
CALIFORNIA BUDGET REPORT

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A Happy New Year of Budget Balancing, Borrowing and Ballot Box Foreplay!

Our New Year's wishes to readers of the California Budget Report. This is the third year of our report; the fourth if you count all the informal e-mail reports in 2002. We are happy to be back giving you some background information, occasional flights of fancy, and even a fact or two about the state's sometimes futile attempt to balance its budget.

Consider this New Year's issue of the California Budget Report to be based on "conventional wisdom," which means the current opinions of Sacramento's "chattering class"—the political gossips, insiders and players who hover in and around the Capitol. When we differ from the chattering class, we'll tell you.

The big question for this budget is: Which Arnold Schwarzenegger will propose the budget? Will it be the Republican, pro-business, anti-tax Governor of the last year? Or will it be the populist who so charmed the California voters during the recall election? For any early answer to this question, keep your eyes open on the issue of how the Governor intends to pay for his big bond proposal.

How We Ended the Last Budget Year

Governor Schwarzenegger signed the 2005-06 budget on July 11, 2005. Afterward, the Legislative Analyst opined that the budget was balanced, but predicted a \$6.1 billion shortfall in the following year 2006-07, *Major Features of the 2005 California Budget*, http://www.lao.ca.gov/2005/major_features/2005-06_major_features.pdf.

The Legislative Analyst, spoil-sport that she is, reminded all Californians and their elected representatives that the state had not resolved its budgetary dilemma: we annually spend far more than we bring in. It looked like another fight in 2006. However....

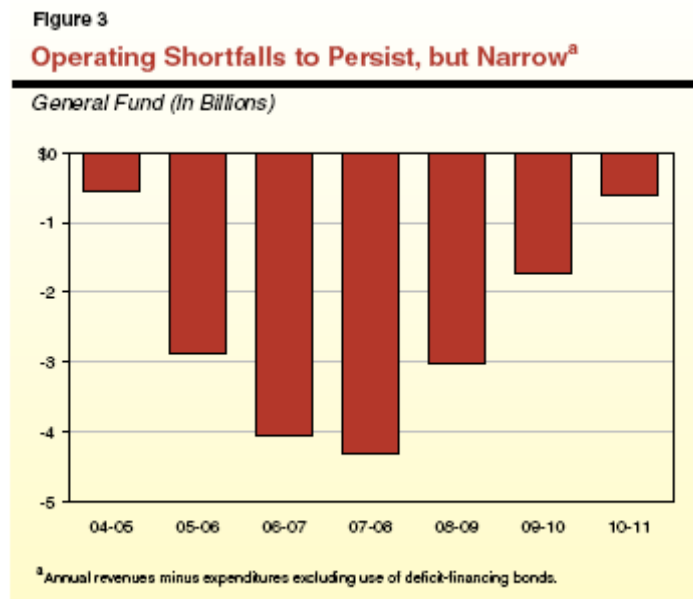
In November 2005, the LAO announced that state revenues had grown dramatically, increasing almost \$4 billion over previous estimates and putting a balanced budget for 2006-07 within reach. Solid economic growth had increased the estimated state reserve fund to \$5 billion. The budget

“shortfall” dropped to \$4 billion! Is it time to wrap things up and move on to other subject? Well...no, there are still problems.

NOTE: Some of our readers keep trying to make mathematical sense of estimates of spending, revenue and the General Fund condition. Forget it! When the economy is good, more money comes in the door. But, the voters of California have created a government system that automatically spends almost all new growth in revenue, almost as fast as the money comes in. Cost of living adjustments, indexed benefits, inflation-adjusted taxes (which drive revenue down), and constitutional earmarking of “new” funds (mostly for K-12 and community colleges under Proposition 98) means there is almost never any money left to spare!

Think of it this way. Years ago, an Assemblywoman (and later long-time Secretary of State) March Fong Eu campaigned to get free toilets in public bathrooms for women. Her slogan was, “For every three, make one free!” Something about our current budget problems—the notion that “new” revenue is never fully available for new programs—reminds us of March’s famous slogan. For all us budget wonks, the legislator’s cry is clear: For every three dollars received, spend one!

Politicians breathed a sigh of relief when they read that the LAO said the 2006-07 budget could be balanced by using reserves. However, they ignored the Analyst’s additional comment: even with the increased revenue, California still will spend \$4 billion more than it generates from taxes and other revenue. And more important, the state will continue to suffer operational shortfalls for years to come. Take a look at the interesting chart from the LAO’s *California Fiscal Outlook* (November 2005), found at http://www.lao.ca.gov/2005/fiscal_outlook/fiscal_outlook_05.pdf.



Remember, these projections by the LAO assume no new spending approved by the Legislature and Governor, no new tax reductions, no new big General Obligation bond debt payments to come from the General Fund. This means that if we just maintain the status quo on spending—one tall order!—we grow out of our financial problems very slowly.

Since most of the readers of the California Budget Report (and those of us who write it) spend much of our professional lives figuring ways to increase spending for programs we like, and knowing that there are a lot of hungry lobbyists looking for stray cash for their clients, we are confident that no one—not Republicans, not Democrats, not liberal or conservatives--will show much interest in trimming back spending or halting tax cuts. Well, maybe Senator Tom McClintock, but no one else comes to mind.

Conventional Wisdom on the November 2005 Special Election: The Governor Lost Big.

One reason the budget fight this year seemed so easy was the pending November special election. As the weeks rushed by and no mega-deal to avoid a special election occurred, the Governor, legislators and the political classes geared up for the ballot fights. And the Democrats in the Legislature did not want to hand the Governor any fodder for his stump speeches by dragging out the budget process into September.

You know the special election rap. Eight measures made the ballot; four “sponsored” or actively supported by the Governor, the others placed there by various interest groups. All failed. From a budget perspective, the most fiscally relevant measure, Proposition 76—which would have imposed a confusing set of limits, restrictions and modifications on future budgets—was defeated by a very large margin: 62.4 no to 37.5 yes.

The conventional wisdom was that the Governor suffered a major loss, and with some qualifications we agree with that conclusion. We note that in rejecting all the ballot measures, California voters still appear to believe that taxes should be lower, government spending should be higher and politicians should “just buckle down” and make it happen.

The Governor is buckling his seatbelt for a long ride this re-election year. A small cadre of the media still speculates that he will eventually not run, but not even the Flat Earth Society agrees with them.

Paddle to the Right, Paddle to the Left.

Former Governor Jerry Brown gets the credit for coining the phrase “paddle to the right; paddle to the left” as a principle for governance in California. Governor Schwarzenegger looks like he is borrowing unabashedly from this play book.

He picked a fight with far-right Republicans by appointing Susan Kennedy as his Chief of Staff. Kennedy is the smart, tough, ultra-operational Democratic political pro who served Governor Gray Davis as Cabinet Secretary and then member of the Public Utilities Commission. Forget the politics for a minute; there is almost no one else who brings to the job the level of skills, knowledge and organizational sense that Kennedy exhibits. Republican complaints have faded since the appointment and closed-door meetings with the Governor. Some diehard Republicans, however, still complain about First Lady Maria Shriver’s appointment of Daniel Zingale as her chief of staff. Zingale served as Deputy Chief of Staff to Governor Davis and before that as head of the Department of Managed Health Care.

Governor Talks About Massive Bond Issue

At this stage it looks as if most of January, February and March 2006 in the Capitol will be spent with the Governor and legislative leaders trying to hammer out a big bond package for “infrastructure.” When the Governor headed to China right after the special election, some observers were surprised to hear him announce that he would propose a big bond package, perhaps more than \$50 billion for the 2006 ballot. Now that is a subject that gets the political juices flowing!

The Governor is expected to give a general outline of his bond proposal and his 2006-07 budget in his January State of the State Address. We hear that the following spending areas will be part of the Governor’s package:

- **Transportation.** Expect money for state freeways, local roads and some for mass transit as well. Expect something in the neighborhood of \$10 billion to \$15 billion.
- **Flood Control.** Some money will be earmarked for levee repair and maintenance in the Central Valley. Our sources tell us that \$2 billion would be the maximum, and that may be high for the proposed package. Flooding in Northern California this past weekend might lead to an increase in this amount.
- **School construction.** Last week, some media reported the Governor apparently had a private kiss-and-make-up meeting with Barbara Kerr, president of the California Teachers Association. If so, we assume that he may indicate some willingness to support additional school construction bonds for K-12. Speaker Nunez has stated he will carry a bill to authorize at least \$10 billion.

Add these three items, throw a bit more to ports (maybe mentioning new Liquefied Natural Gas facilities) and you get close to \$30 billion to \$35 billion, which is the current private, guaranteed-to-be-solid insider guess --based on conventional wisdom-- of what the Governor will propose.

Although bond money for hospitals has not been part of the media speculation about the bond, we noted that the Governor’s Weekly Radio Address of December 30, had this intriguing statement:

“... next week, I will present my State of the State Address, and offer my plan for the coming year.

I want to build even more momentum behind our economic recovery, create even more jobs and produce even more revenues to pay for the government services we depend on most.

And I want to make a historic commitment to prepare our state for the incredible growth that lies ahead with a greater investment in our roads, hospitals, environment, schools, ports, and more.”

And what could the “more” be? Well, missing from the bond gossip are things of interest to the following groups who will demand a place at the table:

- **Environmentalists** want to create and preserve parks, improve water quality, save the ocean, increase funding for resource protection, you name it. They are circulating a draft of *The Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act of 2006*, that would cost about \$4

billion (number subject to negotiations). Senator Wes Chesbro also has his parks bond, SB 153. There are lots of other ideas around. You can be sure that either as part of the Governor's bond package, or by initiative, the environmental side will pitch for more money.

- **Hospitals** have a state-imposed deadline to comply with earthquake standards. The costs are in the billions and they are demanding that state bonds pay a good share. Maybe the Governor wants to spend bond money to increase training opportunities for nursing students.
- **Higher education** wants a cut of the action. Sure, giving money to K-12 and community colleges is good, but who can doubt that colleges are far behind?
- **Cal-Fed.** Media reports indicate that the Schwarzenegger Administration is trying to jump start the Cal-Fed process. For those of you who don't know about Cal-Fed, think lots of federal money, some state money, big group of federal/state/local water interests, plus an occasional environmentalist and some others. Think "if we only spend lots more money, all the water warriors will agree on how to send more to Southern California" and you get some idea of what has been going on.
- **Low/moderate income housing.** Democrats in the Senate are including something for low/moderate housing in their bond package. No idea if this is sure to be part of any deal.

How could all of these needs be satisfied? Well, they can't, but one trick being discussed is to phase in the bond issues. Similar to the high-speed rail bond proposal, it is possible the Administration could increase the size of its bond package to beyond \$50 billion --- but with a package that is phased (e.g., \$30 billion maximum to be sold in 2006; \$10 billion in 2008 and \$20 billion in 2010). Another option is to pass several bond packages, but have them submitted to the voters at the next few elections.

Historic note: Under the category of "honored in the breach," place the 1999 statute mandating annual production of a five-year State Infrastructure Plan. Yes, plans have been submitted in 1999, 2001 and 2003, but not since. You can read the latest plan at http://www.dof.ca.gov/HTML/CAPOUTLY/CA_5yr_plan03web.pdf, but don't expect too much. The Davis Administration identified \$54 billion worth of need, but a lot of things are simply not included in this figure. Some media have suggested that the "need" for capital construction funds could exceed \$250 billion, but we beg ignorance on the subject.

The real fight, however, is just how the bonds will be paid for.

Financing Bonds: A Short Primer

Bond financing, as most insiders know, is nothing more than borrowing money. It is much like financing a house purchase with a mortgage. The purchaser agrees to pay a certain amount each month for 30 years or so, and at the end of that time she "owns" the property. Very few people ever add up the principal, interest and other costs, and figure out that a \$350,000 home winds up costing at least double that, or more!

To understand what is going on, you have to read a lot of things, but we recommend you start with this relatively simple explanation by the LAO on the methods of bond financing. It was written in 2003 as part of the analysis of ACA 11, http://www.lao.ca.gov/2003/aca_11/020503_aca_11.html.

How Are Infrastructure Projects Funded?

“Highway construction and renovation is the only state infrastructure program that has reliable and dedicated revenue sources (state gas taxes and federal funds). Most other infrastructure programs, however, require either direct General Fund appropriations or bond appropriations, whose related debt service is repaid from the General Fund (this covers both general obligation and lease-revenue bonds). Figure 3 shows recent history on state capital outlay spending from these two sources. (The figure excludes spending on transportation and K-12 schools.) It shows that very little infrastructure spending is supported from direct appropriations—an annual average of 0.2 percent of total General Fund spending over the period shown. More spending has been supported from bonds, averaging \$1.2 billion a year or about 2 percent of total General Fund spending for the period shown.

Figure 3
General Fund Supported
State Capital Outlay Spending^a

(In Millions)

Fiscal Year	Direct General Fund Expenditures	Expenditures From General Fund Bonds ^b
1990-91	\$9	\$1,021
1991-92	35	851
1992-93	—	1,001
1993-94	—	1,511
1994-95	11	671
1995-96	33	761
1996-97	62	791
1997-98	56	581
1998-99	169	731
1999-00	244	771
2000-01	511	1,151
2001-02	284	1,321
2002-03		
(estimated)	169	4,091
2003-04		
(proposed)	74	2,981
Totals	\$1,657	\$18,261

a Figure excludes capital spending for K-12 public schools and special fund supported capital outlay (including transportation-related programs).

b Includes both general obligation and lease-revenue bonds.

Given this financing situation, there is really no stable funding source year-in and year-out for most state infrastructure projects. Those programs which typically have been funded through general obligation bonds must wait to see if a bond authorization is placed on the ballot and then wait further to see if voters approve the measure. (Some state projects use lease-revenue bonds, which do not need voter approval.) Many state facilities, however, are not funded from bonds. As a result, there have been little or no funds routinely available for projects to, for example, upgrade or replace various facilities in the state hospitals, developmental centers, and prisons. This, in turn, has contributed to an under investment in certain components of the state's infrastructure.”

OK, thanks to the Analyst, you are now an expert! Here are the types of bonds you should think about:

- General Obligation Bonds (debt service paid by the General Fund).
- Bonds with “dedicated revenue” (sometimes called lease-revenue bonds) and paid for by earmarked revenue streams, often a share of the General Fund.
- Bonds with “dedicated revenue” other than the General Fund. The best example are the historic transportation bonds, which are normally based on dedicated amounts of the state gasoline tax or federal transportation funds.

Why should you care about this? Well, if you are interested in the state funding education, or continuing its prison system and Highway Patrol, or protecting the environment, or supporting the court system, supporting cities and counties, or helping give a decent life to the aged, blind or disabled, you have to care! Money for these activities mostly comes from the General Fund, and that means for every dollar of bond debt payment coming out the General Fund, there is one dollar less for these services.

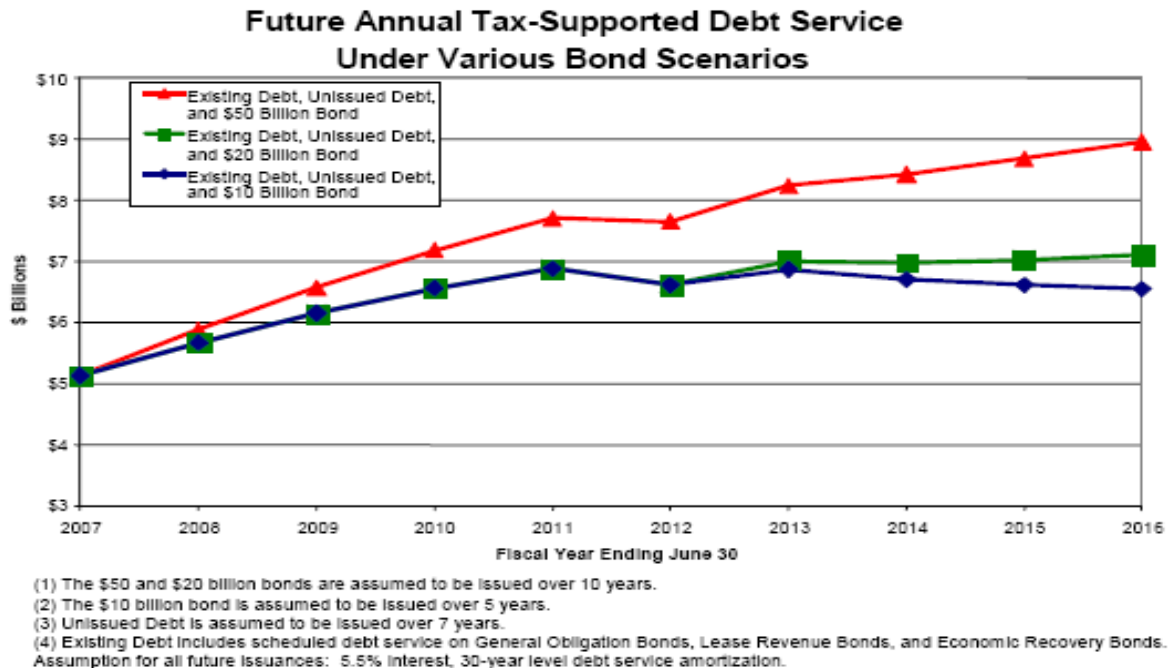
How Much Does a Big Bond Package Cost?

State Treasurer Phil Angelides is a strong critic of the Governor and his fiscal programs, including the \$15 billion worth of “deficit borrowing” authorized in 2004. He is also a candidate for Governor in 2006, so examine the following with care.

Angelides generally supported the Governor’s plan to borrow to pay for needed state capital projects. However, Angelides also pointed out the implications of taking the easy road and letting the General Fund pay for the borrowing. Late last month, Angelides issued a short report entitled *Smart Investments 2006: Five Keys to Smart Investments in California’s Future*, <http://www.treasurer.ca.gov/publications/smartinvest/dec2005.pdf>. Angelides made some interesting points, which we have summarized here and include one of his charts.

- ✓ \$33.2 billion worth of authorized bonds (both General Obligation and lease-revenue) have yet to be issued. This means that authorized borrowing will be competing with “new” borrowing authorized by any big bond package in 2006.

- ✓ \$3.5 billion has been borrowed from transportation funds to backfill the state General Fund. The money has to be repaid, which further strains the ability of the General Fund to pay for new bonds.
- ✓ Add all this together and you start to get the picture of what borrowing to finance a “big bond package” can mean, particularly if it is financed from the General Fund. **Angelides estimates as much as \$3.5 billion more in bond payments per year if the package is at \$50 billion.**



Angelides took the bond debate to its logical level: who pays for all this “good spending?” The Treasurer targeted only a couple of users who should pay for the borrowing cost of the bonds: a) those that ship freight through California ports and b) homeowners and businesses who receive the benefits of flood protection in the Central Valley. We do not think that this list is sufficient to cover bond borrowing costs for those who directly benefit from the infrastructure provided, but we are surprised that any elected official has the courage to identify potential targets at all. For fiscal prudence, we need a lot more of this kind of identification.

Normally, the Governor’s staff would denounce the Treasurer’s statement, but the *San Francisco Chronicle*, on December 21, reported on comments made by Schwarzenegger’s spokesman Rob Stutzman:

He praised Angelides for not playing politics with the issues, saying the "responsible" treasurer showed up. "Maybe the treasurer is getting smart," Stutzman said. "He has to decide if it's going to be him against the world."

In Sacramento, this is as close as it gets to saying “thank you.”

A last point on bonds: The California Alliance for Jobs, (created by the Associated General Contractors of California, the Engineering and Utilities Contractors Association, International Union of Operating Engineers, Local 3, the Northern California District Council of Laborers and the Association of Engineer Construction Employers) has come out in favor of a big bond package, financed in part by a ¼ cent sales taxes to repay General Fund borrowing costs, and significant new fees on “users”, including HOV lane drivers, ports and those who directly benefit from flood control projects. Yes, this is the organization representing the unionized construction work force in California, but it is significant that they have gone this far so early in the process.

Ballot Measures Galore!

If you liked the November special election, you are going to love 2006! Take a look at the list of 60 initiatives currently qualified, pending or circulating as of December 28, 2005. We extract this directly from the very interesting web site maintained by the Secretary of State, and you can find it at http://www.ss.ca.gov/elections/elections_j.htm#ag:

- Qualified for 2006 Primary: 1 Proposition qualified for the June 6, 2006, Primary Election ballot
- Qualified for 2006 General: 1 Proposition qualified for the November 7, 2006, General Election ballot
- Pending: 1 Initiatives pending signature verification
- Circulating: 29 Initiatives in circulation
- Attorney General: 28 Initiatives pending at the Attorney General's Office

Yes, that’s right, 60 potential initiatives! But relax; a lot of them are duplicate versions, corrections of mistaken drafting of earlier versions or wiser reflections after talking to potential contributors to the campaign.... In fact, several of the major issues are disappearing as we write this Report.

Here is our fast summary of what is really going on:

- ✓ On the June 2006 Primary Election ballot is a \$600 million bond act for **library construction** and improvement.
- ✓ On the November 2006 General Election ballot is the \$9.95 billion bond act for **High-Speed Rail**. The measure was adopted by the Legislature in 2002, but slated for the 2004 ballot. The date was changed to 2006, and we expect it may be pushed off once again, particularly if the Governor and Legislature can work out a big bond package of their own.
- ✓ Awaiting signature verification is the proposal to increase upper-bracket income taxes to fund a **pre-school program** for all four-year olds. You’ve seen the television ads promoting this idea. This would go on the November ballot.

And lost somewhere “in circulation” or at the Attorney General’s office are the following:

- ✓ **Gays**: Fourteen measures to outlaw gay marriages or domestic partner legislation, or both. Most of them are submitted by the same parties, so you can expect that only one or two will seriously seek signatures. One group submitting a number of the proposals has failed to

submit signatures by the deadline, but the others are still active. We think at least one might get on the ballot.

- ✓ **Bonds:** Five additional bond measures, including four on transportation and one on water and flood control are in the works. You can expect this number to increase, but most of them will live or die on an eventual deal between the Governor and the Legislature on a bond package.
- ✓ **Health Care:** Six measures on health care, including duplicate versions of the tobacco tax measure to fund hospital emergency room costs and other items; another measure by the anti-tobacco coalition also raising the cigarette tax; and a consumer proposal to use higher cigarette taxes for health insurance. Expect a lot of commotion on these proposals. At least one or two will qualify, unless there is a deal between the interest groups.
- ✓ **Tax changes for a bunch of things:** Three very complex proposals to use tax increases or changes for various purposes. One is an increase on booze to fund mandatory 25- or 50-year prison terms for sex offenders (and other things); a one-time tax on wealth and making endless other tax code changes; and a hysterically funny 45-percent, one-time surcharge on folks who have more than \$40 million worth of property. Our bet is none of these see the light of day, but who really knows. This *is* California.
- ✓ **Limits on eminent domain:** Three alternative measures try to abolish or severely limit the use of eminent domain (aka, condemnation of property for public purposes) by California governments. One measure could qualify if Republicans like the idea as part of their general election ballot strategy.
- ✓ **Anti-immigrant proposals:** Three measures to prohibit or restrict public benefits (including driver's licenses) for illegal immigrants. One proposal would establish a state border patrol!
- ✓ **Education:** Four alternative versions of the same proposal that basically proposes a parcel tax (at different levels) for specific K-12 education purposes.
- ✓ **Other fun and games:** Two proposals to limit abortion; a ban on corporate contributions to political campaigns (rumors swirl that the same folks who proposed Proposition 75--which would have banned labor contributions without written permission of members--will return); two proposals on identity theft; five proposals to raise the minimum wage; and one good government plan to repeal state law allowing cities and counties to adopt breed-specific dog laws! New proposals also include pro-worker changes in Workers' Compensation laws

Finally: Ballot Box Foreplay

OK, OK, we know it's too cute a title to make sense, but we just can't help it! After 94 years of ballot initiatives in California, we are finally reduced to a process that is run by interest groups, and has very little to do with the anti-establishment rhetoric and motivation of Governor Hiram Johnson and his plucky band of Protestant reformers.

Right now, the political war machine that fuels ballot measures in California is busy building and destroying alliances, plotting strategy, figuring out how to make 'the other guys' spend a lot of money and in general thinking how to achieve their policy and political aims by using, or threatening to use, ballot measures. A couple of examples:

- Hospitals in California circulated petitions to raise the cigarette tax and use the new money to fund hospital emergency room services. Anti-tobacco organizations and the California

Medical Association (who joined forces with hospitals to start all of this by backing Proposition 99, the first voter-approved increase) say, "Hell no, we want to spend the money." The groups huff, puff and threaten each other. Rob Reiner, Chair of California's First Five Commission (the state body that gets a share of Proposition 10 funds from a tobacco tax for early childhood education) threatens to oppose the new hospital tax unless Prop 10 is fully protected. Wow, a fight between good guys!

That would be great theater, but it looks like a settlement is in the works. Many of the major health-specific organizations sign up with the hospitals.....Prop 10 commissions get a bigger share of the pot and withdraw the threat of opposition. As this is being written, only the docs and anti-tobacco health educators (who want more money) are unhappy. What happens next? Well, our guess is some minor internal adjustments, and no formal opposition from the health coalition backing the original Proposition 99. The hospitals go off to circulate a new petition, reflecting all the new compromises, signatures are gathered and the measure qualifies. Watch for some legislators, and maybe the Administration, to forcefully urge the hospitals to drop the idea so they can use the revenue for something else, maybe health insurance for kids.

- Unions submit ballot proposal to prohibit political contributions by corporations without written approval of each and every shareholder. Anti-union forces announce they intend to re-run the Proposition 75 campaign of November. What happens? Well, we guess that both sides are fighting for position. The business community is divided on the idea. One business faction announces that the idea is dead for the time being; another is pushing for it. Both want the labor types to drop the minimum wage increase. Will labor do that? Not likely, although they may want to push a bill to the Governor first, forcing him to veto the measure in an election year...and on and on and on.

You get the point. Many of these early ballot proposals are designed to seduce the other side into an agreement, either enshrined in legislation or jointly placed on the ballot by the former-enemies-turned-bedfellows. Easy passage is then almost assured.

You see why we call this "ballot box foreplay." Expect to see a lot more before the year is done.

The California Budget Report is produced by Phil Isenberg and Maureen O'Haren of ISENBERG/O'HAREN. Questions, comments and requests to be added to the mailing list should be directed to Phil at phil@isenberg-oharen.com or Maureen at maureen@isenberg-oharen.com