MEETING DATE: 2/17/04
ITEM NO. 15

COUNCIL AGENDA REPORT

DATE: FEBRUARY 17, 2004

TO: MAYOR AND TOWN COUNCIL

FROM: DEBRA J. FIGONE, TOWN MANAGER

SUBJECT: DISCUSSION OF PROPOSITIONS 57 AND 58 FOR MARCH 2004 BALLOT

RECOMMENDATION:

1. Accept informational staff report on Propositions 57 and 58 for the March 2004 Ballot.

2. Discuss and consider a Council position on Propositions 57 and 58. Council positions may be either "support," "oppose," or "no position."

PURPOSE:

The intent of this report is to provide Council with background and analytical information on Propositions 57 and 58 for discussion purposes as it relates to taking an official Council position.

BACKGROUND:

According to the State Legislative Analyst's Office, California has experienced major budget difficulties in recent years. After a period of high growth in revenues and expenditures in the late 1990s, state tax revenues plunged in 2001 and the budget fell badly out of balance. Although policymakers reduced program spending and increased revenues to deal with part of the shortfalls, the state has also carried over large deficits and engaged in a significant amount of borrowing. The state budget faces another major shortfall of $15 billion in FY 2004 - 05. This estimate assumes that the currently authorized $10.7 billion deficit-financing bond is sold and that the carryover FY 2002 - 03 deficit is thereby taken off the books. Absent the bond proceeds from this sale, the budget shortfall would be much larger. On top of this shortfall, the State has a variety of other obligations - such as deferrals and loans from special funds - that are outstanding at this time.

DISCUSSION:

In response to the State's fiscal situation, the Governor has placed Proposition 57 and 58 on the March 2004 ballot. The following sections provide an overview of the propositions, including an

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_____Community Development Revised: 2/12/04 4:39 pm

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assessment of related fiscal impacts, arguments in support of and opposition to, and the State Legislature's final voting record for the ballot measures.

Overview of Proposition 57

Proposition 57 puts before the voters authorization for the state to issue a bond of up to $15 billion to deal with its budget deficit. The bond authorized by this measure would be used *in place of* the deficit-financing bond authorized last year by the Legislature.

The repayment of the bond would result in annual General Fund costs equivalent to *one-quarter* cent of California's sales tax revenues, compared to costs equivalent to one-half cent of sales tax revenues for the currently authorized bond. In addition, certain funds transferred to the state's Budget Stabilization Account (created in Proposition 58 on this ballot, if approved) would be used to accelerate the repayment of the bond. The measure includes a backup guarantee that if the sales tax revenues dedicated to the bond are insufficient to pay bond principal and interest in any year, the General Fund will make up the difference. This measure would become effective only if Proposition 58 on this ballot is also approved by the voters.

Fiscal Impact of Proposition 57

With respect to its fiscal impact, the proposed bond would result in near-term budgetary savings compared to the bond authorized in current law, but added annual costs over the longer term. Specifically:

Near-Term Savings. The proceeds from the proposed bond would be up to $4 billion more than from the currently authorized bond. This would provide the state with up to $4 billion in additional one-time funds to address its budget shortfall. The state would also realize near-term savings related to debt service on the bond. This is because the payments would be based on one-quarter cent of annual sales taxes instead of one-half cent. As a result, annual General Fund costs would be one-half of the currently authorized bond for the next few years.

Longer-Term Costs. The near-term savings would be offset by higher costs in the longer term. This is because the proposed bond would be larger ($15 billion versus $10.7 billion) and it would take longer to repay. It is anticipated that the proposed bond would likely take between 9 and 14 years to pay back, compared to a 5-year period for the currently authorized bond.

Arguments Supporting Proposition 57

Governor Arnold Schwarzenegger, Larry McCarthy, Presidents of the California Taxpayer' Association, and Allan Zaremberg, President of the California Chamber of Commerce have sponsored the following arguments in support of Proposition 57:

- The California Economic Recovery Bond Act will consolidate the deficit and allow

California to address its financial challenges without raising taxes.

- The California Economic Recovery Bond Act will keep the state from running out of money and prevent drastic cuts in spending on vital programs like education and health care.

- The California Economic Recovery Bond Act will not take effect unless voters approve the California Balanced Budget Act, which prohibits borrowing to pay deficits ever again and requires enactment of a balanced budget.

- The California Balanced Budget Act also provides for a fund of up to $5 billion that can be used to pay these bonds off early. It also provides for a reserve of at least $8 billion, which can be used to prevent future deficits.

- Last year, the state approved $12.9 billion in bonds to retire the accumulated budget deficit. The courts have declared one bond issuance unconstitutional and the other is subject to legal challenge because they were not approved by voters. Since then, the state has accumulated a larger budget deficit. Proposition 57 will legal restructure and refinance that debt with the approval of the voters.

- Without this bond, the State of California may be out of cash by June. To deal with a calamity of that magnitude in such a short time frame, the only choice will be to drastically increase taxes. The California Economic Recovery Bond will let us refinance our inherited debt and give the state time to deal with its ongoing structural deficit.

- The California Recovery Bond and the California Balanced Budget Act, Proposition 58, together will give California's leaders the tools necessary to restore confidence in the financial management of the State.

Arguments Opposing Proposition 57

Senator Tom McClintock and Senator Bill Morrow have sponsored the following arguments in opposition to Proposition 57:

- Proposition 57 plunges us $15 billion deeper in debt—plus billions more in interest. Total debt service from Proposition 57 will cost an average family more than $2,000.

- Instead of cutting the waste from government bureaucracy and targeting fraud for elimination, they have decided to use the biggest bond in California history to cover their spending addiction.

- Since 1849, California's Constitution has forbidden bonds from being used to paper over deficit spending. Long-term bonds are supposed to be used for schools, parks, highways and

water projects that will serve coming generations. In order to put this unprecedented borrowing on the ballot, the proposition proposes to repeal this historic constitutional amendment.

- Five years ago California spent $57.8 billion from its General Fund. Next year, it will spend $90.2 billion.

- Instead of adding more than a billion dollars of additional debt service to the state budget *every year* for the life of this bond, the State should suspend its spending mandates and restore the power that the Governor had from 1939 to 1983 to make mid-year spending reductions.

- The October 7th election sent Sacramento an important message - No new taxes.

California State Legislature Voting Record for Proposition 57

Below is the final votes cast by the Legislature on Proposition 57:

Assembly:	Ayes - 67	Noes - 13
Senate:	Ayes - 27	Noes - 12

Overview of Proposition 58

This proposition amends the Constitution, making changes related to (1) the enactment and maintenance of a balanced state budget, (2) the establishment of specific reserve requirements, and (3) a restriction on future deficit-related borrowing. The provisions are discussed in more detail below.

Balanced Budget Provisions

This proposition requires that the state adopt a balanced budget and provides for mid-year adjustments in the event that the budget falls out of balance.

Balanced Budget. In addition to the existing requirement that the Governor *propose* a balanced budget, this measure requires that the state *enact* a budget that is balanced. Specifically, estimated revenues would have to meet or exceed estimated expenditures in each year.

Mid-Year Adjustments. Under this measure, if the Governor determines that the state is facing substantial revenue shortfalls or spending deficiencies, the Governor may declare a fiscal emergency. He or she would then be required to propose legislation to address the problem, and call the Legislature into special session for that purpose. If the Legislature fails to pass and send to the Governor legislation to address the budget problem within 45 days, it would be prohibited from (1)

acting on any other bills or (2) adjourning in joint recess until such legislation is passed.

Reserve Requirement

The proposal requires that a special reserve - called the Budget Stabilization Account (BSA)—be established in the state's General Fund.

Annual Transfers. A portion of estimated annual General Fund revenues would be transferred by the State Controller into the account no later than September 30 of each fiscal year. The specific transfers are 1 percent (about $850 million) in 2006 - 07, 2 percent (about $1.8 billion) in 2007 - 08, and 3 percent (about $2.9 billion) in 2008 - 09 and thereafter. These transfers would continue until the balance in the account reaches $8 billion or 5 percent of General Fund revenues, whichever is greater. The annual transfer requirement would be in effect whenever the balance falls below the $8 billion or 5 percent target. (Given the current level of General Fund revenues - approximately $75 billion - the required reserve level would likely be $8 billion for at least the next decade.)

Suspension of Transfers. The annual transfers could be suspended or reduced for a fiscal year by an executive order issued by the Governor no later than June 1 of the preceding fiscal year.

Allocation of Funds. Each year, 50 percent of the annual transfers into the BSA would be allocated to a subaccount that is dedicated to repayment of the deficit-recovery bond authorized by Proposition 57. These transfers would be made until they reach a cumulative total of $5 billion. Funds from this subaccount would be automatically spent for debt service on that bond. The remaining funds in the BSA would be available for transfer to the General Fund.

Spending From the Account. Funds in the BSA could be transferred from this account to the General Fund through a majority vote of the Legislature and approval of the Governor. Spending of these monies from the General Fund could be made for various purposes—including to cover budget shortfalls—generally with a two-thirds vote of the Legislature (same as current law).

Prohibition Against Future Deficit Borrowing

Subsequent to the issuance of the bonds authorized in Proposition 57, this proposal would prohibit most *future* borrowing to cover budget deficits. This restriction applies to general obligation bonds, revenue bonds, and certain other forms of long-term borrowing. The restriction does *not* apply to certain other types of borrowing, such as (1) short-term borrowing to cover cash shortfalls in the General Fund (including revenue anticipation notes or revenue anticipation warrants currently used by the state), or (2) borrowing between state funds.

Other Provisions

With regard to the bond authorized by Proposition 57, the "single object or work" for which the Legislature may create debt includes—for that measure only—the one-time funding of the accumulated state budget deficit and other obligations, as determined by the Director of Finance. Its provisions take effect only if Proposition 57 on this ballot is also approved by the voters.

Fiscal Impact of Proposition 58

This measure could have a variety of fiscal effects, depending on future budget circumstances and future actions taken by Governors and Legislatures. Possible fiscal effects include:

Balanced Budget and Debt Provisions. In recent years, as well as during difficult budget periods in the past, the Governor and Legislature have at times allowed accumulated budget deficits to carry over from one year to the next. This meant that spending reductions and/or revenue increases were less than what they otherwise would have been in those years. The provisions of this measure requiring a balanced budget and restricting borrowing would limit the state's future use of this option. As a result, the state would in some cases have to take more immediate actions to correct budgetary shortfalls.

Reserve Requirement. The $8 billion reserve target established by this proposition is much larger than the amounts included in past budget plans. This larger reserve could be used to smooth state spending over the course of an economic cycle. That is, spending could be less during economic expansions (as a portion of the annual revenues are transferred into the reserve), and more during downturns (as the funds available in the reserve are used to "cushion" spending reductions that would otherwise be necessary).

The proposition could have a variety of other impacts on state finances. For example, to the extent that the measure resulted in more balanced budgets and less borrowing over time, the state would benefit financially from higher credit ratings and lower debt-service costs.

Arguments Supporting Proposition 58

Governor Arnold Schwarzenegger, Speaker Herb Wesson - California State Assembly, and Assembly Member Jenny Oropeza - Assembly Budget Committee have sponsored the following arguments in support of Proposition 58:

- Proposition 58 will require the Governor and the California State Legislature to enact a balanced budget. Right now, the Governor is only required to propose, not enact, a balanced budget. This loophole has led to the huge budget deficits that plague California.

- The California Balanced Budget Act will (1) require a balanced budget, (2) that spending not exceed income each fiscal year, and (3) general funds to be put in a "Rainy Day" fund to

build a reserve to protect California from future economic downturns; (4) allow the Governor to call a fiscal emergency if revenues drop below expenditures or if expenditures exceed revenues; and (5) prohibit the Legislature from acting on other legislation or adjourning if they fail to pass legislation to address the crisis.

- California faces unprecedented budget deficits. Overspending has led to serious shortfalls which threatens the state's ability to pay its bills and access financial markets. This proposition is a safeguard against this ever happening again. Proposition 58 will prevent the Legislature from enacting budgets that spend more money than we have.

- The California Balanced Budget Act will require, for the first time, the Governor and the Legislature to pass a balanced budget. This proposition, along with the California Economic Recovery Bond Act, will give us the tools we need to resolve California's budget crisis.

- As California faced unprecedented budget deficits for the last 3 years, the problem was ignored, spending exceeded revenues, and there was no process in place to address the fiscal crisis. Proposition 58 will allow the Governor to call a Special Session of the Legislature to deal with future fiscal crises. If the Legislature fails to act within 45 days, then they will not be able to recess and they will not be able to pass any other legislation. This will force the Governor and the Legislature to work together to find a solution to the problem before it is too late.

- The California Recovery Bond, Proposition 57, and the California Balanced Budget Act, Proposition 58, together will give California's leaders the tools necessary to restore confidence in the financial management of the State.

Arguments Opposing Proposition 58

Richard Rider, Chair San Diego Tax Fighters, Bruce Henderson, President Association of Concerned Taxpayers, and Joe Armendariz, Executive Director Santa Barbara County Taxpayers Association have sponsored the following arguments in opposition to Proposition 58:

- The same legislature that created the biggest budget deficit in California's history is proposing to paper over that deficit by borrowing $15 billion, at a total cost of over $2,000 per California family.

- Since 1849, the "single object or work" provision of the Constitution has limited long-term borrowing to projects like schools, parks, or water projects that will serve coming generations. Proposition 58 disregards that provision.

- California's Constitution already prohibits long-term borrowing from being used to balance the budget - which is what the proposition is proposing to suspend. The State's financial crisis is because of short-term borrowing—and short-term borrowing is exempt from

Proposition 58.

- The Governor currently has the power to call the Legislature into session to address a developing budget shortfall. This initiative requires the Legislature to take action before it can move on to other business.

- The Governor's power to make mid-year spending reductions should be restored to keep the budget in balance. Spending restraint can also be achieved by restoring the Gann Spending Limit that produced a decade of balanced budgets and prudent reserves from 1979 until 1990.

California State Legislature Voting Record for Proposition 58

Below is the final votes cast by the Legislature on Proposition 58:

Assembly:	Ayes - 80	Noes - 0
Senate:	Ayes 35	Noes - 5

CONCLUSION:

In response to the State's current fiscal challenges and projected FY 2004/05 budget deficit of $15 billion, the Governor has placed Propositions 57 and 58 on the March 2004 ballot.

Proposition 57 puts before the voters authorization for the state to issue a bond of up to $15 billion to deal with its budget deficit. The bond authorized by this measure would be used *in place of* the deficit-financing bond authorized last year by the Legislature.

Proposition 58 amends the Constitution, making changes related to (1) the enactment and maintenance of a balanced state budget, (2) the establishment of specific reserve requirements, and (3) a restriction on future deficit-related borrowing.

Council may want to consider taking a Council position on Propositions 57 and 58. Positions may be either "support," "oppose," or "no position."

FISCAL IMPACT:

There is no fiscal impact associated with the recommended actions.