely embraces the concept (albeit for the next two years) of "biennial budgeting." Third, it uses the more reliable LAO estimates of the budget shortfall. The plan also wisely rejects the inclusion of $1.5 billion in Indian Gaming Revenue. Until pacts are negotiated and revenue forecasts from this source are more reliable, it is best "to be very conservative when factoring this revenue into a budget deal..

However, a number of flaws exist in the Senate Republican Budget making it an inadequate proposal:

- **Lack of Details:** The plan is only five pages long and is nowhere near as comprehensive as the Governor's Budget. It does not utilize a line-by-line or even a detailed agency-by-agency analysis.
- **Across-the-board Approach:** Rather than highlighting a list of recommended cuts, the Senate Republicans' plan calls for a 7 percent across-the-board reduction in spending, yielding $5.1 billion in savings, and a cap on spending at the same levels for the following year. However, according to legislative analyst Elizabeth Hill, some $9.65 billion in program spending is mandated by court orders, federal requirements, or provisions of the California constitution, and thus could not be included in the proposed cuts.[9] In order to make up for this, the cuts would actually have to be larger for remaining programs.
- **Year Two Mandatory Increases Not Addressed:** As noted above, each year certain programs have mandated spending increases reflecting requirements outside of the legislature's control. Unfortunately, the plan proposed by Republicans merely calls for a "hard freeze" between year one and two of their budget, not reflecting a $2.4 billion increase in mandatory spending during the second year. This mandatory spending increase would have to be offset by an equal reduction in discretionary spending to achieve the plan's "hard freeze" (see Figure 2).
- **Accounting Gimmicks:** The plan also suffers from some of the same accounting gimmicks the Republicans have accused Governor Davis and the Democrats of using to solve budget gaps during the past couple of years. For instance, the plan realizes $1.1 billion in "savings" from shifting Medi-Cal from accrual accounting to cash-basis accounting, despite the trend of moving all government accounting in the opposite direction. Like the Governor's Budget, the Senate Republicans' plan relies on the issuance of Pension Obligation Bonds to pay $1.5 billion that the General Fund was supposed to contribute to the Public Employees' Retirement System and the State Teachers' Retirement System. This proposal suffers from the same criticisms of bond funding mentioned previously.
- **Raiding Local Government:** Finally, the Senate Republicans' plan favors $500 million in "contributions" from local governments for each of the next three years instead of the Governor's realignment proposal. It additionally calls for the deferral of approximately $1 billion in reimbursements to local governments for state-mandated programs. Again, the state should deal with its own budget problems, rather than shifting the burden to local governments and taxpayers.

The Legislative Democrats "Plan"

The Democrats in the legislature have not put together any kind of plan on their own. As a result, they have abdicated their leadership role. Until the Democrats who control the legislature can offer a proposal, their criticisms of the Governor's proposal and the Senate Republican proposals should be viewed lightly—if not hypocritically.

Digging in for Partisan Trench Warfare

Like armies preparing for battle, the various sides of the budget debate are digging into their positions without offering realistic plans for solving the budget crisis long term. At present, the only two proposals on the table *both* fail to balance fiscal responsibility with ensuring investments in quality-of-life programs as well as creating the conditions necessary for a jobs-friendly state. By labeling one side as "uncaring, mean-spirited" and one side as "job-killing tax-and-spenders" there seems little hope for a positive "win-win" outcome from the present debate. As a result, an alternate budget package presented by a coalition of interests might be needed—if not for a vote, at least to spur creative thinking.