C A L I F O R N I A   B U D G E T   P R O J E C T

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SCHWARZENEGGER BUDGET PROPOSAL WOULD CAP SPENDING, GIVE GOVERNORS UNPRECEDENTED POWER TO CUT SPENDING

Governor Schwarzenegger has proposed far-reaching changes to the state's budget process. The Governor's proposal would amend the state Constitution to establish a new budget reserve, establish a mechanism for appropriating funds into the reserve, and give governors broad power to cut spending if projected expenditures exceed projected revenues. An analysis of past revenue and expenditure data shows that, if the proposal had been in effect prior to the recent budget crisis, it would have significantly limited the state's ability to spend available resources in years of above average revenue growth and would have left the state facing substantial shortfalls in the early years of this decade. The proposed changes would require voter approval and could be placed on the ballot with the approval of a two-thirds vote of both houses of the Legislature or through the initiative process.

The New Revenue Stabilization Fund Would Limit Spending in High Revenue Growth Years

The Governor's proposal would establish a new Revenue Stabilization Fund (RSF) and require General Fund tax revenues that exceed a certain limit to be deposited in the new reserve.[1] The RSF would be in addition to the two existing reserves, the State Fund for Economic Uncertainties and the Budget Stabilization Account (BSA) established by Proposition 58 of 2004.[2] Specifically, the proposal would:

- Require, beginning in 2009-10, the Department of Finance to calculate the average annual percentage growth in General Fund tax revenues for the preceding 10 years. This percentage would be used to calculate a "revenue limit" for 2009-10 by multiplying the 2008-09 General Fund tax revenue collections by the growth factor. In subsequent years, the revenue limit would be the prior year's limit multiplied by the growth factor. The revenue limit would be adjusted to reflect any legislated changes in tax revenues.
- Require any General Fund revenues in excess of the new limit to be transferred to the RSF. Funds transferred into the RSF would not count toward either the Proposition 98 school funding guarantee or the State Appropriations Limit in the year transferred, but would count toward both in the year that the funds are transferred back to the General Fund for appropriation.

[1] This analysis is based on draft constitutional amendment language contained in RN 08 01492 and related documents.

[2] Proposition 58 requires a transfer equal to 2 percent of General Fund revenues in 2007-08 and 3 percent of General Fund revenues in 2008-09 and thereafter until the balance in the BSA reaches 5 percent of General Fund revenues for that fiscal year or $8 billion, whichever is greater. The governor can suspend the transfer to the BSA through an executive order.

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- Allow funds in the RSF to be transferred back to the General Fund in any year when General Fund revenues are projected to be below the state's revenue limit.[3] Use of funds in the RSF would require a two-thirds vote of the Legislature and the signature of the governor. The governor would have line item veto authority to reduce the amount that would be transferred into the General Fund. The bill authorizing the transfer could not contain any other unrelated subject matter. In contrast, funds can be transferred out of the current BSA in a bill containing other subject matter, such as the annual budget act.[4]
- Require, in years when the balance in the RSF reaches 15 percent or more of the revenue limit, the excess to be divided among K-14 education, tax cuts, General Obligation (GO) bond debt service, and construction or maintenance of state public works projects.[5]

By requiring the transfer of revenues that exceed the long-term growth rate into the RSF, the Governor's proposal would limit state spending in years with high revenue growth.

Governors Would Gain Sweeping Power To Make Mid-Year Spending Reductions

This proposal would give governors broad powers to cut spending if the Director of Finance estimates that General Fund spending will exceed General Fund revenues in any fiscal year. Specifically, the proposal would require the Director of Finance, who is appointed by the governor, to report to the Legislature on revenues and expenditures three times during the year.[6] If the director estimates that General Fund spending for the year will exceed estimated revenues, spending would be reduced by:

- 2 percent on an annualized basis in years when estimated General Fund spending exceeds revenues by less than 1 percent; and
- 5 percent on an annualized basis in years when General Fund spending exceeds revenues by 1 percent or more.

Each appropriation or line item in the budget would be reduced by the same percentage, except for specifically excluded programs and expenditures as noted below.[7] The proposal would limit the maximum reduction to any program to 5 percent of the annual appropriation. The measure allows the Legislature to provide statutory guidance for implementing the required reductions, but in the absence of such guidance, allows governors to make the required reductions.

The proposal would allow the governor to "suspend the operation of any statute or regulation to the extent that it would prohibit or restrict any reduction of appropriations of General Fund revenues. … Pursuant to any such suspension, the Governor may impose changes in funding formulas and in benefit eligibility or amounts as necessary to implement reductions of appropriations." The suspension of state laws or regulations, including changes to funding formulas, eligibility for state-supported benefits, or changes to the amount of benefits provided, would remain in effect until and unless legislation was subsequently enacted to overturn the Governor's action. This would

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[3] The sum of General Fund tax revenues for the year and any amounts transferred from the RSF could not exceed the revenue limit for that year.

[4] The Legislature can transfer funds out of the BSA for any purpose. In 2007-08, the Legislature authorized the use of the entire balance in the BSA through that year's budget act.

[5] The portion allocated to education must be used for purposes subject to the Proposition 98 school funding guarantee; however, amounts spent would not count toward fulfilling the Proposition 98 guarantee. The share of the excess allocated to education would be calculated using the "test 1" percentage of the Proposition 98 guarantee. For background on Proposition 98, see California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006). The test 1 percentage is approximately 40 percent.

[6] The proposed measure requires reports to be submitted to the Legislature on November 1, January 10, and June 1.

[7] Items of appropriation can be broad, such as in the proposed $14.9 billion General Fund local assistance appropriation in the Department of Health Care Services that pays for health care services through the Medi-Cal program, or relatively small, such as the proposed $1.0 million appropriation for state costs related to the operations of primary and rural health programs.

mean, for example, that a governor could unilaterally reduce eligibility for health coverage in the Medi-Cal program, the benefits provided by the Medi-Cal program, or payments to providers of services in the program. The change would be permanent, unless legislation is enacted reversing the governor's action.

The Governor's proposal would not apply to payments:

- Required by federal law;
- Associated with bonded indebtedness;
- Required by contracts signed prior to the effective date of the proposed measure, including collective bargaining agreements;[8] or
- That would result in a loss of state revenues or increase in state costs.

The proposal specifically allows reductions to constitutionally mandated spending, such as "basic aid" allocations to school districts, reimbursements for state-mandated programs, and reimbursements for local property tax revenue losses related to the homeowners property tax exemption.

The governor could reduce spending for K-14 education, but could not unilaterally suspend the Proposition 98 guarantee. If the governor were to reduce spending below the Proposition 98 minimum, the state would incur a "settle up" obligation, meaning that it would be required to appropriate funds to bring spending up to the minimum for that fiscal year. Alternatively, the Legislature could suspend the guarantee, which would create a "maintenance factor" obligation in future budget years.[9]

A Spending Cap by Any Other Name

In order to assess how the proposed revenue limit would affect state spending, the CBP considered two scenarios.[10] The first assumed that the revenue cap was in effect beginning in 1990-91. The second assumed the cap first applied in 1998-99. If the cap first applied beginning in 1990-91, the CBP estimates that:

- It would have prevented the state from spending available revenues in two years (1999-00 and 2000-01). A total of approximately $4 billion would have been transferred from the General Fund to the RSF.
- The RSF would have been exhausted at the end of 2001-02 and would not have prevented cuts in subsequent years. In the absence of significant borrowing, such as the deficit-financing bonds approved by the voters in 2004, the state likely would have needed to make much deeper cuts in 2002-03 and 2003-04.
- The RSF would not have reached its maximum level in any year during the period.

[8] Payments required by contracts signed after the effective date of the proposed measure would be allowed.

[9] Legislative Analyst's Office, *The 2008-09 Budget: Perspectives and Issues* (February 2008), p. 151.

[10] This analysis is based on draft constitutional amendment language outlining the Governor's proposal. For purposes of this analysis, the CBP assumed that funds would accumulate in the RSF up to a balance equal to 15 percent of the General Fund revenue limit for a particular fiscal year and that amounts in excess of 15 percent would be allocated as outlined in the draft language. For simplicity, this analysis did not adjust the revenue limit for tax increases or decreases, which understates the impact of the proposal on the state's ability to spend available resources. Adjusting the cap for tax cuts that have occurred since 1993 would have forced the state to cut spending by billions of dollars during four years if the cap had first applied in 1998-99. This would have occurred because the adjustment for legislated policy changes would have substantially lowered the annual spending cap. On the other hand, adjusting the cap for the tax increases that occurred in the early 1990s would not have increased the level of state spending. While adjusting the cap to reflect the 1991 tax increase would have allowed the state to spend more, the state lacked additional revenues to spend.

If the cap had first applied in 1998-99, the CBP estimates that:

- It would have substantially reduced state spending over the last decade. A total of more than $25 billion would have been transferred from the General Fund to the RSF during four years (1998-99, 1999-00, 2000-01, and 2005-06), forcing the Legislature to make deep reductions in state spending.
- The reserve would have exceeded the 15 percent limit in 1999-00 and 2000-01. More than $13 billion dollars in excess of the maximum allowable balance would have been transferred out of the reserve to K-14 education and tax cuts, GO bond debt service, or other infrastructure spending.
- While the RSF would have helped cushion the impact of the sharp downturn in revenues that began in 2001-02, it would have been depleted by 2003-04, forcing the state to cut spending, raise taxes, or take other steps to balance the budget.
- The proposal would have required the state to transfer revenues to the RSF in 2005-06, despite the fact that the state still faced a sizable budget shortfall. This would have occurred because the relatively strong revenue growth in 2005-06 would have exceeded the state's revenue limit due to the mixed performance of revenues in the preceding years.
- No funds would be available in the RSF in 2008-09 to offset the impact of this year's budget shortfall under this scenario.

This analysis shows that the point at which the cap first takes effect is critical because it essentially "locks in" the revenue level from the prior year. The cap would be adjusted annually based on the average of the prior 10 years' revenue growth. However, a cap that began in a year when the state's revenues are relatively low or that first took effect after several years of relatively weak revenue growth – a "bad" budget year – would prevent the state from restoring past cuts when revenue growth recovers.

In contrast, if the cap began immediately following a year of relatively high revenues, the cap would be less likely to limit state spending and less likely to build a significant balance in the RSF. This would occur because the state would have a greater ability to spend available revenues since the growth factor would be larger. As a result, the proposed measure would be less likely to help the state weather low revenue years.

What Would the Governor's Proposal Mean for Future Budgets?

The Governor's proposal would result in deep budget cuts in 2010-11 and 2011-12, according to projections prepared by the Department of Finance. The Department's multi-year budget forecasts, which assume enactment of *all* of the reductions proposed in the Governor's January Budget and May Revision, project that in 2010-11 the Governor's proposal would require $5.8 billion in spending reductions, while in 2011-12, the measure would result in $6.1 billion in reductions.[11] The 2010-11 cuts would be required under the provision that requires mid-year spending reductions in the event estimated expenditures exceed estimated revenues. The 2011-12 cuts represent the impact of carrying forward the 2010-11 reductions. The combined impact of the proposed changes to the budget process and spending reductions contained in the Governor's January Budget and 2008-09 May Revision would reduce 2010-11 spending by $14.3 billion below the current workload level and to reduce 2011-12 spending by $12.7 billion relative to the current workload budget.[12]

[11] Department of Finance, *General Fund Multi-Year Projection at 2008-09 May Revision (Total With Budget Reform)* (May 14, 2008).

[12] The workload estimate represents the current level of programs and services adjusted for caseload/population growth and inflation.

Policy Issues Raised by the Governor's Proposal

The Governor's proposal would significantly change the dynamics of California's budget process. The new reserve requirement would limit the state's ability to spend available revenues, and the mid-year spending reduction authority would substantially shift power over state spending to the governor, a power that is traditionally vested in the Legislature. Moreover, the shift could be triggered by a very modest imbalance between revenues and expenditures. The Governor's proposal raises a number of important policy issues. Specifically, the proposal would:

- **Lock in the state's structural imbalance between revenues and expenditures**. California suffers from a long-term imbalance between the revenues raised by the state's tax system and the revenues needed to fund current programs and services. By basing the new limit on a level of revenues that is insufficient to pay for the current level of programs and services, the Governor's proposal would permanently lock this disparity into place, absent deep spending cuts.[13] The state's ability to spend available resources would be further constrained by the measure's requirement that funds transferred to the BSA be paid for out of revenues subject to the new limit.[14] The Legislative Analyst notes that, "Under our revenue estimates, the administration's revenue cap leads to counterproductive results – the required deposit of General Fund monies *into* a new reserve at the same time that the state faces multibillion dollar shortfalls."[15]

- **Allow governors to unilaterally and permanently overturn state law in response to an imbalance between revenues and expenditures of as little as 1 percent.** Revenues often lag projections, especially early in the fiscal year.[16] This proposal would allow governors to make large spending reductions based on very small disparities between preliminary estimates of revenues and expenditures.

- **Not allow the Legislature to exempt some programs or services from mid-year reductions.** The proposed measure allows the Legislature to provide statutory direction for implementing mid-year cuts, should they be required, but does not allow the Legislature to protect high-priority programs from the across-the-board reductions, even on a "cost neutral" basis.[17] By doing so, the measure prevents the Legislature from establishing priorities and treats all state programs and services as if they were of equal value.

- **Potentially result in spending reductions that are larger than the amount needed to balance the budget.** Governors would be required to cut spending by an amount equal to 2 percent or 5 percent on an annualized basis in years when estimated expenditures exceed estimated revenues. The governor would be required to cut spending by 5 percent if spending exceeded revenues by more than 1 percent; thus, for example, the governor would be required to make a reduction equal to 5 percent on an annualized basis even if the gap between revenues and expenditures were as little as 1.1 percent.[18] This could lead to a more substantial impact on public services than would be needed to bring the budget into balance.

- **Be based on estimated revenues, not actual collections.** Calculations used for the proposed revenue limit and authorization for governors to make unilateral spending cuts would both be based on estimated, rather than

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[13] Legislative Analyst's Office, *The 2008-09 Budget: Perspectives and Issues* (February 2008), p. 152.

[14] This requirement reduces the amount the state would have available to spend for other purposes, even though deposits in the BSA are reserves, available for use during a budget shortfall, rather than an ongoing obligation.

[15] Legislative Analyst's Office, *Overview of the 2008-09 May Revision* (May 19, 2008), p. 3.

[16] The state receives a large share of its revenues during the second half of the fiscal year.

[17] For example, the Legislature couldn't cut non-critical services by a greater amount in order to exempt critical services from a reduction.

[18] Thus, for example, the proposed measure would require a 2.5 percent reduction implemented on January 1, midway through the fiscal year, in a year when governors are required to make a cut equal to 5 percent on an annualized basis.

actual, revenue collections. There is no provision for recalculating the annual revenue limit if final collections are higher or lower than the estimated figure, and there is no provision for restoring midyear spending cuts if, in fact, revenues equal or surpass expenditures during the remainder of the fiscal year. Actual revenue collections often vary significantly from estimated amounts. Estimates made during the first few months of the fiscal year often differ significantly from final collections. In particular, personal income tax estimates made prior to receipt of fourth-quarter estimated payments are often a poor indicator of final collections. Preliminary estimates are more subjective and easily manipulated than estimates made later in the year and could be used to give the governor extraordinary power to overturn existing law.

- **Create an incentive for the state to borrow and/or raise fees in years when revenues hit the cap.** The proposed revenue limit applies to revenues raised by taxes, but not fees or the proceeds of borrowing. In years when revenues exceed the proposed revenue limit, the state could raise fees or borrow from internal or external sources to support additional spending. Ironically, since revenues are most likely to exceed the cap in "good" budget years, this could create an incentive to raise fees or borrow in years when such increases might not otherwise be needed in order to maintain baseline funding.

- **Limit the state's ability to respond to natural disasters or other unforeseen events**. Funds in the RSF could only be used in years when estimated revenues are less than the state's revenue limit. They could not be used to respond to a major disaster – such as the Loma Prieta or Northridge earthquakes or other unforeseen events, such as an adverse legal decision – in a year with strong revenue growth. This lack of flexibility could require the state to increase taxes or make deep reductions in spending in order respond to a major disaster, even if it had a reserve sufficient to cover the cost of disaster-related expenditures.

Conclusion

The Governor's proposal would substantially shift the power of critical budget decisions from the Legislature to the governor, lock California into a structural gap between available revenues and the amount needed to support programs and services, and limit the state's ability to respond to future needs and/or natural disasters. While the proposed measure would establish a mechanism for funding a reserve to cushion against the impact of future budget shortfalls, nothing prevents the Legislature from establishing a larger reserve or preventing a governor from using his or her line-item veto authority to increase the size of the state's reserve. Moreover, by requiring the state to make across-the-board reductions in years when projected revenues lag projected expenditures, the proposal fails to recognize the fact that not all programs and services are equally important. Critical services that protect the vulnerable and public safety would be reduced by the same proportion as less essential services.