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WHAT DOES THE GOVERNOR'S SPENDING CAP PROPOSAL DO?: A PRELIMINARY ANALYSIS

Governor Schwarzenegger has asked the Legislature to place a constitutional amendment on the March ballot modifying the state's spending limit and expanding a governor's powers to revise state laws during future budget crises. This measure would be tied to the Governor's proposed $15 billion "deficit retirement" general obligation bond. If approved by the voters, the Governor's proposed spending cap, as contained in ACAX5 4 (Keene), would amend the state's Constitution to:

- Specify that 2004-05 General Fund spending could not exceed 2004-05 General Fund revenues as projected by the Department of Finance in the May Revision revenue forecast.
- In 2005-06 and beyond, limit General Fund spending to 2004-05 levels adjusted for population growth and inflation using the same formula used by the state's existing spending cap.
- Establish a mechanism for adjusting the spending limit to reflect transfers of responsibility between the state and local government and from the General Fund to special funds.
- Transfer any General Fund revenues that exceed the cap to a new "Budget Stabilization Fund" that could only be used for tax rebates; repayment of the deficit retirement bonds; expenditures related to an emergency declared by the Governor; or, in years when projected General Fund revenues are below the new spending cap, to make up the difference between forecast revenues and the new cap upon approval by a two-thirds vote of the Legislature.

In addition to these changes, the proposal would give the Governor sweeping powers to revise state laws in order to address the current or a future budget crisis. This paper examines what the Governor's proposed changes might mean for future years' budgets.

What Would the Governor's Proposal Mean for Future Years' Spending?

If approved by the voters, the Governor's proposal would:

- **Lock in spending at a historically low level.** 2004-05 General Fund spending could not exceed 2004-05 General Fund revenues and future years' spending would be limited to 2004-05 levels, adjusted for inflation and population growth. The Legislative Analyst projects that 2004-05 General Fund revenues will be approximately $15 billion below expenditures required by current law. The Governor's proposal does nothing to address the fundamental mismatch between revenues and expenditures and would make it difficult, if not impossible, for future Legislatures to restore spending cuts made in this year's or the 2004-05 budget.

- **Reduce spending below anticipated revenues beginning in 2006-07.** Calculations based on the Legislative Analyst's Office (LAO) November forecast show that the Governor's proposal would reduce allowable spending below projected revenues beginning in 2006-07.[1]

- **Require significant reductions in programs outside the Proposition 98 guarantee.** Health, higher education, public safety, transportation, social services, and other programs outside the Proposition 98 guarantee would bear the brunt of spending reductions required by the proposed cap. A significant portion of the increase in spending allowed under the cap would be taken up by growth in the Proposition 98 guarantee, repayment of the deferrals and loans contained in the 2002-03 and 2003-04 budgets, and debt service on the deficit retirement bonds. The remainder of the budget would face cuts potentially in excess of $12 billion in 2005-06 and beyond relative to current spending levels, equivalent to an across-the-board cut of over 20 percent. A $12 billion reduction would exceed 2005-06 current law spending for the Department of Corrections, California State University, and University of California ***combined.*** If outstanding "maintenance factor" obligations are not repaid to K – 14 education, programs outside the guarantee would still have to be cut by approximately $10 billion, equivalent to an 18 percent across the board reduction.

California Already Has a Spending Cap

California has a spending cap that limits appropriations from the proceeds of taxes. The state has exceeded the State Appropriations Limit (SAL) twice: in 1986-87 and 1999-00. Moreover, other features of the state Constitution constrain spending and revenue growth, such as the two-thirds vote requirements for passage of a budget, spending other than for education, and measures that increase tax revenues. The current limit is designed to limit the share of the economy paid in state taxes.[2] The current inflation factor (per capita personal income growth) mirrors the resources from which Californians pay their taxes. This provision prevents taxes from rising as a share of per capita personal income over time. The current limit reflects the growth in K -12 enrollment for the portion of the budget dedicated to programs covered by the Proposition 98 spending guarantee and the growth in population for the remainder of the budget.

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[1] These calculations were done by the California Budget Project, but draw on forecasts presented in the Legislative Analyst's Office, *California's Fiscal Outlook* (November 2003).

[2] Specifically, the current SAL establishes a limit on appropriations from the proceeds of taxes for the state and every local government jurisdiction and provides for an annual inflation adjustment based on the percentage increase in per capita personal income and change in population. The population growth factor is the percentage change in population multiplied by the percentage of the budget that goes to all programs other than K – 12 education plus the percentage change in K – 12 enrollment multiplied by the fraction of the budget that goes toward K – 14 education. Current law requires, in the event that state revenues exceed the SAL in two consecutive years, amounts in excess of the SAL to be divided equally between K – 14 education and tax reductions within two subsequent fiscal years. The current SAL excludes appropriations for debt service; appropriations required to comply with court or federal mandates; appropriations for qualified capital outlay projects; and appropriations from the proceeds of tobacco taxes imposed by Proposition 99 of 1988 and Proposition 10 of 1998 and the increase in the gas tax imposed by Proposition 111. The current SAL also counts state aid to local governments toward the local jurisdiction's appropriations limit, rather than the state's, if the aid is provided in a form that is unrestricted by statute.

- **Leaves California ill-equipped to cope with the state's changing demographics, as well as broader economic trends.** The true impact of the proposed spending cap will likely be magnified by demographic and economic factors. Growth in the number of Californians over the age of 65 is forecast to exceed overall population growth through 2009. Population growth in this age group will result in significant cost pressures in the Medi-Cal program, since one out of four California seniors relies on Medi-Cal for their health coverage.[3] Moreover, Congressional Budget Office forecasts show Medicaid expenditures nationally rising at an average annual rate of 8 percent through 2008, a growth rate that is approximately 60 percent higher than the projected annual average increase in the state's spending cap. Adopting the Governor's proposal would create significant pressure on the state to reduce benefits and/or scale back eligibility in order to stay within the limit.

Other Issues Raised by the Governor's Proposed Spending Cap

The Governor's proposed spending cap also:

- **Establishes a historically low spending year as the baseline for the future.** The Governor's proposal establishes 2004-05 as the baseline for future spending, without regard to the resources needed to adequately fund public services. The 2004-05 budget will reflect the cumulative impact of an unprecedented multi-year budget shortfall. In the early 1990s, spending fell far below the state's appropriation limit. As the economy improved, increased revenues allowed the restoration of budget cuts made earlier in the decade. The Governor's proposal would sharply curtail the state's ability to make similar restorations in future years by establishing 2004-05 as the baseline for the future. Had the Governor's proposal been enacted with a 1993-94 base year, for example, 2003-04 spending would be limited to $65.8 billion, $7.9 billion below budgeted spending and $8.4 billion below General Fund revenues.

- **Excludes schools from receiving a share of revenues that exceed the cap.** Under existing law, K – 14 education receives half of revenues that in excess of the SAL when the limit is exceeded in two consecutive years. Under the Governor's proposal, education would not share in revenues that exceed the cap. Moreover, the Governor's proposal would also make it unlikely that schools' "maintenance factor" obligations would be fully repaid, thereby permanently reducing school funding by approximately $2 billion per year.

- **Allows revenues in the Budget Stabilization Fund to be diverted to tax rebates, rather than saved for a rainy day.** The Governor's proposal allows monies in the proposed Budget Stabilization Fund to be used for tax rebates; emergencies declared by the Governor; to help pay off proposed deficit retirement bonds; or to make up the shortfall in years when General Fund revenues are less than the state's spending cap. Allowing Stabilization Fund monies to be used for tax rebates is contrary to the basic function of a budget reserve. Funds spent on tax rebates would not to available to fulfill the "rainy day" function of a reserve.

- **Contains no guarantee that a tougher spending cap would prevent future budget crises.** Proponents of amending the state's spending limit argue that out-of-control spending caused the current budget crisis. In fact, the current crisis was largely caused by an

[3] California HealthCare Foundation, *Medi-Cal for Seniors* (September 2003).

unprecedented drop in state tax revenues related to the sharp drop in the stock market. Those who believe overspending caused the budget crisis point to the increase in spending between 1998 and 2000. An analysis of spending trends over a longer period reveals a different trend. During the early 1990s, spending failed to keep pace with population growth and inflation.[4] When revenues increased during the boom, spending rose. Similarly, appropriations subject to the state's existing spending cap were far below the limit in the early 1990s and actually surpassed the limit in 1999-00.[5] If spread out over the course of the decade, spending closely tracked inflation and population growth.

- **Discourage investments in infrastructure.** The state's current spending cap excludes appropriations for debt service and capital outlay from the state's spending limit. These exclusions encourage the Legislature to appropriate funds for infrastructure in years when spending is near the cap. By counting General Fund infrastructure spending toward the state's spending limit, the Governor's proposal creates competition for scarce resources between ongoing program demands and infrastructure.

- **Cause court and federal mandates to crowd out state priorities.** The state's current spending limit excludes appropriations made to comply with federal mandates or court orders. The exclusions reflect the fact that state policymakers have no control over these expenditures and that, if included, spending for these mandates could limit the state's ability to address other priorities. Eliminating the exclusion for court and federal mandates could require significant reductions in spending for programs reflecting Legislative and voter priorities in order to accommodate mandated expenditures within the cap.

The Governor's Proposal Includes a Hidden Power Grab

The Governor's proposal would give this and future governors sweeping powers to revise state laws under the guise of balancing the budget.[6] Revisions could only be blocked by a two-thirds vote of the Legislature. Specifically, the measure states that:

> "If the Governor determines that it is necessary to revise existing laws in order to eliminate this deficit or to bring estimated expenditures into compliance with Section 1, he or she may declare a fiscal emergency and by proclamation cause the Legislature to assemble in special session pursuant to subdivision (b) of Section 3 of Article IV. Concurrent with issuing that proclamation, the Governor shall submit to both houses of the Legislature a fiscal recovery plan, in the form of one or more bills to reduce General Fund spending or make other changes in law, to eliminate the deficit or to reduce estimated expenditures, as applicable. The plan shall take effect immediately as a statute within 30 calendar days after the date that it is transmitted to the Legislature **unless, prior to that date, legislation is passed in each house of the Legislature by rollcall vote entered into the journal, two-thirds of the membership concurring,** and is sent to the Governor, containing the declaration that the changes in law set forth in that

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[4] California Budget Project, *Did California Spend Its Way Into the Current Fiscal Crisis?* (May 2003).
[5] Spending exceeded the limit despite the fact that per capita personal income, the inflation factor used to adjust the State Appropriations Limit, does not include capital gains, which are not considered "income."
[6] ACA X 5 4 (Keene).

legislation will eliminate the deficit or reduce estimated expenditures, as applicable." (emphasis added)

Such a change would allow a Governor with the support of a third of the Legislature to overturn laws enacted by a majority or even a unanimous vote of a prior Legislature, representing a substantial shift in power from the legislative to the executive branch of government.

In 1992, voters defeated a more modest shift of power to the executive branch. Proposition 165 of 1992 would have limited the governor's ability to make unilateral reductions to circumstances when (1) expenditures exceeded budget amounts by 3 percent, or (2) cash receipts fell at least 3 percent below estimates, or (3) receipts were at least 1.5 percent below estimated revenues and cumulative expenditures exceeded budget amounts by at least 1.5 percent. The Governor's proposal allows a "fiscal emergency" to be declared when expenditures exceed revenues by any amount. Proposition 165 also excluded appropriations subject to the Proposition 98 guarantee, local government reimbursements and subventions, and state debt service from the governor's authority to make unilateral reductions. The Governor's proposal includes no such exemptions.

Jean Ross prepared this brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. Support for the CBP comes from foundation grants, publications and individual contributions. Please visit the CBP's web site at www.cbp.org.
