
CALIFORNIA BUDGET REPORT

Volume 4, Number 13

July 10, 2006

The Budget: The Legislative Analyst Explains It All To You

Despite all of our editions of the *California Budget Report*....and despite all of the media and press reports on this year's budget fight and the implications for Governor Schwarzenegger's re-election, it is clear that hardly anyone (perhaps only 0.003 percent of Californians) really knows what the budget did this year.

The Legislative Analyst, however, always manages to give us a broad picture and lay the groundwork for understanding what was done, what was not done, and what might be the implications for the future. The single best description of this year's budget is found in *Major Features of the 2006 California Budget*, just released by the LAO. We bring this report to your attention since it is the final word—at least until the LAO issues its California Fiscal Outlook in November.

For the time being, you can get the full 35-page report at the following sites:

http://www.lao.ca.gov/2006/major_features/major_features_2006.pdf

http://www.lao.ca.gov/2006/major_features/major_features_2006.html#I

We recommend that you try to understand the budget in roughly this order:

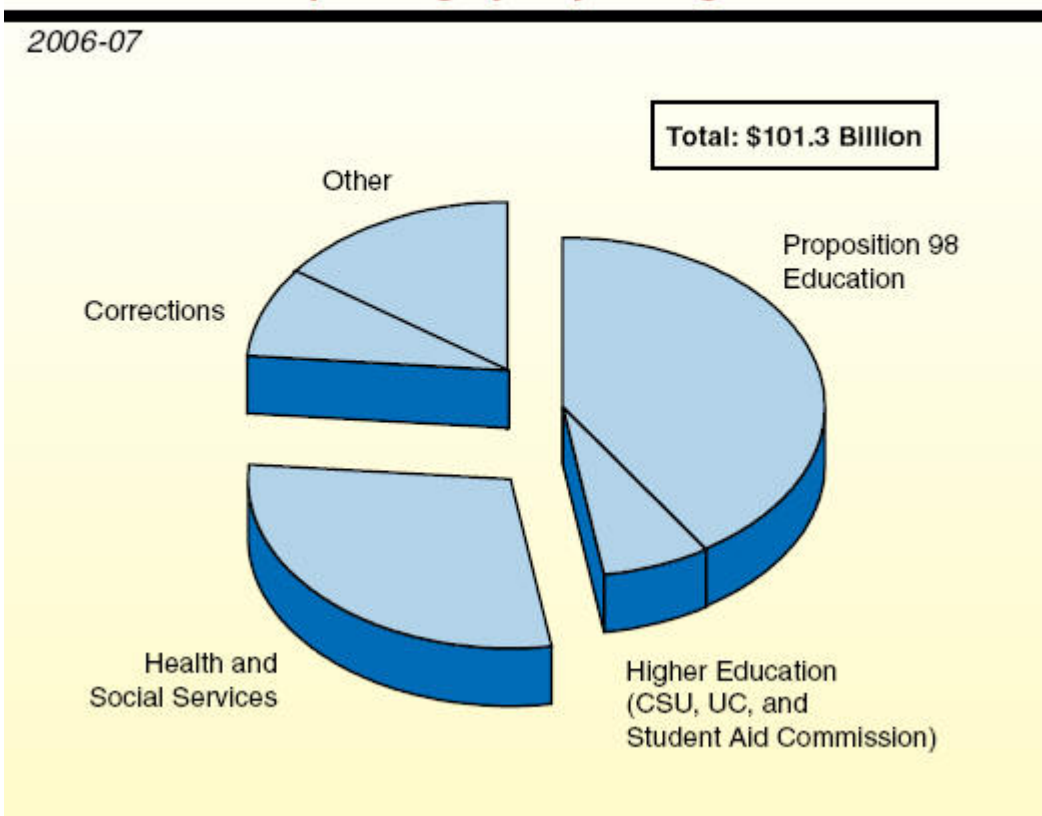
- How much money was spent?
- How much of an increase is that over the previous year?
- How much of the budget spending comes from prior year savings (essentially one-time money)?
- What is the budget shortfall for 2007-08; that is, the difference between revenue and spending?
- Finally, how did the Governor and Legislature agree to spend the money?

Here is what the LAO has to say about the budget:

“On June 27, 2006, the Legislature passed the 2006-07 Budget Bill along with implementing legislation (see Appendix 1 for a list of these “trailer bills”). The Governor signed the budget on June 30, after using his line item veto authority to reduce appropriations by \$112 million (\$62 million General Fund). The budget package authorizes total spending of \$127.9 billion, of which \$101.3 billion is from the General Fund and \$26.6 billion is from special funds. Figure 1 shows the distribution of General Fund spending by major program area.

Figure 1

General Fund Spending by Major Program Area



Basic Features

The 2006-07 budget reflects a sharply improving fiscal picture, brought about by continued stronger-than-expected growth in General Fund revenues. Spending under the plan increases by over 9 percent between 2005-06 and 2006-07, reflecting significant program augmentations, budgetary debt prepayments, and rising caseloads and costs in state programs.

Spending Highlights. The budget includes substantial increases in education spending. It allocates \$8 billion in new funds for K-14 Proposition 98 education, resulting in an over 11 percent increase in K-12 per pupil funding relative to the level provided in the 2005-06 Budget Act. It also provides large funding increases for the University of California (UC) and California State University (CSU), including funding in lieu of planned fee increases for 2006-07. The budget package also rolls back

community college fees from \$26 to \$20 per unit beginning in spring 2007. The budget provides \$40 million in Proposition 98 General Fund support to backfill the foregone fee revenue.

In the transportation area, it provides the full \$1.4 billion annual Proposition 42 transfer of sales taxes on gasoline to fund transportation programs, and it repays \$1.4 billion of past Proposition 42 related loans.

In the health and social services area, the budget package includes: (1) one-time funding for hospitals to increase patient capacity to meet health care emergencies such as an avian flu pandemic; (2) increased funding for county block grants for California Work Opportunity and Responsibility to Kids, child welfare services, and foster care, and (3) funding for pass through of the federal January 2007 Supplementary Security Income cost-of-living adjustment, which-under the terms of the 2005-06 budget package-had previously been delayed until April 2007.

The budget includes significant funding increases for corrections to cover higher inmate population and health-related costs.

Debt Prepayment. The budget devotes \$2.8 billion in General Fund revenues to the repayment of budgetary debt which had been incurred in previous years. About one-half of the total is for the prepayment of Proposition 42 loans from transportation (cited above), and the remainder is for local governments, schools, and special funds." (pp. 3-4)

--Source: LAO

A Caution

We remind our readers that "total spending" does not include vast amount of federal spending, pension funds and other money that flows through the State of California. If you add up all the money involved, what used to be called "Total State Spending," the overall figure is close to \$300 billion per year!

Which leads to the next question: Will we still have a budget shortfall in future years?

The LAO clearly answers "yes" to the question. The exact amount of the shortfall depends on several large questions:

- a) Will the economy continue to be strong and how strong?
- b) Will spending continue to increase and by how much?
- c) What unanticipated events might complicate the budget picture?

These are all important questions, and a certain amount of bickering between the Governor and Democratic challenger Phil Angelides will focus on budget "facts." We predict, with some confidence, that the issue of the state spending beyond its means will not be a major driver of this election year.

The only thing that might upset the feeling that everything is financially OK is if the restive and unpredictable California voter decides that the 13 measures on the November ballot—including bond measures sponsored by the Governor and Legislature, interest group initiatives, as well as bonds and tax increases for designated spending—are just too much. In that case, perhaps the campaign for Governor might focus on hard economic realities. We doubt that will occur, but you never know.

Here is what the LAO has to say about our ongoing budget shortfall:

General Fund Condition

"Figure 2 shows that 2005-06 began with a prior-year balance of \$9.5 billion (reflecting the combination of better-than-expected revenues and past budgetary borrowing). Revenues and expenditures are an identical \$92.7 billion in 2005-06, leaving the fund balance at the end of the year at the same \$9.5 billion. After accounting for \$521 million in encumbrances, the year-end reserve is \$9 billion.

Figure 2

The 2006-07 Budget General Fund Condition

(In Millions)

	2005-06	2006-07
Prior-year fund balance	\$9,511	\$9,530
Revenues and transfers	92,749	94,354
Total resources available	\$102,260	\$103,884
Expenditures	92,730	101,261
Ending fund balance	\$9,530	\$2,623
Encumbrances	521	521
Reserve	\$9,009	\$2,102
Budget Stabilization Account	—	\$472
Reserve for Economic Uncertainties	\$9,009	\$1,630

In 2006-07, the budget assumes that revenues will total \$94.4 billion (a 1.7 percent increase), and that expenditures will total \$101.3 billion (a 9.2 percent increase). The \$6.9 billion operating shortfall between revenues and expenditures leaves the General Fund with a reserve of \$2.1 billion at the conclusion of the budget year. This reserve estimate does not include the fiscal impacts of future collective bargaining contracts approved by the Legislature. (For example, the tentative agreement recently reached between the administration and Service Employees International Union would, if approved, result in 2006-07 costs of more than \$100 million.)

Out-Year Implications of the 2006-07 Budget. Based on our current projections of revenues and expenditures under the 2006-07 Budget Act policies, the state would continue to face operating shortfalls in the range of \$4.5 billion to \$5 billion in 2007-08 and 2008-09. The carryover reserve from 2006-07 would be available to offset a portion of the shortfall in 2007-08. We will be updating our fiscal projections in November 2006, when we release our California Fiscal Outlook." (pp. 4-5)

We close with some observations:

1. For every budget shortfall, there are always tricks, gimmicks and one-time money available to “solve” the problem for the year. Using one-time reserve funds for on-going program spending is the clearest example.
2. The LAO suggests that the economy will probably remain hot enough during 2006 and 2007, and that there should be a significant increase in the anticipated budget reserve to cover a good portion of the projected shortfall.
3. Whatever else happens, you can be sure that the Legislature and the Governor will continue to increase spending beyond what was estimated by this budget. We remind you that a Special Session has been called to deal with the so-called crisis in California’s prison system, which could have major cost implications. We suspect that increased spending for law enforcement (not prisons) is pending, plus some additional funds for homeland security and natural disaster prevention. Put all those together with the relatively rich employee contracts the Governor is signing, add in pending court actions likely to go against the state.....well, you see the point.

The shortfall is only going to get bigger.

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