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TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: The Deficit Bond and Spending Growth Limit Proposals

1. This is the sixth in an ongoing series of memos on state budget issues and their relationship to the California economy. Our work is supported by a grant from The James Irvine Foundation. Previous memos are posted at www.ccsce.com.
2. This memo discusses the proposal for a \$15 billion deficit bond on the March 2004 ballot and the proposal for a state spending growth limit.

3. The Proposed \$15 Billion Deficit Bond

There are five questions related to the proposed bond:

- 1) Is a deficit bond needed?
- 2) Should residents vote on the borrowing?
- 3) Are the bond and spending growth limit technically linked?
- 4) How much money should be borrowed?
- 5) Should the borrowing be for five years or thirty years?

Is Borrowing Needed?

Most of the bond replaces money already scheduled to be borrowed in the adopted 2003-2004 budget agreement. This includes the \$10.7 billion deficit bond and the \$1.9 billion bond to pay state pension obligations.

This \$12.6 billion in borrowing is required as part of how the 2003-2004 budget was balanced.

Is a Vote Needed?

Questions have been raised as to whether the legislature can approve multi-year borrowing without a vote of the public. A court has invalidated the \$1.9 billion pension obligation bond and the \$10.7 billion deficit bond is being challenged. One purpose of the March 2004 bond ballot measure is to obtain voter approval for the borrowing.

One question is whether a new bond is needed or if it would be sufficient to have a ballot vote that asks, "Do you approve of the \$10.7 billion deficit bond and the \$1.9 billion pension obligation bond approved by the Legislature?"

In the end, the choice of going to the voters rests on both political and legal considerations.

Are the Bond and Spending Growth Limit Linked?

The bond and spending growth limit are not linked by legal or fiscal requirements. The bond relates to legal questions about the 2003-2004 budget and the spending limit would not begin until the 2004-2005 budget year or later. So, it is possible to vote on the bond in March and debate the spending growth limit during the 2004 debate on the Governor's budget proposal.

The Governor has linked the bond and spending growth limit as his political requirement but that is different from a legal or fiscal linkage.

How Much Borrowing is Required?

\$12.6 billion in borrowing is required to match the \$10.7 billion deficit bond and \$1.9 billion pension obligation bond in the 2003-2004 budget. The recent cut in vehicle license fees increases the deficit in the current budget year. The Governor has proposed bonds totaling \$15 billion. It appears that the extra money is intended to compensate for some of the loss in revenue from reducing vehicle license fees.

There is no "right" or "wrong" answer as to how much to borrow at this time. It should be decided as part of new discussions on how to balance the 2003-2004 budget now that revenues will be less than projected.

Should the Borrowing be Long Term or Short Term?

The major change in the Governor's bond proposal is changing the borrowing from short term to long term. The borrowing in the adopted

budget was to be repaid within five years. The Governor's proposal changes the term of the borrowing to a longer term for repayment.

The major reason for extending repayment of the deficit borrowing is to lessen the need for immediate adjustments to spending or revenues in order to pay off past debts.

Four major objections have been raised to having a long-term repayment period to any deficit-related borrowing.

One, long-term borrowing is usually reserved for projects that leave lasting value for future generations, projects like schools, roads, energy and water systems and public transportation systems. Since our children and grandchildren pay part of the cost of long-term bonds, it is usually considered important that the bonds fund projects that will bring benefits to those who are paying for the bonds. **The proposed bond is to pay off past deficits and does not fund projects that build for the future.**

Two, the state has limited long-term borrowing capacity and the use of long-term borrowing to pay off past deficits may "crowd out" infrastructure spending to improve the economy and quality of life. To be very specific, the proposed \$15 billion deficit payback bond may compete with a school construction bond on the March ballot. The Treasurer's Debt Affordability Report points out that the deficit bond in combination with other proposed infrastructure bonds will **push the state's debt service burden above levels normally considered prudent.**

Three, **The \$15 billion bond does nothing to solve the state's ongoing deficit challenge of approximately \$15 billion per year.** It is hard to see how this kind of borrowing will help to restore our credit rating or restore the confidence of Wall Street that California has embarked on a path of return to prudence. If anything, the bond sends the opposite signal, that California wants to continue delaying the settlement of past debts.

Four, the resort to long-term borrowing to pay off past deficits sends a bad signal about California's business climate. There is broad agreement that California is spending far less than is needed to improve the state's infrastructure. The deficit bond, if long-term, will compete with both state and local bonds designed to support future economic growth and quality of life. It will be another sign to business that California is stepping back from investing for the future.

4. The Proposed Spending Growth Limit

Background

California has had a spending growth limit since the late 1970s. The state's spending growth limit was more restrictive in the 1980s and was amended to allow slightly larger increases in spending in the 1990s. There are now three active spending growth limit proposals:

--The Governor's proposal

--A bipartisan legislative proposal (ACA 1)

--An existing proposal (ACA 6) authored by Assemblyman Campbell

It is important to be careful about language when discussing the issue. What California has is a **limit on the growth in spending, not a limit on spending**. A spending growth limit keeps the year to year increase in spending from exceeding a set limit—usually based on the growth of population and either the consumer Price Index or per capita income.

It is also important to distinguish **how budget balance is first achieved** from **how budget balance is maintained**. A spending growth limitation imposed **after the budget is in balance** might help prevent the state from repeating the recent deficit buildup. **But a spending growth limitation will not cause the budget to become balanced.**

The Governor's proposal combines a proposed substantial cut in 2004-2005 spending with the imposition of a spending growth limitation for succeeding years. The Governor proposes to limit 2004-2005 spending to the level of estimated revenues and then to impose a spending growth limit after that.

Residents and the legislature should carefully separate the questions of how do we get to budget balance from the questions of how do we prevent a large deficit from occurring in the future. For example, the initial balance could be achieved by spending cuts, revenue increases or a combination—**exactly the same choices that have faced Californians for three years.**

Four Components of a Spending Growth Limit

There are four important criteria that are necessary components of any spending growth limit proposal. First is the choice of base year. Second is whether spending is limited to the growth rate of the economy (population plus per capita income) or whether spending growth is required to grow

more slowly than the overall economy (population plus inflation). The third criterion is what exemptions are allowed in the spending limitation, for example, whether school funding is exempt from the spending growth limitation. The fourth major criterion is the use of “extra” revenues in years when more revenue is collected than is allowed to be spent.

Choice of the Base Year for a Spending Growth Limit

The choice of base year will significantly affect the spending allowable under any growth limitation formula. For example, the LAO forecasts that spending in the 2004-2005 budget year will be approximately \$85 billion under current trends. Revenues are estimated at \$74 billion. Thus, for example, there would be an \$11 billion difference in the base year between the Governor’s proposal and ACA 1 and **that difference would grow over time.**

The base year choice should, ideally, be **an average year.** It should not be a “high” spending year like 2000-2001 or a “low” spending year like 2002-2003 or 2003-2004. The ACA 1 bill suggests 2005-2006 as the base year.

Choice of the Growth Factor

The major choices are between population and a measure of inflation such as the California Consumer Price Index and population and some measure of income growth such as per capita income.

Over the long term, per capita income will grow faster than consumer prices so a formula based on per capita income growth will allow more spending growth than a formula based on consumer prices. Per capita income growth has a “keeping up with inflation” component and a “real income growth” component.

Productivity growth allows wage and income gains to exceed the rate of inflation and allows workers and their families to experience an increase in their standard of living. The choice of a spending limit growth factor is about whether or not public sector spending should participate in the real growth of the economy.

Nearly all of our measures of fiscal prudence and sustainability are based on comparison to the growth of the economy. We talk about what share of national income goes to the federal budget, what share of the state budget is prudent for debt service, what share of income is prudent for households to pay for rent. Keeping up with the growth in income is the standard in the state’s current spending growth limitation.

Put another way, the question becomes should our spending on schools and infrastructure and our safety net spending be able to grow along with the economy or should they be constrained to grow more slowly.

It is here that one can see how discussing the spending growth limit once **the state is in budget balance** makes such a difference. Normally, a spending growth limit reflects a decision about how spending should increase assuming that the budget is in balance to begin with. The question of how to achieve budget balance in the first place represents a separate set of choices.

The choice of population as part component of a spending limit growth factor is universal, but still raises critical issues. Population is an overall surrogate for caseload growth but all caseloads do not grow at the same rate. For example, in the decade ahead, K-12 enrollment will stay relatively flat while higher education enrollment is projected to increase by more than 20%.

Health care and social service caseloads grow faster during recession periods and more slowly during periods of strong economic growth and may grow faster than the rate of population growth as the state's population ages. Health care inflation is probably the fastest growing state budget component as health care costs are rising more than twice as fast as overall inflation.

What Exemptions are Allowed?

Next, there is the question of exemptions. Should school spending be exempt from a spending growth limit? Any new spending limit would have to deal with how the Proposition 98 guarantee for school spending is integrated into a spending limit growth factor. Should spending on programs mandated by the federal or state government be exempt from a spending limit? What about spending on infrastructure?

Where Should "Extra" Revenue Go?

One of the major reasons advanced for establishing a spending growth limit is to make sure that all revenues are not spent in years of exceptionally high revenue growth. A spending growth limit bill must establish how the "extra" revenue should be "spent".

Most policy experts and legislators agree that California needs a mandatory budget reserve to provide protection against the next economic slowdown. ACA 1, for example, requires "extra" revenues to go into a reserve fund until a 10% budget reserve is established.

If a reserve is established, the next question is what to do with revenues that are still “extra” after the reserve is filled. Three alternatives have been mentioned in current proposals: 1) put money into an infrastructure fund, 2) put money into K-12 education and 3) use “extra’ funds for tax rebates. Some proposals include a combination of these uses.

Final Note

One point is clear about a spending growth limit. There are many details to be worked out and choices about the details involve billions of dollars.