
CALIFORNIA BUDGET REPORT

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Legislative Analyst looks at Governor's Budget: "...the overall plan moves the state in the wrong direction..."

You can be sure that the Corner Office is not very pleased with the just-released *Overview of the Governor's Budget: 2006-07*, by the Legislative Analyst (LAO). Here is the Analyst's fundamental conclusion:

OUR BOTTOM LINE

The budget's more positive revenue assumptions compared to our November report appear reasonable in light of recent positive cash revenue trends, and we believe that some of the actions proposed—namely the prepayment of budgetary debt—make sense in light of the improved outlook. However, we also believe that the overall plan moves the state in the wrong direction in terms of reaching its longer-term goal of getting its fiscal house in order. Instead of using the current unexpected revenue increases—which are primarily from

more volatile revenue sources such as business profits and capital gains—to reduce outstanding obligations, the budget ratchets up ongoing spending by about \$2 billion. Given the state's current structural budget shortfall, as well as the substantial outstanding obligations that eventually have to be repaid related to past borrowings from schools, local governments, and transportation, we believe that the 2006-07 budget should focus more on paying down existing debt before making expansive new commitments.

You can read the full 22-page report at http://www.lao.ca.gov/2006/budget_ov/2006-07_budget_ov.pdf. The LAO thinks the Governor is spending more money than the state can afford, not paying off back debt as fast as we should, and adding new programs (like his Proposition 49, the after-school program) at a time where the state can barely keep up with current programs.

Fundamentally, the LAO faults the Governor for taking a temporary increase in revenue (from highly volatile sources), and applying much of that to new spending. Is it politically popular? Sure, but it is another example of the too-common trick used by Governors of both parties over recent years: punting the problems into the future. We are technically not borrowing money this year to keep the lights on, but we know that next year, and for years to come, the state budget will be dramatically short of funds.

Some examples of what bothers the LAO (and others)

1. **Higher spending/lower reserves.** Take a look at the excellent LAO chart summarizing the Governor's decisions and the impact on the state reserve:

Figure 1
Changes to 2006-07 Reserve Estimate
(Dollars in Billions)

2006-07 Reserve, LAO November Estimate	\$1.2
Differences in the 2006-07 Governor's Budget:	
Higher Costs:	
Proposition 98	\$2.2
Higher education	0.2
Prepayment of portion of Proposition 42 loan	0.9
Additional deficit-financing bond payments	0.5
Pension bonds not issued	0.5
Other (net)	0.3
Total Higher Costs/Reduced Resources	\$4.6
New Resources/Savings:	
Higher revenue estimate	\$2.6
Revenue-related proposals	0.3
Social services	0.9
Statewide/other (net)	0.2
Total, New Resources/Savings	\$4.0
2006-07 Reserve, Governor's Budget Forecast	\$0.6

We all know that “budget reserves” are common sense fiscal practices, much praised in the abstract, and ignored by almost everyone. Didn't we just go through three really bad years, caused by a downturn in the economy, and political decisions to increase spending based on temporary increases in revenue? What happened to the idea that you build a rainy day reserve to cushion the impact of the next economic downturn? The LAO's caution is very good on this point.

2. **Higher operating deficits for years to come.** Sacramento Bee columnist and budget wonk Dan Weintraub posted a fascinating web note on January 10, <http://www.sacbee.com/static/weblogs/insider/>. It clearly shows the fiscal impact of the Governor's budget recommendations, which will haunt us for years to come. We quote it in full:

“As far as the eye can see...

Finance Director Michael Genest got back to me and said he misspoke when he said the operating deficit would be \$5.5 billion in 2007-08. He now says it would be bigger. And he's provided the chart that shows the projection for the annual operating deficits for several years going forward.

The numbers:

2005-06 \$2.6 billion
2006-07 \$6.4 billion
2007-08 \$6.6 billion
2008-09 \$9.7 billion
2009-10 \$8.6 billion

And this in good economic times. Wow”

We also recommend you read Weintraub’s column in the Bee today, <http://www.sacbee.com/content/opinion/story/14064589p-14895480c.html>. Weintraub has been generally supportive of the Governor’s efforts to balance the budget. Not in this column. He joins a growing band of critics who find the proposals to be politically calculated, not designed to solve the state’s fiscal problems.

3. **Some high risk assumptions may turn out to be wrong.** All budgets contain assumptions about revenue and spending. The Governor’s proposal is not different. However, the LAO identifies about \$1 billion worth of risky assumptions which may come back to haunt us, including:
 - a. Assuming that the state will win the *Guillen* litigation. If not, the state is out another \$460 million.
 - b. The budget includes no funds for state employee contract negotiations. OK, that may be smart tactics (why lay on the table a dollar amount you know will be the bottom line for union?), but it begs the question. About 18 contracts with state employees expire this year. How is the Governor going to pay for it and which spending gets cuts to pay for the contracts?
 - c. The budget assumes no additional state costs to reimburse local governments for state mandates. The LAO estimates about \$140 million of additional spending will be required.

4. **The Governor’s bond package has problems too.** Generally, the LAO likes the idea of using bonds for needed capital improvements. We discussed this in some detail in earlier editions of the California Budget Report. However, the Analyst continues to raise very important questions about the proposed spending, the financing and the impact on the state General Fund. We strongly recommend you read this section in detail, pp. 10-13.

About the only good news for the Governor in the LAO report is their agreement that state revenue growth continues. They note, however, that the growth is slowing and promise to take a close look at revenue assumption when they release their detailed budget review in February.

We are not going into the details of the Governor’s proposed spending at this point. We know that big fights are pending over the proposed “user fees” to pay for part of the Governor’s bond program. Other fights will be focused on his recommendation to not give the federal cost-of-living-adjustment to the aged, blind and disabled (SSI/SSP), and further cuts in health and social services.

However, if the Legislature spends all of its time on the detailed fights, then you can be sure the Governor's overall approach will carry the day --- but with a bit more increased spending, increased bonding and much higher ongoing operational costs. Cynics in this business, and usually we count ourselves among that group, will not be surprised to learn that higher spending, few cuts, and lots of rosy assumptions occur more often in election years.

More later.

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