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Issues in the News
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Two Ideas to Put California on the Road to Long-Term Budget Balance

Joe Matthews and Mark Paul published a book *California Crack Up* that I recommend to anyone who has not already seen their book. The book mostly focuses on changes in governance—elections, initiatives and budget process. I like most of the ideas and am particularly intrigued by their ideas on instant runoff voting (your second choice counts) and multiple-member districts. I think these ideas, even more than redistricting reform, can bring moderation to elections and candidates.

Matthews and Paul also had two policy proposals for changes in spending and taxation that I support and, which, as I explain below can put California on the road to long-term budget balance. We will also need stronger economic growth and probably other changes in taxation and spending but these two ideas have considerable dollars at stake and the possibility of broader support than many competing proposals.

Two Ideas for Long-Term Budget Reform and Balance

There are two long-term changes that offer billions toward long-term budget balance over the next decade.

- Lowering retirement benefits for newly hired employees and raising contributions to retirement funding from current employees.

- Requiring new state General Obligation bonds to have a new funding source.

These changes would result in reduced general fund spending for retirement benefits and debt service and free up money for other programs. It would take five to ten years probably for any significant dollar benefits but an immediate benefit would come from restoring credibility to state budget decision making.

Changing Retirement Benefits and Funding

The current retirement benefits are both unsustainable as a practical matter and seem inconsistent with both increased health and longevity and dramatic changes in private sector benefit practices. Changes are appropriate for newly hired employees who will know about them up front when they apply for jobs. Higher contributions to pension and health benefit funding are appropriate for most current employees, perhaps on a sliding scale relative to their pay.

These changes are appropriate without any disrespect to the thousands of public employees who work hard to serve residents and make California a great state.

The high retirement benefits were originally developed as part of a social contract where public employees traded salaries that were below what they would make in the private sector for a strong benefit program. But times have changed. Some, if not most salaries in the public sector are no longer small compared to the private sector and private sector benefit programs have been cut back. A new social contract for newly hired employees is appropriate even if there were not issues of long-term sustainability and budget pressures.

On the other hand existing benefit commitments are underfunded as a result of over-optimistic investment assumptions (assuming a 7.5%-8% annual return is not prudent in today's investment environment) and previous failure to adequately fund retiree health care benefits. Correcting these systemic problems will require extra money and this underfunding cannot be blamed on public employees. The impact of correcting these past failures will push significant dollar savings from sustainable retirement funding further in the future and bolsters the case for immediate action.

Fortunately there appears to be a growing consensus for change, which would send a great signal to investors worried about whether California can get serious about long-term budget balance.

Requiring a Dedicated Funding Source for State Bonds

California state general obligation bonds are funded from General Fund debt service payments. These payments will top $6 billion in 2010 and are scheduled to go higher as existing bonds are sold and new infrastructure bonds are approved. The State Treasurer and Legislative Analyst have both warned about the surge in debt service payments that is coming while California searches for long-term budget balance**. Finding an alternate way to pay for state infrastructure spending should be a second major long-term solution in addition to retirement benefits reform.**

Voter-approved tax increases (real "pay as you go" funding) is standard practice for school and local government bonds. Approve the bond and you approve the property tax to fund the bond. This is both fiscal prudence and good government. And local bonds are overwhelming approved for schools and other uses even though they come with a tax and have a super-majority requirement for passage.

There is no reason to have state bond issues appear to be "free" as advocates often argue in the voter pamphlet. The money to pay for debt service comes at the expense of other programs. Good government principles argue that residents will make better decisions if they are aware that they must pay for bond expenditures. As Matthews and Paul argue "It would remove any mystery for voters as to how bonds are paid for".

I offered this idea to the Commission on the 21st Century Economy in February 2009. It is good to see others supporting this sensible pay-as-you–go proposal. Hopefully, the candidates for governor and the legislature this year will discuss infrastructure funding and pension reform.

There are two other ways to fund more infrastructure on a pay as you go basis.

Part of the state's large infrastructure spending backlog may be better planned and implemented (and paid for) if local residents make the investments. We have made it easier for local voters to approve school bonds by requiring a 55% not 2/3 majority and that principle could be applied to offer that choice to local voters for other bonds and taxes. If more of this spending is funded locally, the state's requirement for spending will be lower.

In certain cases private investment can be used for infrastructure funding. Users will pay tolls and fees, which are a good way to determine which projects are worthwhile from a user perspective.

The State Budget and the Economy

Balancing the state's budget for the long term is important for many reasons. The budget's role in supporting economic prosperity is one of these reasons.

California's economic competitiveness depends on investing (wisely) in education and infrastructure while at the same time offering entrepreneurs and families a great quality of life if they choose to live and work in California.

Most of the state's high-growth and high-wage opportunities are in sectors that feature innovation and creativity. California is not the most-often chosen site for mature industries. Whether it is new innovations in clean energy or technology or social networking or creative entertainment products and services, the California economy grows by being on the cutting edge.

We strive to attract entrepreneurs and families who have high skills and many choices about where they live and work. **For these reasons, California's investments in education, infrastructure and quality of life should be at the heart of the state's competitiveness agenda.**

These investments to support economic growth will cost money and California starts from a position of lagging the nation in education spending, facing pressures to restrict higher education enrollments and a large upcoming slate of infrastructure projects.

California's budget challenges and gridlock are a major blot on the state's ability to attract talent and capital—they are a major, if not the major, negative "business climate" challenge for our state. Getting started on retirement reform for public employees and providing funding for infrastructure that does not drain the General Fund will be good starts on restoring credibility to state budget decisions.