THE 2005-2006 STATE BUDGET

Structural Reform Proposals

The 2005-06 Governor's Budget does not solve the state's ongoing structural budget problem. In her initial assessment of the budget proposal, for example, the Legislative Analyst estimated that the budget has only enough ongoing solutions to resolve about $5 billion of the roughly $10 billion budget problem that the state faces in the following year 2006-07—with major budget imbalances continuing indefinitely. The Governor recognizes that his budget does not solve the ongoing structural problem and, instead, proposes a set of "structural reforms" that are intended to "lay the groundwork for balanced budgets in the future."

On January 5th, the Governor called a special session of the Legislature to consider placing a constitutional amendment on the ballot to implement his budget reform proposals (along with other constitutional amendments concerning redistricting, merit pay for teachers, and pension reform). The major elements of the Governor's Budget Reform proposals include the following:

- ***Automatic Across-the-Board Cuts.*** If General Fund spending exceeds resources by $250 million or more (adjusted for inflation) the Governor must call a special session of the Legislature to remedy the imbalance. If legislation is not enacted within 45 days (30 days if the budget has not yet been enacted), the State Controller would have to make across-the-board reductions in all General Fund payments for all programs except debt service and amounts required by federal law. Language submitted by the Administration would deem any contract or state law enacted after adoption of the constitutional amendment to include the automatic payment reduction provision.

- ***Continuing Appropriation When Budget is Late.*** In the event that the budget is not enacted by July 1, expenditure authority at the prior-year levels (as provided in the prior-year Budget Act and any laws amending the Budget Act) would continue, subject to the same conditions specified in the prior Budget Act. This interim expenditure authority would continue until a new budget is enacted.

- ***Reduction in Proposition 98 Education Funding Requirement.*** The Governor proposes reducing required state funding of K-14 education under Proposition 98. Under existing Proposition 98 requirements, the state will have a $3.6 billion "maintenance factor" obligation after fiscal year 2005-06 under the Governor's Budget. This is the amount that, over time, the state must restore to the ongoing K-14 funding base to meet the long-term funding requirements of Proposition 98. The state incurs a maintenance factor obligation in any year when savings are achieved through a suspension of Proposition 98 or under "Test 3," which allows reduced funding growth in years when the state's revenue growth lags. The basic long-term Proposition 98 requirement is that state and local funding must grow as much as the economy (measured by per-capita personal income) and student enrollment. This is "Test 2." (Test 1—linking funding to a percentage of state revenues is not operative since Test 2 results in a larger requirement) The maintenance factor ensures that education funding stays on track over the long term despite temporary funding shortfalls. The Governor proposes the following changes to Proposition 98:

- ***Lower the base***. The "base" funding requirement for Proposition 98 in the future would be reset at the 2004-05 budget appropriation level (about $3 billion less than the minimum guarantee due to suspension).

- ***No future suspensions.*** Future Proposition 98 suspensions would be prohibited, and there would not be any reduction of the funding requirement in a "low revenue" year, as currently allowed under Proposition 98's "Test 3."

- ***No Restoration of Proposition 98 Base Funding.*** The state's maintenance factor obligation would be converted to a one-time cash obligation to be paid to K-14 education over 15 years, rather than a gradual increase in the ongoing funding base. There would be no future creation of maintenance factors because there would be no future suspensions or Test 3 years.

- ***Stretch out existing "settle-up" obligation.*** The existing "Settle-Up" obligation (about $1.3 billion under the budget proposal) would be repaid over 15 years. Settle-up amounts are amounts that the state still owes K-14 education for prior years. However, the Governor's proposal would mandate that future Settle-up obligations will have to be identified within 24 months and the settle-up payments would be continuously appropriated.

- ***Extra funding not required to be permanent.*** Any appropriations in excess of the Proposition 98 guarantee will not be rolled into the ongoing funding base (as they are now) unless the Legislature designates them as base increases.

- ***Prohibition of New Borrowing from Special Funds.*** The proposal prohibits new borrowing from special funds starting in fiscal year 2006-07 and requires repayment of existing special fund loans within 15 years.

- ***Payment of Mandated Cost Deferrals.*** Extends the payment period to 15 years for approximately $1 billion of local government claims for mandated cost reimbursements. Current law requires payment of these claims over a 5-year period ending in fiscal year 2011-12.

- ***Proposition 42 Transportation Funding.*** The reform proposal includes repeal of the suspension authority for Proposition 42 transportation funding after, fiscal year 2006-07 and requires repayment of all past suspension amounts over 15 years, in equal annual installments, with authorization for the state to bond out this obligation to provide more immediate transportation funding.

- ***End Defined-Contribution Pensions.*** The Governor proposes a constitutional amendment to prohibit the state and local governments from offering traditional pensions (those that provide specific retirement payments) to new employees. Instead, new employees would be offered defined-contribution plans, such as 401(k) programs to which the employer contributes a set amount without any guarantee of the eventual retirement benefit.

Some Problems with the Governor's "Reforms"

Reform or Reductions? The proposed Proposition 98 "reforms" will result in a $3.6 billion (plus growth) ongoing reduction to the existing long-term K-14 funding requirement. Furthermore, they would stretch out the settle-up payments over 15 years, so that schools and community colleges will have to wait longer to receive money still owed to them for past years. The flexibility for the Legislature to provide additional funding over the guarantee without making it permanent might be a reasonable reform if the basic level of the guarantee were adequate. Moreover, the pension restructuring proposal will have little fiscal impact anytime soon because it will only affect new employees. Furthermore, 401(k)s are not necessarily cheaper than regular pension plans— the cost will depend on the amount the employer contributes. The actual savings that the Governor proposes comes not from reform, but rather from shifting state costs to employees.

Autopilot on a Crash Course. Nearly every serious observer of California state government (including the Governor) has bemoaned the multitude of constitutional and other spending formulas and constraints that hamstring budget decisions. The Governor's proposals add even more. Spending truly would be on autopilot with spending continuing indefinitely in the absence of a budget and with blind across-the-board cuts to solve budget imbalances.

Unworkable and Potentially Costly Approach. Across-the-board cuts are an unworkable and potentially costly approach. In household terms, it's like deciding to underpay every bill because you're a bit short that month. The result is a lot of late charges and angry creditors. Telling those who supply goods and services to the state that their payment will be cut by any amount if we fall short will not engender confidence in the state or get the state the best price for those goods and services. The Governor's proposal simply amounts to reserving the right to break the promises that the state makes. Moreover, the across-the-board approach would not be workable or effective. For example, the controller would have to determine *for each warrant* whether, or how much of, the payment is federally required. The multitude of federal requirements, the extremely complex legal issues involved (not to mention the certain lawsuits), and the fact that many payments involve a variety of programs (exactly how many of the paper towels that the Department of General Services buys for state buildings are for federally required programs?) ensure that this approach would result in a messy and costly implosion. Being unworkable, this approach will not be effective in restoring fiscal balance. Moreover, being unworkable, it is more likely that ways will be found around it than that it will spur any meaningful action that would not otherwise occur.