
CALIFORNIA BUDGET REPORT

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THE MAY REVISE: SOME TWISTS, SOME TURNS, SOME SHIFTS, SOME THINGS OLD, SOME THINGS NEW

Today started off with good news for the Governor. The Pentagon unveiled its recommendations for military base closures and realignments, and California was largely spared. The Governor should enjoy this news. It may be only positive story he gets for many weeks to come.

We have only had a brief look at the May Revision, but wanted to give you some background as you pour through the proposed changes. This is our first cut only; more to follow.

Please go to the Department of Finance web site for the May Revision and all major budget documents, http://www.dof.ca.gov//HTML/BUD_DOCS/bud_link.htm.

Background

Financial picture at the end of last year

The Legislative Analyst said the state approached the 2005-2006 budget year with an \$8 billion "shortfall"--the difference between mandated and caseload-driven spending and estimated revenues.

Governor's January Budget

In January, the Governor's proposed 2005-2006 General Fund Budget spent \$85.8 billion, but only generated \$83.7 billion in revenue. Built into these figures were many of the Governor's proposed cuts, shifts and transfers.

January 2005 budget figures were based on September and October 2004 estimates of both revenue and spending. *All projected General Fund revenue and spending figures assume that all other changes proposed by the Governor (or comparable changes) are adopted.*

Here is how the Governor proposed to balance the budget:

- **Cuts**, mostly in social services, state employee compensation and across-the-board reductions, some health care and the controversial decision to hold Proposition 98 (K-14) spending to current levels. Collectively, these changes “save” about \$4.6 billion.
- **Funding shifts** (reducing state contribution to local teacher’s pension funds), shifting federal funds around and using public transportation spillover funds for general purposes. This generated \$969 million.
- **Loans and other tricks** included using a portion of the unused deficit financing bonds (borrowing authorized in year’s special election), delay of Proposition 42 money going to transportation, and other changes, generating \$3.5 billion.

The LAO’s February Review

Toward the end of February, the Legislative Analyst released her evaluation of the proposed budget, suggesting that an additional \$2.4 billion would be available, mostly resulting from higher revenue and somewhat lower expenditures. Remember, the LAO had an additional two months of financial information and it showed the economy bouncing back. Historians of the budget can find all the details in Perspectives & Issues,

www.lao.ca.gov/analysis_2005/2005_pandi/highlights/pandi_highlights_022205.htm.

The Tax Amnesty Surprise

To the surprise of almost everyone, the tax amnesty program previously adopted by the Legislature generated about \$3.8 billion more than expected! The Department of Finance, scurrying to make sure that this one-time windfall is not spent foolishly, advised the Legislature that only \$300 million of this amount might safely be assumed as a permanent gain to the state. See

<http://www.dof.ca.gov/HTML/FINBULL/Apr05.HTM>.

Since that time, State Controller Steve Westly and now the Governor think that \$800 million might be safely spent this next budget year. Why not spend all of it? Well, almost all of this amnesty money resulted from businesses submitting payments “under protest,” meaning they paid to avoid additional penalties but intend to fight the imposition of the tax. Whether the state spends \$300 million of this amount or \$800 million or all \$3.8 billion, this is one-time revenue only. Seems to us that paying down the borrowing would be the best use of any of this amount.

The Governor’s Transportation Play

An improving economy, more money coming into state coffers and blistering criticism of the proposed cuts mean that the Governor will use the May Revision to reduce the pain of his January proposal. Legislative Democrats and Republicans will suggest that the “new” money be spent for their preferred priorities.

The Governor sought to control the debate by his announcement on May 11 that \$1.3 billion would be spent for transportation—or rather that he would not steal \$1.3 billion that voters wanted put into building roads to reduce bumper-to-bumper traffic:

“On Friday, I will present a budget for California that will fully restore Proposition 42 and put more than \$1.3 billion into transportation. This will allow us to move ahead with new projects that were approved for construction years ago and finish or expand current projects that have been stalled by the lack of funding.”

The Governor referred to a previously approved list of projects to be funded from Proposition 42 funds, guaranteeing that the communities interested in those projects would become the lobbying arm of his May Revision.

More important, the Governor's staff indicated that additional surplus funds would be used to reduce the borrowing previously approved by the voters to balance the budget. By earmarking the new revenue and the tax amnesty windfall for transportation and deficit reduction, the Governor is attempting to constrain the spending inclinations of the Legislature. History suggests it will not work. For the perspective of a fiscally prudent budget, however, using one-time money for one-time spending makes sense.

The November 2005 Special Election

It is only May, but already the November election is an old, tired subject. We add this issue to the mix again only because it will color everything that happens from this point on. Although signatures have not yet been certified by local election officials, at least seven (maybe eight) ballot measures appear likely for a special election, if it is called. As we write this CBR, the Governor and legislative Democrats are engaged in a political dance that has each side accusing the other of dastardly behavior while holding out the potential of "compromise." It is remotely possible that a special election will not occur and more likely that it will. But some of the issues in the pending ballot measures may be "solved" by legislation this year.

Do not take our short summaries as either comprehensive, or a fair way of explaining these complicated proposals, but here they are:

The Governor's three proposals:

- Retired judges draw state legislative district lines, not legislators.
- Budget spending limits imposed; current spending continues if a new budget not passed on time.
- Teacher tenure is granted only after additional years of teaching.

Other proposals:

- Forces labor unions to get written approval from their members before spending any dues for political purposes. Note: Labor is collecting signatures for a measure set for the 2006 ballot that would prohibit corporations from contributing unless their shareholders agreed.
- Lowers drug prices in California. Note: Litigation is pending to challenge placement of this measure on the ballot, based on the claim that certain provisions violate the state constitution.
- It is possible a competing drug price/rebate ballot measure by the pharmaceutical industry may make the ballot.
- Proposal to re-regulate the state's electrical energy system.
- Measure requiring parental consent for abortions performed on minors.

Which leads to the May Revision to the budget.....

The Governor's May Revision

You can read all the details of the May Revision, but it is hard to get the larger picture. Here is our suggestion of how to look at this latest proposal:

1. The May Revision does not solve the problem of education funding. The May Revision does not “restore” the \$2.2 billion to K-12! The California Teachers Association and their allies have spent tons of money for TV ads and rallies condemning the Governor for his proposed education cuts. Democrats have promised to save education and return the money. You can be sure that this will be the biggest budget issue remaining to be solved.

Yes, the Governor did sweeten the pot a bit, but it appears to be a modest adjustment. Revised calculations of the Proposition 98 guarantee show that \$509 less is due schools. Rather than adjust, the Governor is leaving that money in the pot. Likewise, he applies \$252 million for prior year Proposition 98 settlements. In the same vein, the Governor claims that re-calculation of the Vehicle License Fee backfill (don’t ask, it’s too complicated to explain here) means the state has to pay an additional \$284 million, but this would appear not to be additional money for schools, just shifting from one pocket to another. Our bet is that the education types will say this is no adjustment at all --- and continue their battle for full restoration of funds.

2. To the extent money is restored to Proposition 98, equal reductions in social services, healthcare and the state workforce will be required.
3. Legislative Democrats have rejected virtually all of the Governor’s proposed budget cuts. They have offered almost none of their own, and are unlikely to do so.
4. No new taxes. The Governor and legislative Republicans continue to oppose any general tax increase and the Governor will continue that theme. Democrats in the legislature support them, but do not believe they will happen. Given the possibility of a special election this year, the chance of legislative approval of any tax increase is slim to none.
5. The Governor’s proposed ballot proposition, the “Live Within Our Means” Act, will have no impact on the 2005-2006 budget, even if the ballot measure passes.

What would a budget deal look like?

If no spending can be cut (or not much) and no taxes can be increased, how can the Governor and Legislature adopt a budget? Putting aside all the practical problems, a typical political deal is something like this:

- a. Borrow money, directly or indirectly. There are limits to this, so assume it is a fairly small part of the solution.
- b. Agree to help transportation, but put a big, new transportation bond issue on the November 2006 ballot. That would free up the \$1.3 billion earmarked by the Governor for transportation. The highway lobby grumpily accepts the deal, in exchange for a big bond issue, in the range of \$10 billion to 15 billion! Everyone agrees to ignore the fact that bond repayment comes from the state General Fund, which is in no condition to make the payments.
- c. Devote the \$1.3 billion to K-12 education. Everyone ignores the fact that one-time money is being used for Proposition 98 purposes, increasing the pressure on the 2006-2007 budget.
- d. Use any remaining Deficit Reduction Bond authority for additional K-12 education, plus some of the remaining cuts proposed by the Governor. Everyone ignores this use of one-time money for ongoing spending.

- e. If you need to get Democrats to vote for any cuts, temper those reductions by making them one-time, or two- or three-year cuts.
- f. If you need to get Republicans to vote for the deal, offer some earmarked transportation money in the proposed bond issue, or just spend some of money for rural law enforcement or similar programs.
- g. Fudge the difference.
- h. Claim victory!

Some May Revision details

In no order of importance, here are some details:

- ✓ Senior citizens property tax relief and renters tax relief restored.
- ✓ \$174 million of Proposition 98 money earmarked for reducing class size in certain low-performing schools. We assume the Administration will argue this is in compliance with the recent *Williams* settlement.
- ✓ Creation of new Office of the State Inspector General, designed to head off problem similar to the scandal at the now-abolished Office of Criminal Justice Planning.
- ✓ Inclusion of \$10 million of Proposition 98 settle-up funds for nursing program expansion.
- ✓ Restores funds for certified applicants assistants, who enroll eligible kids in the Healthy Families Program (HFP).
- ✓ An average increase of 2.9 percent in managed care plan reimbursement in the HFP program.
- ✓ \$3 million increase for the AIDS Drug Assistance Program (ADAP).
- ✓ Makes a complicated set of adjustments in the Proposition 99 funding of various health programs, using one-time funds from the Major Risk Medical Insurance Fund (MRMIF).
- ✓ CalWORKS “income disregard” proposed cuts are reversed and a three-month delay in grant reductions proposed.
- ✓ Restores the \$75 million cut recommended for the Juvenile Justice Crime Prevention Act.
- ✓ Proposes to create the new state agency, the Office of Homeland Security. Since 9/11 a similar office has operated by Executive Order out of the Governor’s Office.
- ✓ Although details are lacking, the May Revision appears to project no state revenue to be gained in the budget year from Tribal Gaming Bonds (see p. 64). These funds were previously earmarked for transportation purposes.
- ✓ Partial repayment of cities and counties for the VLF Gap Loan Repayment, a legacy of prior budget deals. The locals will receive approximately \$614 million. Note that this debt is due in 2007, but the Governor proposes to pay it this year. Prudence would suggest that this allocation may be viewed skeptically by the legislature.
- ✓ The Administration admits that there will be virtually no savings from their Strategic Sourcing Initiative (p. 72).

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