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Governor's May Revision Solves Problems, Spends Lots of Money

*Democrats may push him to spend more...Bond Package goes on
November ballot...plus some other things....*

Governor Arnold Schwarzenegger issued his May Revision to the 2006-2007 Budget today. In 117 tidy pages, you can read the details of government, politics and compromise. Here is the full May Revision (charts are separate)

<http://www.ebudget.ca.gov/pdf/Revised/BudgetSummary/FullBudgetSummary.pdf>.

Let's start off by comparing revenues and expenditures. Here is what the May Revision shows:

Total Estimated Revenue (General Fund, Special Funds)	\$121.6 billion
Total Estimated Spending (General Fund, Special Funds, Bonds)	\$131.1 billion
Difference between spending and revenue	\$ 10.5 billion (or \$6.0 Billion if you ignore bond spending)

“Wait a minute,” you say. “How can we be spending more than we have? I thought those times were long past?” Sorry, but the rules are still pretty simple: unless your growth in revenue equals your growth in spending there is a “budget gap.” Politicians like to “solve” the budget problem without cutting spending or raising taxes. The end result is that they either borrow money (as we did in 2003 and prior years), or they use one-time funds to pay for on-going expenditures. We see the latter in this Revision, although to be fair, somewhat less of it than in prior years.

One way to look at the May Revision is through the changes made to General Fund revenue. Here is a good summary chart from page 16 of the Revision:

2006-07 Revenue Sources
(Dollars in Millions)

	General Fund	Special Funds	Total	Change From 2005-06
Personal Income Tax	\$48,716	\$690	\$49,406	\$3,230
Sales Tax	28,295	4,719	33,014	1,366
Corporation Tax	10,024	-	10,024	403
Highway Users Taxes	-	3,483	3,483	85
Motor Vehicle Fees	22	5,243	5,265	174
Insurance Tax	2,340	-	2,340	94
Liquor Tax	316	-	316	1
Tobacco Taxes	118	978	1,096	31
Other	1,714	9,505	11,219	-1,392
Total	\$91,545	\$24,618	\$116,163	\$3,992

Note: Numbers may not add due to rounding.

And to see just where the General Fund money is spent, look at this chart on page 17:

General Fund Expenditures by Agency
(Dollars in Millions)

	2005-06	2006-07	Change	%
Legislative, Judicial, Executive	\$3,147	\$3,382	\$235	7.5%
State and Consumer Services	578	540	-38	-6.6%
Business, Transportation & Housing	1,714	2,719	1,005	58.6%
Resources	1,388	1,530	142	10.2%
Environmental Protection	78	71	-7	-9.0%
Health and Human Services	27,280	28,473	1,213	4.4%
Corrections and Rehabilitation	7,658	8,081	423	5.5%
K-12 Education	36,058	39,881	3,823	10.6%
Higher Education	10,158	11,223	1,065	10.5%
Labor and Workforce Development	89	92	3	3.4%
General Government	2,166	1,910	-256	-11.8%
Total	\$90,294	\$97,902	\$7,608	8.4%

Note: Numbers may not add due to rounding.

2006-07 Total Expenditures by Agency
(Dollars in Millions)

	General Fund	Special Fund	Bond Funds	Totals
Legislative, Judicial, Executive	\$3,382	\$1,920	\$212	\$5,514
State and Consumer Services	540	783	12	1,315
Business, Transportation & Housing	2,719	6,851	48	9,418
Resources	1,530	1,596	396	3,522
Environmental Protection	71	981	69	1,121
Health and Human Services	28,473	6,741	111	35,325
Corrections and Rehabilitation	8,081	3	0	8,084
K-12 Education	39,881	83	79	40,023
Higher Education	11,223	1,284	1,720	14,207
Labor and Workforce Development	92	299	0	391
General Government	1,910	4,742	31	6,683
Total	\$97,902	\$25,023	\$2,678	\$125,603

Note: Numbers may not add due to rounding.

Here are some major points about the May Revision:

- A General Fund “windfall” of approximately \$5 billion dollars fuels the May Revision. This is money above and beyond what was estimated in the January Proposed Budget.
- Even with this rapid economic growth, there continues to be a “structural deficit,” the difference between anticipated revenue and projected expenditures of slightly over \$6 billion! The May Revision “solves” this structural deficit by using the windfall funds and money carried over from the prior budget year. In other words, once again California balances its ongoing expenditures by using one-time savings or one-time revenue. The Governor takes some pride in announcing that the operating deficit is now only \$4.7 billion (May Revision, page 2).
- Most of this new revenue is probably one-time money. We expect the Legislative Analyst to agree with the estimated amount of new dollars, but caution that much of it is fueled by capital gains and stock options. Earlier this week LAO fiscal wizard Brad Williams (*Sacramento Bee*, May 9, 2006) was guessing that a large part of the windfall might be from stock sales. That led the economic gossips to note that Google founders and original stock holders sold \$4 billion worth of their shares last year! The Gloom and Doom Crowd (count the authors of this CBR among that lot) remind everyone that this is starting to sound a lot like 1999-2000, when the state spent billions of “new” money on ongoing programs, only to learn that it was temporary, one-time money.
- The Governor’s themes are as follows: a) pay down the debt and be fiscally prudent; b) increase spending for education, law enforcement and a bit for healthcare; and c) prepare for potential disasters (the flood control bonds and emergency money), and fund hospital/county equipment needs. We particularly like the paring up of fiscal prudence and more spending. It satisfies the public’s belief that you can have your cake and eat it too! This is very smart politics, although as government it leaves a lot of questions unanswered.
- The major new spending proposed by the Governor is allocated as predicted:
 - ✓ \$4 billion additional to K-12 and community colleges. Of course, \$1.7 billion of this amount repays the Prop 98 money that was suspended in last year’s budget, but forget the details. The education fraternity is happy with this.
 - ✓ \$22.8 million for increased health insurance for kids.
 - ✓ \$43 million to restore the COLA for the aged, blind and disabled. For those of you who think this means the legislative Democrats will have nothing to talk about . . . well, forget that.
 - ✓ \$400 million for hospitals and counties to fund the proposed disaster response system in the state.

- ✓ \$150 million for law enforcement, which the Governor claims will double the money spent to stop methamphetamine labs, add \$50 million to focus on repeat offenders who are mentally ill and money for at-risk kids.
- The Governor also includes his bond package set for the November election as part of his plan to help the state. Technically, it is not part of the May Revision, but it's surely part of the political atmosphere of 2006.
- The Governor is simultaneously trying to keep conservatives happy by increasing the state's reserve and paying off some of the massive state debt. He proposes to use \$1 billion to pay off a portion of the 2003 "deficit" bonds, plus another \$600 million for other borrowing through 2007 and then devotes \$1.3 billion more to the state reserve. This is in addition to his January prepayments of about \$1.6 billion.
- The Governor's education deal settles the lawsuit filed by education interests and Schools Superintendent Jack O'Connell to "make the Governor keep his promises." By giving K-12 and community colleges an additional \$2 billion this year, and another \$3 billion over the next seven years, this messy political dispute may go away. By the way, if education dollars don't add up, this proposal also uses a refigured tobacco tax and estimates of increase gasoline taxes to help pay for schools.
- The Governor proposes to use funds raised by voter-approved Proposition 62 of 2004, which imposed a surcharge on upper-bracket income tax payers and devoted funds to the mentally ill. The Governor wants to put \$75 million a year, for 20 years, into building housing for the mentally ill.
- Once again, the Governor refuses to use the \$3.7 billion of authorized, but not sold, deficit recovery bonds that were approved by the voters in 2003. This refusal can fairly be called a fiscally prudent move.

The Bond Package: A Fast Summary

As all you political groupies know, the Senate and Assembly passed a package of bonds slated for the November General Election ballot. The package contains \$37.3 billion worth of bonds for education, transportation, flood control and housing and will be presented to the voters in November. Not quite the \$50 billion or more originally requested by Governor Schwarzenegger, but close enough.

The politics are clear: The Governor supports the bonds. Virtually all of the Legislature supports the bonds. And Democratic Gubernatorial candidates Phil Angelides and Steve Westly have also agreed (grudgingly) to support the bond package.

We will not go into the details at this time, but if you want to get the full skinny, you need to look at each and every one of the bills in the package. Here is the list.

There were 10 bills in the “package”¹... but only 9 passed.

AB 127 (Nunez/Perata)	\$10.4 billion bond for K-12 and higher education.
AB 140 (Nunez/Perata)	\$4.6 billion for flood control and disaster preparedness.
AB 142 (Nunez/Perata)	Allows ‘design-build’ method to be used in some highway/road projects.
AB 143 (Nunez/Perata)	\$500 million direct appropriation for ‘emergency’ levee repairs which FAILED PASSAGE IN ASSEMBLY.
AB 1039 (Nunez/Perata)	Limited CEQA exemption for flood control, highway and bridge projects.
AB 1467 (Nunez/Perata)	Authorizes state to enter into agreements with private parties for two private toll roads.
AB 1540 (Nunez/Perata)	Ballot label for SCA 7 (see below).
SB 1266 (Perata and Nunez)	\$19.9 billion for transportation projects.
SB 1689 (Perata/Nunez)	\$2.85 billion for housing programs.
SCA 7 (Torlakson)	Proposition 42 protection (limits state’s ability to redirect state gasoline sales tax to non-transportation purposes).

A word about politics...

An endless array of pundits have concluded that the Governor is sure to be re-elected, and point to the successful recent bond deal and this proposed May Revision as the proof. To be sure, the Governor is having a good month and is well along on his plan to move to the middle for this election year. We do not believe, however, that regular citizens think a miracle has occurred just because Sacramento politicians have passed a bond package and are spending some more money. Our experience is that citizens expect their elected officials to do a good job, and don’t give them

¹ “Bills in the package” is a legislative term of art. It means that bond bills plus ‘related measures’ that were adopted to get the needed votes on bonds. Most of these related measures are majority vote bills, allowing members to vote no, confident there are enough votes around to pass the bills. This is also called a “stand for principle.”

Occasionally, there is an after-the-fact dispute among legislators and the Governor over what bills are, or are not, ‘part of the package.’ We don’t think this package will have any lingering questions, but it usually takes several days to ferret out disputes and last-minute amendments that got dropped into bills at the last minute. Ah, the legislative process... sausage...

much credit for doing so. Citizens do blame politicians for inaction, but are much more stingy with praise.

The Arnold of 2003 – the populist hero with a bipartisan base of support – converted himself into a regular Republican politician by his involvement in the George Bush re-election and by that uncharacteristic speech to the Republican National Convention. To cap that off, the Governor decided to pick a fight with teachers, nurses, firefighters and the middle class by presenting a bewildering number of ballot measures for the 2005 Special Election. He got his political head handed to him in a basket and suffered a large drop in poll numbers. All in all, the pundits say, the Governor put himself in a deep political hole.

He is starting to dig out of that hole, but has a long way to go. We watch the national polls on President Bush, who has a favorable rating of about 31 percent, and wonder if the national trend will affect the Governor.

Fighting and arguing between Democratic candidates Angelides and Westly probably benefit the Governor, but any lingering animosity is not likely to survive through November. We suspect a close re-election race, with some voter views affected by the national mood.

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