

The Adult Budget Supervisor Tackles the 2014-15 California State Budget

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“It took decades for Brown to shake his image as uber-flaky. But he’s now become the ideal of “adult supervision” in Sacramento — something the state capitol sorely needed after Arnold Schwarzenegger’s bumpy tenure as ‘The Governor.’”

Commentators Sherry Bebitch Jeffe and Douglas Jeffe¹

In last year’s fiscal chapter for *California Policy Options*, we took a long view and traced the ups and downs of the California state budget going back decades. Since the past doesn’t change, we won’t repeat that history this time.² Indeed, our focus is on the first term of Jerry Brown’s second iteration as governor and especially the budget enacted for 2014-15. As every California school child knows – or should, anyway – Brown was governor in the late 1970s and early 1980s, serving two terms back then.³ He left office in January 1983 and, after a hiatus, began his second coming in state politics which included a stint as mayor of Oakland and as state attorney general.

Meanwhile, Brown’s former chief of staff, Governor Gray Davis, was recalled from his gubernatorial post in 2003 and succeeded by movie star Arnold Schwarzenegger who promised to fix the budget crisis of that era which was the root cause of Davis’ recall. Davis had benefited from the dot-com boom, which raised tax revenue during the first couple of years of his first term, but he suffered from the dot-com bust, which cut off the windfall. Even though Davis won re-election in 2002 against a weak candidate, he was recalled before the first year of his second term was to end.⁴ Schwarzenegger as governor benefited from the state’s housing boom, but budget woes returned when the boom turned to bust and the Great Recession cut into revenue. By the time Schwarzenegger left office to be succeeded by Brown, his (Schwarzenegger’s) unfavorable popularity ratings were about where Davis’ had been at the time of the recall.

In short, Brown’s challenge in his third term, beginning in January 2011, was to deal with the budget problem Schwarzenegger left behind in fiscal year 2010-11. Even in his first iteration as governor,

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This article is based on information only through mid-August 2014 and does not reflect subsequent developments.

¹Sherry Bebitch Jeffe and Douglas Jeffe, “Why Hillary Clinton needs to follow a California dream,” *Reuters*, June 11, 2014. Note: The dates given for news articles cited in this chapter may vary between the online and print editions.

²Daniel J.B. Mitchell, “California’s Sleep Well Budget” in Daniel J.B. Mitchell, ed., *California Policy Options 2014* (Los Angeles: UCLA Luskin School of Public Affairs, 2014), pp. 53-104. Available at <http://issuu.com/uclapubaffairs/docs/californiapolicyoptions2014>

³There were no term limits during Brown’s first iteration. However, he ran for the U.S. Senate after his second term and lost. When term limits were later adopted, Brown’s two terms during his first iteration did not count, so he was free to run for governor again (for up to two terms).

⁴Davis ran TV ads aimed at the Republican primary in 2002 designed to undermine LA Mayor Richard Riordan’s candidacy. Riordan likely would have done better against Davis than primary winner William Simon.

Brown – despite his “New Age” persona – liked to be known as a fiscal conservative. The question we explore in this chapter is whether Brown has “fixed” California’s budgetary problems, at least from the vantage point of the budget enacted for 2014-15.

We put “fixed” in quotation marks since what one governor and legislature do today can always be undone by some later administration. Perhaps the question might be better put by asking whether Brown succeeded in putting the state on a budget trajectory which, if continued, could avoid another state budget meltdown. To kill the suspense, the answer is that the state – despite Brown’s budgetary successes – remains in a precarious position for reasons Brown himself would likely acknowledge. Another downturn in the economy would produce another budget crisis. Nonetheless, Brown has established his public image as the adult supervisor in the room when it comes to the legislative budget process.

Budget 101

“Wisdom and prudence should be the order of the day.”

Governor Jerry Brown’s cover letter
to his January 2014 budget proposal⁵

State and local governments usually have what is called the “general fund” for day-to-day operating purposes. There are then a variety of other funds (really accounts) that are typically earmarked for specific purposes and which may have dedicated revenue sources of their own. California has over 1,100 such other funds, the most important earmarked for transportation and funded through a gasoline tax and other motor vehicle taxes.

When you hear about the state budget, the reference is typically to the general fund. The general fund is devoted heavily to education from kindergarten through higher ed and to social programs and the prisons. In some cases, especially K-14 funding, general fund expenditures are actually administered locally, e.g., by school districts. Even in such cases, however, the state may require the local administrators to follow various rules and/or direct them to particular purposes. The general fund also goes to support much of the state-level bureaucracy.

You can think of the general fund as a kind of state checking account. As long as there is money in the account, bills can be paid, and payrolls can be met, simply by writing a check. If the account is overdrawn and falls below zero, money must be borrowed to keep state operations going. Some of the borrowing can be internal; that is, borrowing from funds outside the general fund. When internal borrowing is used, however, the other funds are left with IOUs from the general fund instead of cash.

⁵Governor’s Budget Summary 2014-15, January 10, 2014. Available at http://www.dof.ca.gov/documents/FullBudgetSummary_2014.pdf.
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If too much internal borrowing occurs, the earmarked functions of the lending funds may be impeded. So the state can also borrow externally on a short-term basis. In California's case, the most common form of borrowing to cover general fund overdrafts is through issuance of Revenue Anticipation Notes (RANs). RANs involve borrowing *within* a fiscal year which in California begins on July 1 and ends on the following June 30. They are used to smooth the seasonality of state tax receipts.

When there is a deep budget crisis, the combination of internal borrowing and RANs may be insufficient to cover all state bills. In such circumstances, the state can issue Revenue Anticipation Warrants (RAWs) which cross from one fiscal year to the next. Even with internal borrowing and access to RANs and RAWs, a budget crisis can become so severe that the state cannot pay all its bills. In that event, the state issues "registered warrants" – essentially IOUs – to those to whom it owes money.

Registered warrants essentially pay the involuntary creditor at a later date when monies are again available. Such events are rare but one occurred under Schwarzenegger in 2009. Some commentators might label the handing out of IOUs rather than paying all bills as "bankruptcy," and during the Schwarzenegger episode there was much commentary to that effect about California. However, as a formal legal matter, there is no mechanism for a state to declare bankruptcy, unlike a local government or private organizations or persons.

Direct Democracy

"California's century-old ballot initiative system is cherished and cockeyed. What began as political reform — giving citizens the power of direct democracy — has become a tool of special interests and a plaything for nut jobs."

Los Angeles Times columnist George Skelton⁶

California's budget process is complicated by its tradition of "direct democracy," the initiative, referendum, and recall, three reforms which date back to the "progressive era" of the early 20th century. In particular, Proposition 13 – passed by voters during Jerry Brown's first term in 1978 – drastically cut and limited local property taxes making local jurisdictions dependent to varying degrees on state funding. School districts were especially affected. Prop 13 also required that any state tax increase pass by at least a two thirds vote of the legislature. This provision is still in effect and in fact has been tightened by later initiatives.⁷

Prop 98 of 1988 (in conjunction with another, later initiative) applies three formulas to determine the amount of funding required for K-14, generally (and loosely) described as earmarking around 40% of the

⁶George Skelton, "Little initiative for change," *Los Angeles Times*, February 16, 2012. Available at <http://articles.latimes.com/2012/feb/16/local/la-me-cap-initiatives-20120216>.

⁷There is a legal distinction made between a tax and a user fee. The two-thirds requirement applies to taxes, not fees. Voters tightened the definition of fees so that the legislature could not easily substitute fees for taxes.

general fund. The legislature can suspend the formula guarantee. But when it does so, the lost funding accumulates as a liability of the general fund sometimes termed by Sacramento policy wonks as the “credit card” to be paid in the future. When the budget outlook improves after a crisis, a large chunk of the added revenue goes to K-14 to meet the Prop 98 formula requirements and to pay off the credit card.

Just as initiatives can constrain budgeting, they can also ease the rules. For example (and very important during Jerry Brown’s second iteration as governor), voters in 2010 enacted Prop 25 which removed a Depression-era requirement that budgets had to be passed by at least a two-thirds vote of both houses of the legislature. The combination of Prop 13 and Prop 25 means that a simple majority of the legislature can pass a budget *unless it involves a tax increase via the legislature* in which case a two-thirds vote would be required. Governor Schwarzenegger and his predecessors could only enact a budget with a two-thirds vote which in practice meant passing a budget with some degree of bipartisan support. Since the Democrats now have a strong majority in the legislature, Brown had the option of ignoring Republican legislators once Prop 25 was enacted.

At one time in the pre-Prop 25 era, the few votes needed to achieve two thirds could be gotten from the minority party through political buy offs of one kind or another. Maybe a particular legislator was anxious to have some infrastructure improvement in his/her district funded in exchange for a vote. (These deals when made were always implicit for legal reasons, but they happened.) However, as California politics became more partisan, making such political deals became more difficult.

Term limits – enacted by voters in 1990 – may have been part of the problem. Legislators, knowing their careers in the assembly or state senate were limited, kept an eye on other state or local offices for which they might run when they were termed out. Under the traditional primary system (before voters modified it as will be discussed below), receiving a party nomination for subsequent career moves required remaining appealing to the median voter *in your party*, not the median voter in the relevant electoral district. Thus, inter-party cooperation became more and more difficult, deals were harder to cut, and lengthy delays in enacting a budget beyond constitutional deadlines became common, particularly during budget crises.

At this writing, Democrats have just under a two thirds majority in the legislature. Absent Prop 25, Democrats could not pass a budget without a few Republican votes. With Prop 25, however, no Republican votes are needed unless a tax increase is involved. Note also that because of the direct democracy option, even when tax increases are involved in a budget, if voters rather than the legislature approve a tax increase, only a simple majority of the popular vote is needed.⁸ Thus, legislative Republicans can be completely bypassed for a budget approval, even one involving a tax increase, so long as the increase is done through the initiative process.

⁸As will be discussed later, if a constitutional amendment is needed, and if it is to be put on the ballot by the legislature (rather than by voter petition), a two-thirds vote of the legislature is needed.

Of course, even with the Democrats having a strong majority in the legislature, Democrat Brown might not agree with those in his own party about key elements of the budget. Prop 25, however, puts pressure on the legislature by requiring them to forfeit pay for each day without a budget after the constitutional deadline for legislative action (June 15). The governor could veto the legislature's budget but legislators must enact one by the deadline or lose pay. There is some vagueness, however, in defining what a "budget" is or who should make that determination. We will come back to that point below.

Electoral Institutions

"No, (running for President is) not in the cards, unfortunately. Actually, California is a lot more governable."

Governor Jerry Brown⁹

California's "progressive" tradition has often centered on the weakening of political parties, seen by early 20th century reformers as inherently corrupt. California, for example, up through the 1950s, had a system of cross-filing in which candidates could run in the primaries of as many parties as they wanted. More recently, the sense by voters that partisanship in Sacramento was too strong led the success of two ballot propositions. One (Prop 11 of 2008) took redistricting after the 2010 Census of Population away from the legislature and put it in the hands of an independent citizens' commission. The objective was to avoid "gerrymandering" and to create more "swing" districts – essentially districts in which election of a Democrat or a Republican was not easily predicted. Whether the commission succeeded is still debated.

More important was Prop 14 of 2010, which created the "top-2" primary for state legislative and administrative offices. Under Prop 14, all candidates – not just those from a particular party – run initially in a single primary. Candidates may be labeled by their party, but they are all running to get the most votes. In the general election, the top-2 candidates (the ones who came in first and second) are pitted against each other. Indeed, the top-2 contest proceeds to the general election *even if a candidate in the primary achieved a simple majority* (unlike nonpartisan primaries often used in local California elections).¹⁰

⁹Quoted in Seema Mehta, "Brown rules out presidential bid," *Los Angeles Times*, January 14, 2014. Available at <http://articles.latimes.com/2014/jan/14/news/la-pc-brown-rules-out-presidential-bid-20140114>. Brown ran for president three times earlier in his career.

¹⁰Litigation challenges to the top-2 primary have not been successful, although one is still pending at this writing. The fact that non-partisan primaries are common at the local level in California – and have been for a long time – complicates making a case against such systems at the state level. It might be noted that Governor Brown received a simple majority of the votes in the June 2014 primary but will nonetheless go on to face the number two vote getter from the primary in the November 2014 general election.

Prop 14 was intended to produce more “centrist” candidates – particularly in the legislature – who in theory would be more prone to compromise than victors in a party-only contest. It was a reaction against budget gridlock that occurred before Prop 25’s simply-majority budgets. In principle, even in districts with a heavy majority of voters for one party, the minority would have a voice in the primary, and candidates would have an incentive to take account of the minority’s views.

The incentives and strategies under Prop 14 are complicated. Although aimed at nonpartisan results, Prop 14 rewards a degree of party discipline. In a district in which there is a strong majority for one party, the minority party will do well by limiting (if it can) the number of its serious candidates. If too many candidates from the majority party run, they may divvy up the votes and not come in first or second. Thus, a Democratic district might end up with a choice between two Republicans if many Democrats ran as candidates in the primary. Or the reverse could happen.

On net, Democrats initially did better at the Prop 14 “game” than Republicans, thus achieving the two-thirds threshold at times in the legislature. The coming and going of legislators sometimes pulled the level below two-thirds, however, and scandals involving three (Democratic) state senators in 2013-14 dropped the level below two-thirds more permanently.¹¹ At this writing, it is unclear which party was able to play the Prop 14 game better in the 2014 election cycle.

The various propositions we have discussed give the impression of a popular thrashing around of the electorate. If the budget situation had remained strong, it is doubtful these changes would have been on the agenda. The electorate’s impression of whether things are going along as they should in Sacramento is heavily affected by the condition of the budget. If there is a perception of crisis and if there is a stalemate causing budget enactment to be delayed, the impression that something needs to be done to change the system develops.

In a sense, there are two approaches voters could take in response to a perception that the legislature is too partisan. One approach is to try and make it less partisan through devices such as non-legislative redistricting and the top-2 primary. The other is to make it more functional, given partisanship. Allowing the legislature to pass budgets by a simple majority falls into that second category. Republicans and Democrats in the legislature may be far apart. Political science research suggests the legislature in California is more polarized than most.¹² But since Democrats command a majority in both

¹¹Senator Roderick Wright was eventually convicted of not living in his district as required by state law. Senators Ron Calderon and Leland Yee were both indicted for taking bribes. Their trials are pending at this writing. Calderon’s misdeed involved in part a state tax credit program begun under Governor Schwarzenegger to keep movie production in the state. The program is controversial since it amounts to an industry subsidy, and Calderon’s involvement didn’t improve its standing. However, the program continues at this writing and may even be enhanced.

¹²Boris Shor and Nolan McCarty, “The Ideological Mapping of American Legislatures,” *American Political Science Review* (August 2011), Vol. 105, No. 3 pp. 530-551.

houses of the legislature, allowing simple majority rule enables the legislature to function without gridlock.

Table 1 shows the voter approval level of the state legislature in various time periods. During the dot-com boom, when money was pouring into the state treasury, approval ratings were relatively high. By the time of the Davis recall, there had been several years of budgetary crisis thanks to the dot-com bust. So approval dropped substantially. Approval recovered much of the lost ground by 2007 before the start of the Great Recession. During that recession, however, the crisis atmosphere surrounding the budget returned and by 2009, IOUs were being handed out. Not surprisingly, in that period the approval ratings of the legislature sank to an all-time low.

By 2013, Governor Brown had created the impression that the budgetary problems of California – if not fixed – were on the mend. In addition, the delays caused by the supermajority two-thirds requirement had ended, thanks to Prop 25. So voter approval was up again. A scandal involving three state senators who were suspended for misconduct caused a drop by mid-2014. But on the whole, the public perception remains that of an improved budget situation and the end of annual crises.

Brown's Initial Budget Approach

“No more smoke and mirrors on the budget. No empty promises... No new taxes unless the people vote for them.”

Governor Jerry Brown, 2011 inaugural address¹³

Brown was elected in 2010 on a pledge that there would be no new taxes *without a vote of the people*. That pledge did not preclude a tax increase; it simply said any tax increase the governor might propose would be on the ballot. In effect, he was promising not to support (indeed, to veto) any tax increase that the legislature might enact by itself. So ballot approval for taxes would be needed.

However, the pledge did not indicate the method by which the tax increase would be placed on the ballot. Nonetheless, there were only two alternatives. The legislature could put the proposition on the ballot. But that approach would require a two-thirds vote (and, hence, some Republican support). Or an initiative could be used which wouldn't involve the legislature at all. Initiatives require a voter petition process, not a legislative process.

Newly-elected governors – including Brown – face an initial budgetary challenge. Under the state constitution, after being elected, they have to produce a budget proposal in early January for the next fiscal year. Thus, after the election in early November 2010, Brown had only a few weeks to prepare a budget for 2011-12 (July 1, 2011 – June 30, 2012). And he would have to live for six months with the budget signed by his predecessor for 2010-11.

¹³Inaugural address, January 3, 2011. Available at <http://governors.library.ca.gov/addresses/39-JBrown03.html>.
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Brown's first decision was probably based on his first iteration as governor. Back in the late 1970s and early 1980s, there was much more bipartisan cooperation in the legislature than exists today. Brown wanted to put to voters an "extension" of some temporary taxes enacted under Schwarzenegger. Putting the issue to voters would fulfill his campaign pledge of no new taxes without a vote of the people. The question, as noted, was how to put the tax extension issue before the voters.

Brown believed he could convince a handful of Republicans to support a ballot proposition – one put on the ballot by the legislature – that would give the proposed tax extensions an air of bipartisanship. As indicated earlier, however, using the legislative route to the ballot requires a two-thirds vote. He kept emphasizing to Republicans – who opposed any new taxes (or extensions) - that they did not have to support the tax extensions, only the idea of putting the proposal to the voters. Long story short, Brown did not succeed, despite offering a variety of concessions to Republican legislators.

While the January submission of a budget proposal is a constitutional requirement, there has developed a tradition – not a requirement – of the governor submitting to the legislature a "May revise." The May revise is essentially a redrafted budget proposal that takes account of new information on the economy, tax receipts, etc., as well as the politics of what seems feasible. By the time Brown got to the May revise in 2011, without securing any Republican votes, the clock was running out on the time needed to put a proposition before the voters in the following November. More importantly, it had essentially run out on the second option, going the initiative petition route without involving the legislature.

As the June 15 deadline for the legislature to pass a budget (or to lose pay under Prop 25), the Democrats in the legislature panicked and passed something they called a budget. Brown vetoed it, but the legislative leaders argued that they had met their deadline. The state controller – John Chiang – who writes most state paychecks (except for the University of California) refused to pay the legislature on the grounds that what was passed wasn't a full budget and had various technical problems.

Subsequently, after lengthy litigation, a court ruled that only the legislature – not the controller – could decide what a budget was, but it took months for that ruling to be made.¹⁴ In the meantime, both Brown and Chiang became folk heroes since the public interpreted their decisions as the result of an unbalanced budget. Brown and Chiang were perceived as standing up to a spendthrift legislature.

After the controversy died down, Brown and the legislative Democrats worked out a budget that simply assumed that \$4 billion in extra revenue would appear from somewhere in the course of the coming fiscal year, thus "balancing" the budget on paper. Chiang ruled that the new deal was a valid budget and thus a budget – with its phantom revenue assumption – was ultimately enacted for 2011-12. But Republicans had succeeded in blocking a ballot proposition extending the Schwarzenegger temporary

¹⁴Even with the ruling, if some future controller decided to do what Chiang did on some rationale, there could be new challenges in court and, in the meantime, legislators would not be paid.

taxes which therefore expired. On the other hand, they had also convinced Brown that he was not going to deal with them the following year.

A Look at the (Cash) Numbers

“The budget is not just a collection of numbers, but an expression of our values and aspirations.”

Jacob Lew, U.S. Secretary of the Treasury¹⁵

Table 2 presents a selected California budget history on a cash flow basis. The legacy budget for 2010-11 that Brown inherited from Schwarzenegger in fact ran a small surplus (income > outflow). But the general fund was so overdrawn that the reserve in the general fund simply became less negative, dropping from -\$9.9 billion to -\$8.8 billion by June 30, 2011. Brown’s new budget - with its phantom revenue assumption and expiring Schwarzenegger taxes - not surprisingly turned out to be in deficit (outflow > income) and the reserve therefore became more negative (-\$9.6 billion as of June 30, 2012). In short, California’s budget crisis was not resolved by Brown in his first full budget year. Indeed, absent the revenue from the expired temporary taxes, the situation was worse. But thanks to Prop 25, at least the lengthy delays in enacting a budget were a thing of the past.

The next year Brown’s strategy had to adapt both to the tax expirations that had occurred and to the lesson he had learned about the degree of party polarization in Sacramento. His January 2012 budget proposal now involved new temporary taxes (not extensions) and would be taken to the electorate by the initiative process, thus bypassing the legislature. The new budget for 2012-13 would assume voter support, i.e., that the initiative – which eventually became Prop 30 – would pass. But there would be trigger cuts, especially to education, if it didn’t. Public opinion polls suggested that voters were especially concerned about education. The question was whether the threat to education, if the initiative were to fail, would induce voter support. Or would voters be angry about being made to face the threat?

There was some drama about negotiating what taxes would be raised temporarily and by how much. In the end, there was a small upward adjustment of the state sales tax and a significant personal income tax increase at the upper bracket level. We will skip the details and just note that despite weakness in the voter opinion polls, in November 2012, voters did enact Prop 30, despite a significant campaign against it.¹⁶ The combination of higher taxes and an economic recovery brought in a jump in revenue. The budget swung into surplus (income > outgo) as Table 2 shows.

¹⁵<http://www.brainyquote.com/quotes/quotes/j/jacoblew442942.html#Cu0Uq8JRmc6etuXU.99>

¹⁶There was a controversy and eventually litigation over hidden out-of-state funding of the anti-30 campaign generally viewed as coming from sources associated with the conservative Koch brothers. Ultimately, the committee in California was fined and terminated.

However, the surplus was not large enough to eliminate the negative reserve (overdraft) in the general fund completely. The reserve finished the fiscal year on June 30, 2013 as -\$2.4 billion. Nonetheless, Governor Brown assured Californians when the 2013-14 budget was enacted for the next fiscal year that they could “sleep well” with the new fiscal plan.¹⁷

While Governor Brown might have been a bit premature in inviting a good night’s sleep, the 2013-14 budget as seen on Table 3 in the end ran a surplus (income > outflow) with a full year of Prop 30 money and further economic recovery. And the reserve for the first time in years was positive (+\$2.0 billion) as of June 30, 2014. By that time, of course, still another budget had been enacted, this time for 2014-15. As Table 2 indicates, that budget runs a deficit on a cash basis and ends with a negative reserve, although the official source documentation is unclear on the accounting treatment of cash flows in the context of the rainy-day fund.¹⁸

Background on Confusing Budget Methodology and Lingo Before Getting to 2014-15

“It looks like Gov. Jerry Brown took my advice and will use \$11 billion of the state’s surplus to help pay down California’s wall of debt instead of funding new programs.”

Former Assembly Speaker Willie Brown at a time when neither the budget surplus nor the reserve was anywhere near \$11 billion¹⁹

Our prior budget chapter for the 2014 edition of *California Policy Options* ended in summer 2013 after the 2013-14 budget was enacted. Here, we pick up the story leading to the adoption of the 2014-15 budget. One thing to note is on Table 2. The projection for cash flows in 2014-15 has outflow > inflow, i.e., a deficit, even adjusting for the creation of a separate rainy-day fund above and beyond the regular reserve in the general fund. The deficit is large enough on a cash basis to put the general fund reserve back into negative territory by June 30, 2015. Of course, whether that actually happens depends on the accuracy of the forecasts of spending and receipts.

Budgets are inherently forecasts and forecasts presume knowledge of the future which, of course, no one has. We will come back to this point below. It is important to note that budget forecasting is not quite the same as general economic forecasting. The latter tries to make the best estimate possible of

¹⁷Quote from Dan Walters, “Budget Won’t End Fiscal Angst,” originally in *Sacramento Bee*, June 28, 2013. The link is now at <http://www.sanluisobispo.com/2013/06/28/2563830/budget-wont-end-fiscal-angst.html>.

¹⁸The cash flow statement for 2014-15 which is the basis of Table 2’s ending reserve for that year is opaque, even by California standards. Starting reserves are taken from the June 2014 statement of the state controller. Receipts are as shown in the source table minus \$104 million from the Special Fund for Economic Uncertainties. Disbursements are as shown in the source table minus \$3,183 million transferred to the rainy-day fund. The implicit reserves at the end of fiscal year 2014-15 are the starting reserves plus receipts minus disbursements.

¹⁹Willie Brown, “Governor paying down state’s debt,” *San Francisco Chronicle*, January 11, 2014. Weekly column available at <http://www.sfgate.com/bayarea/williesworld/article/Governor-paying-down-state-s-debt-5134878.php>.

the future. The former is a political process, and it may sometimes be seen as beneficial to tilt toward optimism and sometimes toward pessimism.

There is also the matter of budgetary accounting. Up to this point, we have focused on cash accounting when budget figures have been examined. As accountants will point out, cash accounting can be misleading in that changes in timing that have little significance can affect results. For example, whether a check arrives or a payment is made on July 1 rather than June 30 really has no importance for fiscal health. Yet with the fiscal year arbitrarily ending on June 30, cash accounts will be affected.

To deal with the issue of arbitrary timing, accountants generally use an “accrual” rather than a cash approach. Accrual methodology attributes flows of money into and out of the treasury on the basis of when such flows are due to occur rather than when they actually occur. In theory, this approach should reduce the effect of arbitrary timing of transactions and give a more reliable picture of the budget situation.

What happens in theory and what happens in practice, however, is not the same thing. The official date on when things are due to occur under accrual can be manipulated. For example, at one point during the state’s most recent budget crisis, state payrolls were made to be due on July 1 rather than June 30 so that one fiscal year would show as expenses only 11/12ths of actual yearly employee expense.

The actual budget that the legislature adopts is on an accrual basis and ultimately the legislature and governor determine the details of the accounting methodology. That is, how accrual is carried out is not fixed but is at the discretion of the legislature and governor. So there can be cosmetic adjustments to affect public perceptions of the fiscal situation. Moreover, it would be helpful if the state would undertake to publish a reconciliation of its cash and accrual accounts. California makes no effort to do so, however. Thus, a key element of that overused word – transparency – is missing from the state’s accounts.

California also is rather loose with regard to the terminology used to describe what is happening in its fiscal affairs. Up to this point in this chapter, we have used the word “deficit” to mean a situation in which the inflow of funds is less than the outflow. We have used “surplus” to mean the reverse. This usage is consistent with common English parlance and with the use of those terms at the federal level. In short, surplus and deficit are terms that describe *flows* of funds during a specified time period, typically a fiscal year. We have used the term “reserve” in this chapter to refer to stocks rather than flows, i.e., to a snapshot of how much is in an account such as the general fund on a particular date, especially the date of the end of the fiscal year, June 30 (which is the same as the level in the account at the beginning of the next year, July 1).

In contrast to our descriptive approach, California officials often use vague terms such as budget shortfall, budget gap, or even budget hole during fiscal crises and even in good times. But such terms can mix stocks and flows. In particular, a budget may be deemed to be in balance, or even in surplus, as

long as some money is projected to be left in the reserve at the end of the fiscal year. That is, outflows can be greater than inflows and yet the situation might be described as a surplus or in balance as long as some money is left in the till at the end.

The problem is that describing such a situation in reassuring terms is misleading. If you keep drawing down your checking account (outflow > inflow), you know that the situation cannot persist since you will eventually run out of money. Corrective action is needed before the account goes to zero or less. If you wait until the last penny is gone, you will have a crisis; your checks will bounce or you will have to borrow more and more to cover them. So you don't want to describe outflow > inflow with terminology which suggests that all is well. What is true for you as an individual is – or should be – true for the state.

As it happens, the governor's budget for 2014-15 provides a perfect example of this problem. Figure 1 reproduces a chart from that budget. You find the words shortfall, deficit, and balance all used in ambiguous ways on that chart. Note that the negative bar on Figure 1 for 2009-10 is around -\$40 billion. Ask yourself, could a budget in the neighborhood of \$100 billion annually actually run a deficit of that amount, if "deficit" is used in its standard English meaning? And if such a deficit did arise, would anyone in practice be able to fix it? Surely, the answer to both questions is "no."

The problem is even more egregious than the chart shows. At the time, i.e., in 2009-10, there was a tendency to sum the prior two bars with the -\$40 billion and to talk about a deficit of around -\$60 billion. If a -\$40 billion deficit is implausible – at least in common English usage – think about the added implausibility of -\$60 billion! Such looseness in terminology clouds understanding of the budget problem. How many term-limited legislators, do you suppose, actually understood what the budget situation was back then? For that matter, how many understand it now?

The Making of the 2014-15 Budget: A Numerical View

"Given the vagaries of the business cycle, and particularly the volatility of capital gains income, we must be ever vigilant in the commitment of public funds."

Governor Jerry Brown's cover letter
to his January 2014 budget proposal²⁰

Problematic as Sacramento's accounting practices may be, as noted above, the numbers that the legislature and governor look at in enacting a budget are on an accrual basis (as they define it). So we will use the official accrual figures in what follows, keeping in mind that they cannot be – or at least aren't – reconciled with the cash numbers. Table 4 shows the numerical history of the 2014-15 budget as it was presented to the legislature using accrual methodology. We will first look at those official numbers and then look at the events that surrounded the making of that budget. Recall, however, that budget making is an incremental process.

²⁰Governor's Budget Summary 2014-15, January 10, 2014. Available at http://www.dof.ca.gov/documents/FullBudgetSummary_2014.pdf.

Each annual budget is really an adjustment to what happened in the prior year(s). Over time, the state has established various programs that are ongoing commitments as a practical matter. No budget starts from scratch. Thus, the story of the 2014-15 budget really started well before that budget began to be put together. And the budget story goes on into the indefinite future. Perhaps it is more correct to say that we will be looking at the year leading up to the enactment of the 2014-15 budget, a somewhat arbitrary time period but one which begins where the 2014 budget chapter for *California Policy Options* left off.

The 2014-15 budget cycle is shown on Table 4. It is made more complicated than usual by Governor Brown's proposal for a rainy-day fund, essentially an implementation of an idea that began under Governor Schwarzenegger but was never really put into effect. As we have noted, the general fund has a "natural" reserve, just like your checking account. If you continually spend less than you put in, the balance in your checking account (and the reserve in the general fund) becomes bigger. Whatever you accumulate is available for a rainy day. Put another way, there is already a *de facto* rainy-day fund inherent in the normal budgetary arrangements. You don't need a formal rainy-day fund to have an informal rainy-day fund.

However, the Schwarzenegger-Brown idea was to create another separate fund to hold some of the reserve. By formula, a certain amount would be put away in good times for use in periods of hard times. Note, therefore, there is nothing that happens under an explicit, formula-driven separate rainy-day fund that couldn't happen without it. For example, when Earl Warren was governor in the 1940s and early 1950s, he had a policy of building up the (ordinary) reserve and referred to the accumulated reserve as a rainy-day fund, even though there was no mandatory formula or separate account.

The idea, therefore, of a rainy-day fund of the Schwarzenegger-Brown variety is that if it is enshrined by law into fiscal affairs of the state, it is more likely that monies will in fact be put aside. Brown proposed that a constitutional amendment be provided to the electorate in November 2014 that would establish the mandate and formula. Since that date is after the writing of this chapter, we cannot know for sure whether voters will approve it. But since saving for a rainy day sounds like a good idea, and since Brown is currently popular and likely to be reelected, it is also likely that his rainy-day fund will be enacted by voters. In any event, it is built into the 2014-15 budget as an assumption.

A complication arises because, as a technical matter, diverting money into the rainy-day fund, i.e., transferring it from the general fund to the rainy-day fund, is treated as a diversion in the official budget accounts. But that is not a good way to think of accumulating money.²¹ Officially, the revenue that would otherwise go into the general fund doesn't arrive there but instead goes directly into the rainy-day fund. Hence, on Table 4 we present the general fund as the accounts have it and then adjust the

²¹As noted earlier, it is unclear whether or not the cash flow statement that accompanies the budget diverts the rainy-day fund deposit from receipts. The text here refers to the official accrual presentation of the budget.
Chapter for *California Policy Options 2015*: August 22, 2014

numbers so that putting money into the rainy-day fund is treated in the same way as any reserve accumulation. That is, we include the diverted revenue as a receipt of the general fund and sum together the regular reserve and the rainy-day fund.

Typically, the annual budget cycle starts not with the governor but with the Legislative Analyst's Office (LAO). The LAO is a non-partisan arm of the legislature that provides the legislature with a neutral analysis of various policies including the budget. Its history goes back to the early 1940s when the legislature felt at a disadvantage to the governor because it lacked an analytic capacity. Standard practice is that the LAO in November comes up with a current services budget estimate. The estimate assumes that no changes in fiscal policy are made on the tax side or the spending side, and so the budget just continues "as is." Of course, there are likely to be changes. So the current services budget is simply a base to which changes can be applied.

Table 4 shows the LAO's estimate in the left-hand column. It includes no rainy-day fund since that would be a change in policy and because Brown did not unveil the specifics of his plan for such a fund until after the LAO reported. Any increase or decrease in the general fund shows up in the reserve. The LAO estimated that the 2014-15 reserve on July 1, 2014 would be \$3.1 billion. The net of receipts and outflows would be a surplus of \$3.3 billion. If that were to occur, by the end of the 2014-15 fiscal year, the reserve would have risen to \$6.4 billion ($\$3.1 + \$3.3 = \6.4). Put another way, if nothing were done by the legislature and the budget was left on auto pilot, the existing reserve would more than double.

The governor released his initial budget which included an explicit rainy-day fund as well as the ordinary reserve in early January 2014. Note first that although his budget came later than the LAO's estimate, both the LAO and the governor's Department of Finance had to be looking at the same economic background. Thus, the fact that his starting reserve for the 2014-15 fiscal year (July 1, 2014) was \$4.2 billion rather than the LAO's \$3.1 billion had to mean one of two things (or a combination of both). It had to mean that either there was some change in accounting methodology by the governor, or there was more optimism about how the economy would perform during the second half of the fiscal year.

As for the fiscal year itself, the governor assumed less revenue would come in than did the LAO. Since there were no major changes proposed on the tax side, the governor was shifting to a more conservative (pessimistic) estimate than the LAO on receipts. On the spending side, he assumed more expenditures than the LAO's current services estimate. So either there would be policy changes that would raise spending, or he was assuming that current services would simply cost more than the LAO had projected. With the removal of the deposit into the rainy-day fund from the spending level, whereas the LAO had assumed spending of \$104.4 billion, the governor assumed \$106.2 billion.

If you spend more than you take in during the course of a year, the money you have left "in the bank" will decline. The "bank" at the beginning of the 2014-15 fiscal year was just the ordinary reserve which

– as noted – the governor assumed would be \$4.2 billion.²² The bank at the end of the fiscal year (during which voters were assumed to enact an explicit rainy-day fund) consisted of the ordinary reserve (\$1.9 billion) and the new rainy-day fund (\$1.6 billion). So there would be a drop in total reserves (ordinary reserve + rainy-day fund) to \$3.5 billion. That is, the governor was proposing a deficit in the 2014-15 budget of -\$0.7 billion, at least on paper, when saving in the rainy-day fund is added back in.

Did the governor really expect a deficit? It appears that he likes to make a conservative revenue estimate as a way of constraining the legislature. Brown assumes that if the legislature is told by him that there will be less money available than the LAO projects, the legislature will be more frugal. It therefore will be “surprised” to find that by year’s end there is in fact more in the bank than had been forecast. So maybe instead of the small deficit, he really had in mind a small surplus. Either way, there wouldn’t be much of a cushion in the regular reserve plus rainy-day fund if there was a downturn of the economy or some other emergency.²³

Figure 1 gives some idea of the precarious nature of the budget by using historical data from Brown’s first iteration as governor. By 1977-78, he had built up the reserve to roughly a third of general fund spending, a huge amount. But then Prop 13 came along, and local governments and school districts had to be bailed out by the state. The reserve fell almost in half.

At that point, the U.S. economy went into a double-dip recession. In three years, a reserve far in excess of anything recently proposed disappeared and went negative the following year. The resulting budget crisis was left to Brown’s successor, Republican George Deukmejian, to resolve. One point, not shown on the chart, is that budgetary volatility in California is now greater than it was back then due to greater present-day state dependency on the income tax and capital gains taxation.²⁴ Therefore, a given percentage in reserves relative to general fund spending now is less protective than the same percentage would have been in the past.

So much for the distant past. As noted earlier, California has a tradition of the governor submitting a May Revise budget which reflects updated forecasts and political developments. The May Revise typically is close to the final budget. The legislature adjusts it incrementally in a negotiation with the governor, but drastic changes are generally not made. In May 2014, the revised budget assumed a somewhat lower starting reserve than in January of \$3.9 billion. Spending was up a bit, and revenue was, too. On net, however, the deficit adjusted for the contribution to the rainy-day fund was about

²²As Table 4 notes, an error was later found by the Legislative Analyst in this estimate. We retain the original numbers to be consistent with the official document.

²³A year earlier, the credit rating agency Standard & Poor’s had criticized the practice in California of political adjustment of revenue assumptions in budgeting. Obviously, that practice continues.

²⁴The state sales tax omits services which causes receipts to grow more slowly than the overall economy as consumers spend more of their incomes on services. See California Legislative Analyst’s Office, “Why Have Sales Taxes Grown Slower Than the Economy?,” August 5, 2013. Available at <http://www.lao.ca.gov/reports/2013/tax/sales-tax/sales-tax-080513.pdf>.

what it was before (\$0.8 billion instead of \$0.7 billion). But with starting reserves a bit lower, so, too, were ending total reserves.

After negotiations with the governor, the legislature produced an on-time budget only marginally different from the May Revise. The governor made minor cuts with his line-item vetoes and the final budget took effect. With a deficit adjusted for the assumed rainy-day fund, total reserves were projected to fall from \$3.9 billion at the beginning of the fiscal year to \$3.0 billion by June 30, 2015. Not much of a cushion and a falling one at that! And this development is occurring during an economic recovery when the reverse should be happening! The total reserve (regular plus rainy-day) should be rising.

What about the more distant future? The final budget includes estimates of total reserves (ordinary reserve + rainy-day fund) out to 2017-18 that can be seen on Figure 3. These estimates assume no economic downturn occurs over the period shown. Thus, they assume nine years of no recession since the Great Recession ended in 2009, and the economy began its recovery. Such a scenario is not impossible but it would be unusual. In the 1990s, we had a record period from 1991 to 2001 of continuous expansion. So the chart's assumed recovery is pushing towards a long-term record. Nonetheless, even if we have an uninterrupted expansion to 2018, total reserves (ordinary reserves + rainy-day fund) would be only five percent of budget spending, a level that could quickly disappear in any downturn thereafter.

Events and Issues Rather than Numbers: Summer-Fall 2013

...(T)hat's something that interests me, to try to understand ... to get a real world feel of what's under my responsibility..."

Governor Brown saying he was planning to tour California²⁵

So far, we have traced the development of the 2014-15 budget numerically. But there had to be a political decision process that – in conjunction with economic trends – produced those numbers. So let us trace some of the highlights in the year leading up to its enactment.

Around the time that a budget is being enacted, Sacramento's attention becomes more and more focused on fiscal affairs. After the legislature passes a budget, there is a bit of suspense over what the governor might line-item veto. However, because Governor Brown negotiates deals with the legislative leaders, he doesn't veto much.²⁶ With only a simple majority needed to pass a budget, and with

²⁵"Jerry Brown seeking 'real world feel' of government," CapitolAlert blog of *Sacramento Bee*, October 2, 2014. Available at <http://blogs.sacbee.com/capitolalert/latest/2013/10/jerry-brown-seeking-real-world-feel-of-government.html>.

²⁶One oddity was that he vetoed an earmark he had insisted on of \$10 million for online education at UC after having gotten pledges from the UC administration to spend the money for that purpose without a mandate to do Chapter for *California Policy Options 2015*: August 22, 2014

Republicans largely cut out of the process, the deal is more or less the final product although there may be some minor gubernatorial trimming.

Prisons and Realignment

"Dangerous prisoners that belong in state prison continue to be released early, time and time again, to return to our communities and endanger our families and friends."

Fontana Police Chief Rod Jones²⁷

Nonetheless, once a final budget is in place, vetoes and all, other fiscal issues surface or re-surface. And there is often some summer follow up on the enacted budget. In particular, after the 2013-14 budget was signed, there remained longer term issues such as prison realignment – the shift of prison inmates to county jails – largely due to court decisions related to overcrowding. A blip up in crime rates raised the issue of whether realignment was at fault.²⁸ The state tried, without much success, to persuade the courts to delay implementation of mandates to reduce overcrowding of prisons. And the governor and the state senate president differed on the latter's plan to craft some kind of legislative compromise that might be seen favorably by the courts.

If there had been a substantial chance that Republicans could beat Brown in his (presumed) bid for re-election in 2014, there might have been more heard about realignment and its alleged potential for raising crime rates. There were in fact three candidates or assumed candidates on the GOP side for governor by the summer of 2013. One was Abel Maldonado, the former Lieutenant Governor. He *did* talk about realignment but his candidacy went nowhere, and he eventually dropped out. That left Tim Donnelly, a "tea party" state assembly representative whom establishment Republicans were anxious not to have at the head of the ticket.²⁹ And there was Neel Kashkari, a relatively unknown former U.S.

so. UC also dropped a plan to raise tuition for most graduate students, apparently on the ground that the legislature and governor were opposed.

²⁷Quoted in Phil Willon, "Gov. Jerry Brown's prison program blamed in fatal stabbing," *Los Angeles Times*, April 9, 2013. Available at <http://articles.latimes.com/2013/apr/09/local/la-me-fontana-slaying-20130410>.

²⁸In principle, the state was supposed to be pushing the least dangerous prisoners to county jails. But where such jails were themselves at capacity, the result was a release of persons who otherwise would have been occupying county jails back on to the streets. Apart from issues regarding moves of prisoners to county jails, there were problems in the state prisons beyond overcrowding. For example, it was found that female prisoners had been subject to tubal ligations (sterilization) improperly. In two prisons, a court ordered a movement of prisoners to other facilities due to exposure to valley fever. Cases of valley fever led to litigation and claims against the state. During the summer of 2013, there was also a hunger strike in some prisons protesting the use of solitary confinement as a disciplinary device. At one point, a UN human rights investigation was threatened. Meanwhile, at the local level, although counties complained about overcrowding and early releases, none of them had completed construction of new jails despite funding for that purpose provided by the legislature in 2007.

²⁹Donnelly was associated with the anti-illegal immigration Minuteman movement and so potentially would reinforce problems the Republicans have had with Latino voters in California. At one point in his campaign, he toyed with pushing for recall of some Latino legislators. On the other hand, there could be intolerance on the anti-Donnelly side. For example, when a Latina actress endorsed Donnelly in a YouTube video, she was ostracized and

Chapter for *California Policy Options 2015*: August 22, 2014

Treasury official under President George W. Bush and an administrator of the federal TARP bailout program during the Great Recession. Kashkari at the time – compared with Brown - lacked sufficient resources to put out a message that would attract substantial voter attention.³⁰

Transportation

“I would take the (high-speed rail) dollars and redirect it [sic] to other, more pressing infrastructure needs, and I am not the only Democrat that feels this way.”

Lieutenant Governor Gavin Newsom announcing opposition to Governor Brown’s high speed rail project³¹

Governor Brown’s push to create a high-speed rail service between southern California and the Bay Area continued to create resistance. His Republican gubernatorial election opponent Neel Kashkari referred to it repeatedly as the “crazy train.”³² Both of these issues – prisoner realignment and high-speed rail - had budget connections, apart from their implications for crime control and transportation policies. Although prisoner realignment was largely court driven, the official rationale was that it was best to leave matters to local governments whenever possible, a concept for the policy which the governor termed “subsidiarity.” But other aspects of policy pulled in the reverse direction, i.e., toward central control.

The high-speed rail project was a state effort despite the complaints of the lieutenant governor and others that transportation money should go to local transit rather than for long-distance intercity travel. There was also local resistance to high-speed rail in the Central Valley even though construction there – if nothing else – would create needed jobs.³³ Freight railroads were concerned that the project – which in part was to use their corridors (although not their tracks) – would interfere with their operations.

lost a part. Nonetheless, establishment Republicans saw Donnelly as a loose cannon who could embarrass the party, even in out-of-state races, and wanted someone with a more moderate image to head the ticket.

³⁰Former Republican minority leader in the state senate, Jim Brulte, had been made chair of the California Republican Party with the seeming agenda of removing tea party control. He created a stir by accepting some donations from public sector unions. His placement as head of the party suggested that of the three GOP candidates, establishment Republicans would not support Donnelly (which is what happened).

³¹Quoted in “Newsom Changes Mind On High-Speed Rail, Wants Money Redirected,” *CBS San Francisco*, February 14, 2014. Available at <http://sanfrancisco.cbslocal.com/2014/02/14/newsom-changes-mind-on-high-speed-rail-wants-money-redirected/>.

³²“Neel Kashkari hits California Gov. Jerry Brown on 'crazy train,’” CapitolAlert blog of *Sacramento Bee*, January 28, 2014. Available at <http://blogs.sacbee.com/capitolalert/latest/2014/01/neel-kashkari-hits-california-gov-jerry-brown-on-crazy-train.html>.

³³Republicans generally opposed the project on the grounds that it was unneeded and likely to cost more than the \$68 billion official estimate, as large infrastructure projects often do. See Bent Flyvbjerg, Massimo Garbuio, and Dan Lovo, “Delusion and Deception in Large Infrastructure Projects,” *California Management Review*, vol. 51, no. 2 (Winter 2009), pp. 170-193. Democrats were more likely to make the argument that funding should go to local transportation. As will be seen below, ultimately the high-speed rail’s requirement for state funding gave Democrats in the legislature some negotiating room with the governor.

And in the Bay Area, some locals opposed a specific segment of the proposed route. Meanwhile, the project seemed to see-saw between favorable and unfavorable court rulings.³⁴ Still some preparatory work got under way during the summer of 2014, although no track was laid and, in fact, acquiring the initial Central Valley right-of-way had yet to be accomplished.

Local transit became embroiled with a dispute with the federal government involving labor relations and pension issues. Brown had entered the governorship in 2011 pledging to come up with a plan to deal with unfunded liabilities in public-sector pensions. Eventually, a bill was passed that reduced benefits for new hires and made other money-saving changes.³⁵ Federal law, however, required such matters to be negotiated with unions rather than imposed. After threats by the feds to withhold funding for local transit operations, the legislature produced a bill providing a transit exemption.

The Bridge

“To be sure, some of the longest delays were not the fault of the bridge builders. Rather, they were the product of political infighting at the very highest levels of California state government.”

Legislative report on Bay Bridge deficiencies³⁶

The Bay Area, incidentally, was home to another project that seemed local but in fact was being administered by the state, the replacement of the Bay Bridge. That project was beset by a seemingly endless procession of defective components and poor administrative oversight by CalTrans. There were also allegations of suppression of engineer/whistleblowers within the agency who pointed to deficiencies.

For a time, it appeared that the new bridge segment would not open by Labor Day 2014, although eventually it did, defective or not. The governor managed to be out of town for the opening ceremony and left it to the lieutenant governor to do the honors. He also opposed a Bay Area movement to name the bridge after former assembly speaker and mayor of San Francisco, Willie Brown. But eventually, the

³⁴One issue was whether the proposed system – or at least its initial segment which was slated just to run within the Central Valley – met the requirements of a voter-approved bond issue for a high-speed rail. But aside from the legal issues, there were concerns about management of the project such as the high cost of consultant fees.

³⁵Various ballot initiatives on the pension issue have been submitted although none has gotten to the ballot at the state level. Noteworthy during the 2013-14 fiscal year was an initiative sponsored by maverick San Jose Mayor Chris Reed. Ultimately, he could not develop enough support to put the initiative on the ballot in 2014. Whether such support might be developed for 2016 is unknown at this writing. Although he is a Democrat, Reed supported the Republican candidate for state controller in 2014.

³⁶Quoted in Dan Walters, “Political hubris plagues Bay Bridge, other big public projects,” *Sacramento Bee*, August 5, 2014. Walters points out that a relatively modest structure that had been planned by the state was upgraded to a more complex (an aesthetically appealing) design at the insistence of local political figures.

bridge was so named. The bridge's problems raised doubts about how well the high-speed rail would be constructed if done by the state.³⁷

Local Development

"The self-financing nature of these agencies worked fine when the goal was to make over "blighted" areas in postwar urban cores and to build affordable housing. But after voters adopted Proposition 13 property tax limits in 1978, cities and their redevelopment agencies became increasingly aggressive in establishing project areas and discovering "blight." What better way, after all, to cling to scarcer tax dollars than by setting up a mechanism that kept more of those dollars at home instead of in Sacramento?"

Editorial in the *Los Angeles Times*³⁸

In an earlier budget cycle, the state had abolished local redevelopment agencies – officially because they were judged to be inefficient but in fact because they were seen as diverting property tax revenue from school districts which the state then had to backfill under Prop 98.³⁹ As part of the 2013-14 budget cycle, another local development tool – the enterprise zone – was ended because the zones diverted tax revenue from the state.⁴⁰ About a billion dollars per annum was expected to be saved by the state once the zones were fully phased out.

However, phasing out proved to be difficult. Projects could not be stopped that were already underway, so some means of continuing what was in the pipeline had to be created. Local governments rushed to put projects in the pipeline during the transition period and then fell into disputes with the state over which projects were truly underway.

Nonetheless, there were periodic efforts to re-establish some version of redevelopment and of enterprise zones, none of which have succeeded as of this writing. What was offered to replace the

³⁷The state has also had costly problems with developing large computer systems for such purposes as handling state payrolls, keeping track of fair housing complaints, and processing unemployment insurance claims. Such efforts have been beset with well-publicized failures.

³⁸"California redevelopment agencies, the sequel," *Los Angeles Times*, September 22, 2013. Available at <http://articles.latimes.com/2013/sep/22/opinion/la-ed-redevelopment-20130922>.

³⁹The saga of redevelopment involved an earlier budget compromise while the redevelopment agencies chose to litigate the deal. The end result, however, was a court decision which killed redevelopment. Had the agencies not gone the legal route and had just accepted the political compromise, they would still be in business.

⁴⁰Redevelopment agencies were largely funded through a diversion of incremental property tax revenue. The agencies would coordinate and provide funding for a redevelopment project. The project would raise property values in the affected area, and the extra property tax revenue would then go to the agency to repay loans used for the redevelopment projects. Thus, whether the property tax that went to the agency was a diversion from the state, or whether it was revenue that would not have existed absent the redevelopment, was debatable. In any case, the agencies were abolished. Enterprise zones promised preferential tax treatment to firms that set up businesses in the defined zones. So they directly cost the state money. Generally, research has not found the zones to be especially effective in job creation. They tended to shift activity from one area to another rather than create new jobs in total.

zones was in part a system that created a state pool state tax credits (slush fund?) that could be handed out to firms seen as potential job creators or preservers. It was not clear that replacing local discretion in creating enterprise zones with discretionary subsidies to politically-connected or politically-appealing firms at the state level was a net improvement.

Education

“Instead of prescriptive commands issued from headquarters here in Sacramento, more general goals have been established for each local school to attain, each in its own way. This puts the responsibility where it has to be: In the classroom and at the local district. With six million students, there is no way the state can micromanage teaching and learning in all the schools from El Centro to Eureka – and we should not even try!”

Governor Jerry Brown, 2014 State of the State address⁴¹

Another issue that the budget created - and which required subsequent attention after the 2013-14 budget enactment - was a revision of funding for K-12 known as the Local Control Funding Formula. Traditionally, school districts had been funded on the basis of average daily attendance. In addition, special programs were sometimes added for disadvantaged students. Governor Brown had proposed that the payment per pupil should vary with the level of student disadvantage, a concept that was enacted as part of the budget process.

This concept was generally endorsed by school reformers. However, implementing a concept requires specific funding formulas. Moreover, some school districts would benefit and others would lose – especially over time – under the new approach, making implementation a contentious process.⁴² Apart from the new formula, the state was also in a dispute with the federal government regarding teacher testing. The dispute could in theory have resulted in significant lost federal funding. In practice, the feds have tended to back down when in conflict with the largest state. But it was unclear at the time whether California would receive another dispensation (although it eventually did).⁴³

Community colleges are operated by local districts with some state supervision. Their funding is included in the Prop 98 formulas which cover K-14, not just K-12. Nonetheless, community colleges are definitely the neglected afterthought when it comes to Prop 98 monies. Yet they are increasingly being pushed to be the money-saving solution to the cost of higher education. Students can attend community college at modest cost – community college tuition in California tends to be low compared with other states - and then transfer to four-year institutions for the remainder of their college

⁴¹Delivered January 22, 2014. Available at <http://gov.ca.gov/news.php?id=18373>.

⁴²See Legislative Analyst’s Office, *An Overview of the Local Control Formula*, updated December 2013. Available at <http://www.lao.ca.gov/reports/2013/edu/lcff/lcff-072913.pdf>.

⁴³The state produced its own new test of student achievement that was to be administered through a computer system. After a federal dispensation was received, the actual administering of the test was hindered by computer glitches.

educations. Community colleges are also seen as providers of vocational education for students who are not focused on four-year bachelor's degrees.

Despite these goals, the community colleges experienced substantial cutbacks during the Great Recession and its aftermath. The number of classes offered was limited for budget reasons, thus preventing students from advancing. Some colleges experimented with offering more sections of key courses at higher tuition. The idea was that some students would pay to take the additional sections and their enrollment in the extra sections would open up more slots in the regular sections for those who couldn't pay or didn't want to pay. Initially, these experiments were shut down. But the legislature began to consider authorizing such differential tuition schemes for some community colleges during the summer of 2013 and the bill was eventually signed into law.

At the UC and CSU levels, apart from encouragement of transfers from community colleges, there was more rhetoric than solutions for rising tuition. In effect, tuition at both systems was frozen, at least for a year or so, in deference to what the governor considered an implicit promise to the electorate when Prop 30 was passed. But other than requirements for data and "performance" measures (such as time to graduation), the main thing demanded was more online education.⁴⁴ The chief driver in recent boosts in tuition was cutbacks in state support during the Great Recession and its aftermath. On a longer term basis, the 1960 Master Plan's promise of free tuition had long before been eclipsed by diversion of funds to other state priorities. Back in 1960, for example, there was no Medi-Cal program.

Local Fiscal Distress

"A well-managed bankruptcy is how we'll get on firm footing for not just the next year but the next 20."

San Bernardino Mayor Carey Davis⁴⁵

Apart from redevelopment concerns, city governments also had fiscal issues. The Great Recession had adversely affected local governments as well as the state. But the state tended to squeeze the locals to deal with its own fiscal problems. One recently-created small city actually announced it would disincorporate after expected revenue was removed by state action.⁴⁶ Moreover, some locals in the high mortgage foreclosure areas of the state were disproportionately affected as property taxes and other revenue declined. Thus, while the perception at the state level was one of fiscal recovery, Stockton and

⁴⁴California's Little Hoover Commission was a supporter of performance measures. See its report, "A New Plan for a New Economy: Reimagining Higher Education," October 2013. Available at <http://www.lhc.ca.gov/studies/218/Report%20218.pdf>. But the idea was also percolating down from the federal government which wanted to rate higher education institutions.

⁴⁵Quoted in Ryan Hagen, "San Bernardino's bankruptcy reaches two-year mark, quietly," *San Bernardino Sun*, July 31, 2014. Available at <http://www.sbsun.com/government-and-politics/20140731/san-bernardinis-bankruptcy-reaches-two-year-mark-quietly>.

⁴⁶The city was Jurupa Valley in Riverside County.

San Bernardino were in formal bankruptcy proceedings.⁴⁷ Rialto and Adelanto declared fiscal emergencies.

No one at the state level was offering special assistance to these stricken cities although in the case of San Bernardino, the city's suspension of its payments to CalPERS, the large state-run pension plan, threatened to undermine the state's funding model for that program.⁴⁸ In the Stockton case, one of the city's creditors was litigating over the refusal of the local government there to cut pensions. Again, that position – if upheld – could undermine CalPERS.⁴⁹ (Carson and Sacramento's fire district did receive a legislative dispensation to cut CalPERS retiree health benefits, not pensions, pursuant to concessions negotiated with local labor unions.)

Local complaints about Sacramento showed up in some northern California counties as a move to secede from the state. This idea had surfaced as early as the 1940s, when there was a move to create a "State of Jefferson" out of some northern California and southern Oregon rural counties. The complaints this time ultimately morphed into a proposition (that at this writing is undergoing a petition vote count). It was financed by a billionaire - who apparently couldn't think of anything better to do with his money – and would divide California into six new states.⁵⁰

Local governments in California were dependent in varying degrees on property taxes when Prop 13 came along in 1978. Under Prop 13, property is reassessed to market value only when it changes hands. For residential homes, the point of changing hands is obvious; it is the sale of the home to another owner.

For businesses, however, exactly when and if property changes hands is obscured by corporate ownership. Deals can be constructed so that ownership effectively changes, but the corporate entity that owns the property for legal purposes is unchanged. From time to time, this issue is spotlighted by particular commercial transactions that attract public attention. Usually, there are calls for some type of "split roll" system that would treat commercial property differently from residential. A constitutional amendment would be required to establish a split roll system.

⁴⁷Municipal fiscal distress could lead to local political turmoil. In San Bernardino, there was public anger at the city council and a move to recall some members.

⁴⁸It has generally been thought that CalPERS had the authority to obtain the pension contributions it specified and that local governments could not refuse to pay, even in bankruptcy.

⁴⁹Some local governments, notably the City of Bell, had produced outsized pensions due either to pension "spiking" (artificial inflation of final salaries) or just outrageously high salaries. As these cases came to light, CalPERS in some cases reduced the pensions. Bell's city manager ultimately went to jail for illegally inflating his salary and those of other officials. Other officials were also prosecuted.

⁵⁰It appears too late at this writing for the initiative to appear on the ballot in November 2014, but – if enough signatures are found valid - the initiative could appear in November 2016. In southern California, Orange County has been involved in a dispute with the state regarding property taxes that goes back to the County's bankruptcy in the mid-1990s, after it speculated in financial "derivatives" markets. Since that time, the County has periodically pushed to correct what it sees as an inequity. But it hasn't pushed for secession from the state!

There were some real estate transactions that focused attention on the issue in summer 2013. Eventually, a tentative deal among key interest groups was made to redefine by legislation what changing hands in the commercial sector would involve, averting a possible push for a full-fledged split roll. But the deal fell apart before the legislation could be adopted, and at this writing no subsequent deal has been reached.

State Finances

“Schwarzenegger said he was sorry that most of (his latest) movie was being filmed in New Orleans, but that’s where the tax credits are these days.”

Willie Brown’s weekly column⁵¹

There were also aftershocks of the Great Recession for the state. It lost a court case regarding cuts made in the Medi-Cal (Medicaid) program in 2009 affecting rural areas. Enrollment in Medi-Cal was slated to increase under the federal Affordable Care Act (“Obamacare”). Indeed, at this writing there are some estimates that three out of ten Californians will eventually be under Medi-Cal. But in the summer of 2013, questions were just beginning to be raised about how well the state could manage its health insurance exchange, Covered California.

As it turned out, compared to the fiasco that developed initially at the federal level in creating an exchange for states that refused to create their own, California’s problems with Covered California were dwarfed.⁵² Nonetheless, there were problems in such areas as getting information to Medi-Cal about those who signed up under Covered California. In addition, low Medi-Cal reimbursement rates meant that many doctors won’t take Medi-Cal patients, so that access to care can be limited.⁵³

Furloughs of state employees undertaken during the Schwarzenegger period had ended but there was still some residual litigation surrounding those actions. There was also litigation over a fire-fighting fee the state imposed as a budgetary measure in certain rural areas where the state provides protection.⁵⁴ CalFire became involved in a controversy over a “secret fund” that apparently had diverted \$3.7 million to an off-books nonprofit entity. And there was litigation over a plan developed by the Schwarzenegger administration but cancelled by Brown that would have sold off state office buildings and then leased them back. In essence, the plan was a (very costly) indirect way of borrowing. But some investors who were going to buy the buildings wanted to force the state to make the cancelled sale.

⁵¹ Willie Brown, “Schwarzenegger hasn’t terminated action-hero career,” *San Francisco Chronicle*, August 2, 2014. Available at <http://www.sfgate.com/bayarea/williesworld/article/Schwarzenegger-hasn-t-terminated-action-hero-5664866.php>. Willie Brown is the former mayor of San Francisco and state assembly speaker.

⁵² The federally-created website essentially failed to operate when it was put online.

⁵³ “Why Medi-Cal sign-ups crashed,” *Orange County Register*, June 4, 2014. Available at <http://www.ocregister.com/articles/cal-616819-medi-says.html>.

⁵⁴ The fee is indexed to inflation so that it rises periodically, thus automatically engendering renewed opposition.

The state is constitutionally required to provide funding to local governments for functions it mandates they carry out.⁵⁵ During the budget crisis and its aftermath, the legislature looked for mandates to eliminate. Basically, it sought functions that it thought local governments would continue to carry out at their own expense, even if the state mandate ceased. One of these functions was providing public documents under the state's equivalent of the federal Freedom of Information Act.

When the legislature tentatively revoked this mandate, there was a public outcry. How could you be sure the locals would continue to provide documents? To still the protests, the legislature put on the ballot a constitutional amendment that effectively would mandate local provision of public documents but without state money to do so. The proposition eventually appeared on the June 2014 ballot and was approved. It is unlikely that voters understood that they were approving an exception to the general rule that the state must pay for what it mandates.

Environment

"California can't keep pushing a climate change agenda if more states and countries don't do the same thing. You can't do a carbon price all by yourself forever."

Governor Jerry Brown⁵⁶

There were elements of policy that would become, or could become, important in the future. California has a greenhouse gas reduction policy that began in the Schwarzenegger period and includes a mechanism known as "cap-and-trade." In a sense, greenhouse gas cap-and-trade programs set a market price on carbon emissions. Cap-and-trade sets a maximum amount of allowable greenhouse gas emissions which declines over time. Businesses that emit greenhouse gas must buy permits allowing specified amounts of emission. They can buy them from businesses that undertake "green" technologies that reduce emissions.

The state also sells permits and thus receives revenue from the program which is earmarked for green uses. Despite Brown's sometime skepticism about the program – see the quote above - this revenue became relevant as part of the funding mechanism for the high-speed rail project. But in the summer of 2013, the ability of the state to run a cap-and-trade program was being challenged in court although permission to go ahead with the plan was eventually granted.

Governor Brown signed a bill regulating – but nevertheless permitting – "fracking" in oil production.⁵⁷ California is a significant oil producing state. In the early 20th century, it was the home of an oil boom.

⁵⁵The requirement to reimburse locals is part of Prop 4 of 1979.

⁵⁶Quoted in David Siders, "In private meetings with Carlos Slim, others, Jerry Brown encounters a 'more critical' Mexico," *Sacramento Bee*, July 30, 2014. Available at <http://www.sacbee.com/2014/07/30/6594343/in-private-meetings-with-carlos.html>.

There were prospects of a second early 21st century oil boom held out by proponents of fracking. Oil production could conceivably become a source of state finance if taxed, which might make up for loss of revenue when the Prop 30 temporary tax increases expire.⁵⁸

The difficulty is always that although environmental protections are popular in California, paying in one way or another for such protections is not so popular. It's great to limit greenhouse gas emissions but not if gasoline prices rise (a likely effect of cap-and-trade). Water should be cleaned up and protected but not if taxes or water bills rise. Caught up in such contradictions, political decision-makers tend to choose middle paths, e.g., regulate fracking but don't kill it and its potential to general revenue and jobs.

Water

"Whiskey is for drinking; water is for fighting over."

Quote often attributed to Mark Twain⁵⁹

There had been plans going back to the Schwarzenegger era to put a water bond on the ballot. But the bond had been repeatedly delayed when legislators felt it would not be enacted due to the fiscal crisis brought on by the Great Recession and because earlier versions contained controversial "pork." California's water issues were compounded by drought conditions that became more and more noticeable by 2013-14. During Brown's first iteration as governor, he had endorsed a "peripheral canal" project in northern California. The project failed at the polls due to its depiction in the north as a water-steal by the south and by lack of sufficient enthusiasm in the south to overcome northern opposition.

This time around, instead of a canal there were to be twin tunnels. Although plans had been known for some time, Brown did not become specific about the proposal until late 2013. The tunnels were said to be for environmental benefits, however, and did not directly address the drought issue. As in the case of other issues, water is polarizing and not just on north-vs.-south lines. Republicans like dams – although euphemisms such as water storage facilities are used. Democrats seem not to like dams which are seen as anti-environment.

Apart from ideology, for any deal on water bonds to be successful, there needed to be complicated negotiations between environmentalists, farm interests (roughly 80 percent of the surface water supply

⁵⁷Fracking involves injection of liquids at high pressure underground to force out oil. There have been concerns that the practice could contaminate groundwater and stimulate earthquakes.

⁵⁸Tom Steyer, a wealthy businessman who has environmental leanings has said he plans to push for an oil extraction tax, presumably via legislation or initiative. Steyer successfully sponsored Prop 39 in 2012 which was aimed at taxation of out-of-state corporations. Various oil tax initiatives have been proposed, but without financial backing to collect signatures, they have gone nowhere.

⁵⁹Like many great quotes, no one can quite point to where or if Twain said it. Available at <http://www.twainquotes.com/WaterWhiskey.html>.

goes to agriculture), and public water authorities. And there is always the nasty issue of how the bond issue is to be paid off. Will the burden of the payoff fall on taxpayers as a general obligation of the state or on water users? Opposition from significant players can doom a ballot proposition authorizing a bond issue.

Ultimately, facing a deadline for putting a bond on the ballot, the governor and legislature put a bipartisan bond issue on the November 2014, albeit one that was “tunnel neutral,” i.e., arranged so that it neither supported nor banned Brown’s water tunnel proposal.⁶⁰ At the same time, Brown let it be known that he opposed efforts in the legislature to propose a bond for school construction – effectively killing those efforts. The concern was that voters would be wary of adding to state debt if confronted with two state bond proposals.

Scandal

“Once again, the Senate has been tarnished by another FBI raid of a senator's Capitol office.”

Republican senate minority leader Robert Huff
after the indictment of Democratic Senator Leland Yee⁶¹

Given the Democrats’ tenuous hold on a two-thirds majority in the legislature, it would not have taken much for that supermajority to be lost. As noted earlier, it was lost as scandals involving three Democratic state senators began to emerge. One was charged with living outside his district and ultimately convicted. Two others were essentially charged with bribery. All were suspended, killing the supermajority.

Still compared with the federal government, California looked to be a model of sound fiscal policy. When the federal government shut down in fall 2013 due to the usual House-Senate gridlock, Sacramento shined in comparison to Washington, DC. Indeed, the state refused to take over funding of Yosemite during the federal shutdown, even on a temporary basis. Washington didn’t bail out California during the state’s budget crisis; why should the state bail out a federal park? So while federally-operated parks were inaccessible, state parks were conspicuously open. One-party rule in California looked much better than the two-party confrontation nationally. At least (thanks to voter intervention via direct democracy), California had a budget, not just an on-and-off continuing resolution.

Winter’s Budget

⁶⁰The legislature had repeatedly postponed a bond of over \$11 billion negotiated in 2009 which was widely seen as “pork” laden and unlikely to be passed by voters. Brown conceded on the tunnel issue and emphasized that he wanted a bond of substantially less than \$11 billion. The approved substitute bond was about \$7.5 billion and included about \$2.7 billion for dams sought by Republicans.

⁶¹Quoted in “A guide to Leland Yee corruption scandal: ‘Shrimp Boy’ to guns,” *Los Angeles Times*, March 28, 2014.

“It isn’t time to just embark on a whole raft of new initiatives, and that’s the problem.”

Governor Jerry Brown in discussing his initial 2014-15 budget⁶²

It is traditional, as the date of the governor’s January budget unveiling approaches, for there to be pre-budget leaks from the governor about what his budget will contain and from the legislature and interest groups about what they would like it to contain. In late 2013 and early 2014, the process began. The Legislative Analyst, as we noted earlier on Table 4 predicted that the 2013-14 budget was in surplus and would thus end with a larger reserve than originally projected when it was enacted. Democrats in the legislature began suggesting in public that more should be spent on education including pre-school and social programs.

And others picked up the demand. The chief justice of the state Supreme Court noted the need for more judicial spending. CalPERS, the giant state pension system, let it be known that it would be hiking rates which would affect the state and many local governments that use the system.⁶³ The movie industry pushed for increased state film credits. Brown indicated that his budget when released would feature an explicit rainy-day fund. And the idea of using cap-and-trade funds for his high-speed rail project also was surfaced. Discussion of Brown’s water tunnel project became more heated. Brown also signaled that he would not support an oil extraction tax in 2014 which he termed “not the year for new taxes.”⁶⁴

The Unveiling

“The state is now on its most stable footing in more than a decade.”

Governor’s January 2014 budget proposal⁶⁵

As had happened on another occasion, due to a computer mistake, Brown’s budget appeared on the Internet before it was supposed to be announced, resulting in a hurried news conference. Despite the advance leaking, when the budget was (prematurely) released, there were some surprises. Brown expressed some willingness to consider a revival of local redevelopment arrangements which had been

⁶²Quoted in Dan Smith, “Jerry Brown pledges caution despite budget surplus,” CapitolAlert blog of *Sacramento Bee*, January 9, 2014. Available at <http://blogs.sacbee.com/capitolalertlatest/2014/01/jerry-brown-pledges-caution-despite-budget-surplus.html>.

⁶³CalPERS covers most state employees other than UC (which has its own pension system). It also covers many local jurisdictions. Teachers are covered by another plan: CalSTRS. The municipal bankruptcy of Detroit and a court ruling that pensions could be cut in that city may have added to pressure on CalPERS to push up the rates it charged.

⁶⁴Quoted in David Siders, “Jerry Brown rejects oil tax push,” CapitolAlert blog of *Sacramento Bee*, January 9, 2014. Available at <http://blogs.sacbee.com/capitolalertlatest/2014/01/brown-rejects-oil-tax-push-saying-time-not-right-for-new-taxes.html>.

⁶⁵*Governor’s Budget Summary, 2014-15*, January 10, 2014, p. 2. Available at <http://www.ebudget.ca.gov/2014-15/pdf/BudgetSummary/FullBudgetSummary.pdf>.

scrapped in an earlier budget cycle. Earthquake fault mapping by the state would be accelerated. UC and CSU were asked to prepare 3-year budgets and not to raise tuition. On the other hand, the specifics of a plan for dealing with the large underfunding of the state's teachers' pension plan, CalSTRS, wasn't a component of the budget although Brown promised to do something about it later. On the other hand, some complaints were heard about things that were in the budget such as expanded prison capacity.

The leaked items also appeared, notably a rainy-day fund and cap-and-trade funding for high-speed rail.⁶⁶ One surprise – although not immediately relevant – was that the rainy-day fund was to be two funds, one for the Prop 98 world (K-14 education) – and the other for the rest of the general fund. However, the K-14 segment would not operate until a so-called maintenance factor was paid off and other conditions were met related to the Prop 98 formulas. It thus appeared that the mechanism proposed would be unlikely to contribute to the K-14 reserve under most circumstances.⁶⁷ (As will be noted later, the precise trigger for the K-14 reserve was modified around the time of the May revise, along with other aspects of the proposal.)

The inclusion of a K-14 rainy day fund caused some opposition to form in the education community because Brown's state-level K-14 rainy-day fund came with limits on local reserves. Local districts wanted to have the freedom to hold their own reserves and were dubious that a state-level reserve would be a full substitute in practice. Brown's rainy-day fund was focused on saving bursts of capital gains revenue, the most volatile element in budgetary receipts (but also, therefore, the hardest to predict). Another surprise was that although the governor was generally negative about the disbanded local redevelopment agencies and attempts to revive them, he proposed a limited version that could deal with affordable housing and other state goals.

Period for Dissection

"In general, setting aside money for a rainy day is exactly what the state should be doing when revenues are soaring, as they are now."

Legislative Analyst's Report on the governor's January budget proposal⁶⁸

⁶⁶The rainy-day fund proposal was actually a replacement for a constitutional amendment originally negotiated in 2010 that was due to be placed on the ballot in 2014. Among other elements, it would raise the cap on the rainy-day fund from 5% to 10% of general fund revenues. Note that on Figure 3 of this chapter, we show projected total reserves as a percent of spending, not revenue. However, the two will typically not be very different over the long run. The figure shows that by 2017-18 with assumed steady economic growth in the state, reserves relative to spending get only to 5%.

⁶⁷Legislative Analyst's Office, *Budget Reserve Proposals*, April 28, 2014, p. 8. Available at http://www.lao.ca.gov/handouts/state_admin/2014/Budget-Reserve-Proposals-042814.pdf.

⁶⁸Legislative Analyst's Office, *The 2014-15 Budget: Overview of the Governor's Budget*, January 13, 2014, p. 5. Available at <http://www.lao.ca.gov/reports/2014/budget/overview/budget-overview-2014.pdf>.

Once the budget is unveiled, an interim period between the January budget and the May revise begins. Basically, the governor's proposal is dissected by the legislature in hearings with the assistance of the Legislative Analyst's Office (LAO). The LAO produces a general analysis of the overall budget and then churns out analyses of various components. In principle, the LAO is bipartisan and simply outlines issues and options. However, it is an entity of the legislature – not the administration - so it tends to direct legislative attention toward options that put matters more under legislative control and less at the discretion of the governor or administrative agencies. And it feels freer to critique what the governor proposes than what is trending in the legislature. Thus, the LAO raised some legal concerns about the governor's limited redevelopment plan. And it expressed doubts about whether the best use of cap-and-trade funds from an environmental perspective was the high-speed rail project.

The interim period is also a time during which political reactions to the budget are made known. In particular, state senate leader Darrell Steinberg let it be known that universal pre-school was one of his major priorities. That proposal tended to conflict with the cautionary notes sounded by Brown about adding new programs that could become a burden to the state during the next economic downturn.

Because 2014 was a gubernatorial election year, it might have been expected that budget and other related issues would begin to be drawn into the politics of the race. But the only political race at the governor level was within the GOP between Donnelly and Kashkari. Both candidates seemed to be competing for the honor of being defeated by Brown in November. Under the top-2 primary system, Brown – who made a low-key announcement in late February that he would seek re-election - would clearly come out on top since he had no opposition among any serious Democratic opponents. The candidate with the next most votes would be one of the two Republicans, since there were no other significant Republicans in the contest. Brown and either Kashkari or Donnelly would then go on to the general November 2014 election contest.

Both Donnelly and Kashkari sought to make an issue of the drought – not enough advance planning and not enough dams, a literal rainy-day remedy. But Brown announced some drought funding and declared an emergency. (Later, during the summer, the governor and a bipartisan group of legislators negotiated a water bond for the November 2014 ballot.) In any event, voters did not seem to blame the incumbent governor for the weather, and the drought issue didn't seem to reach public consciousness during the primary season, at least in the big urban areas. Administration of whatever water cutbacks and rationing might occur was left to water authorities

The drought issue did not really grab Sacramento until the summer of 2014 after the budget for 2014-15 had been enacted, and the issue of what kind of water bond might be presented to the voters came to the fore. Brown seemed also to escape blame for the woes of the Bay Bridge which now shifted to demolition problems in taking down the old bridge. Environmentalists claimed that Brown was too friendly to oil fracking (a potential future source of state revenue when the temporary taxes of Prop 30 expire). But the two GOP candidates were sympathetic to fracking and so could not make an issue of it.

Public pensions might have been a budget-related issue in the gubernatorial contest, but Brown had pushed through a pension reform prior to his earlier 2012 campaign for Prop 30, the temporary taxes. Groups favoring more pension reforms looked to San Jose Mayor Chris Reed who was proposing a ballot initiative. But Reed did not receive the financial backing needed for such a campaign. He abandoned his initiative, at least before 2016, on grounds that the descriptive title and language for it composed by the attorney general was misleading.

The result was that the GOP primary contest ended up focused on Donnelly and Kashkari and what they had to say about each other. Both candidates debated on the John and Ken (conservative) KFI radio program in Los Angeles, but Governor Brown declined to participate, complaining about the format.⁶⁹ The state budget and Brown's proposals were not much mentioned, although both candidates opposed governor's high-speed rail project. Donnelly seemed to have more informal support than Kashkari at the Republican state convention, but neither candidate got an official endorsement, really a victory for Kashkari under the circumstances.

Donnelly continued to have problems with such personal issues as owning an unregistered handgun, failing to report campaign funding properly, and having an unpaid tax bill on a business he owned that had failed. He referred to his rival as "Cashkari" because of his earlier role in administering the TARP bailout at the U.S. Department of the Treasury under the George W. Bush administration. Donnelly also accused Kashkari of having favored Shariah law. (Kashkari is of Indian origin and is a Hindu, not a Muslim.) At one point in the contest, Donnelly's campaign manager quit.⁷⁰

Kashkari, as noted earlier, had the support of establishment Republicans such as former California governor Pete Wilson who didn't want Donnelly at the top of the ticket. Out-of-state Republicans also opposed Donnelly – such as former presidential candidate Mitt Romney and GOP operative Karl Rove. There was fear that he would have negative spillover effects outside California. Donnelly referred to them all scornfully as "country club" Republicans.⁷¹ The upshot was that Kashkari had financial support plus his own money for TV and other advertising and ultimately prevailed (for the second spot behind Brown) in the June primary.

⁶⁹Despite Brown's expressed concerns, it might be noted that during the 2010 gubernatorial election, Brown did appear on the John and Ken show. Indeed, in part because John and Ken seemed to dislike Republican Meg Whitman, she received rougher treatment than Brown on the program.

⁷⁰Although Donnelly tended to be libertarian in attitude, he supported expanding California's tax credit for filming and the redevelopment agencies that Brown had earlier eliminated.

⁷¹Quoted in Carla Marinucci, "Tim Donnelly: I'm a threat to the GOP 'country club,'" *San Francisco Chronicle*, May 15, 2014. Available at <http://www.sfgate.com/politics/article/Tim-Donnelly-I-m-a-threat-to-the-GOP-country-5478654.php>.

The final tally was Brown 54.3%, Kashkari 19.4%, Donnelly 14.8%, with the remaining votes going to minor candidates.⁷² However, the news media, perhaps because of the colorful nature of the Donnelly campaign, became more focused on the Donnelly-Kashkari contest as a contest and less on the issues. After the primary, Kashkari tried to reframe the focus on Brown by issuing debate challenges – which until mid-August were largely ignored.⁷³ Then Brown agreed to a single debate in early September 2014. Kashkari did succeed in insulting former Governor Schwarzenegger by saying the problems of his regime were due to Schwarzenegger’s desire to be loved.⁷⁴ The question for Kashkari was whether Republican donors from what Donnelly had termed “country club,” were willing to finance a significant Kashkari campaign, once Donnelly had been defeated.⁷⁵

Governor Brown’s main interaction with Republicans was not with Kashkari or Donnelly but with their party’s minority leaders in the legislature. Although the governor did not need GOP votes to pass a budget, he did need them to put a proposition on the ballot for the rainy-day fund which was assumed in the budget – a step requiring a two-thirds supermajority. His problem was that there was slated to be on the ballot, thanks to a budget crisis era deal several years before, a rainy-day fund proposition which Republicans back then favored that differed from what he wanted.

However, Brown could argue to Republicans – who had insisted on the old proposition as part of a budget deal during the Schwarzenegger period – that his (Brown’s) version involved still more saving. In other words, he calculated that his proposal was more attractive to the conservative Republican legislators than their own earlier version. Brown called a special session of the legislature to deal with the rainy-day fund issue in mid-April. In negotiations with both Republican and Democratic leaders in the legislature around the time the May revise was unveiled, he worked out a modified version of the rainy-day fund proposal that received bipartisan support. (Brown during the summer of 2014 also had to deal with Republican legislators concerning a water bond he wanted on the ballot. But those negotiations came after passage of the 2014-15 budget and didn’t directly deal with the budget.)

Like the period leading up to the January budget proposal, as the calendar moves toward the May revise, there is a tendency to try and make a case for funding and generally to test what the governor might or might not accept. Some cities explored putting an initiative on the ballot to restore a more

⁷²Data from the California Secretary of State available at <http://www.sos.ca.gov/elections/sov/2014-primary/pdf/33-governor.pdf>. Note that under the top-2 procedure, although Brown had a majority of the votes, the general election in November 2014 would still be held with Brown vs. Kashkari as the choices.

⁷³Former assembly speaker and mayor of San Francisco Willie Brown suggested that if Brown wouldn’t debate Kashkari, maybe Lieutenant Governor Newsom could do it. See Willie L. Brown, Jr., “Gavin Newsom ought to debate Neel Kashkari if governor won’t,” *San Francisco Chronicle*, August 9, 2014. Available at <http://www.sfgate.com/bayarea/williesworld/article/Gavin-Newsom-ought-to-debate-Neel-Kashkari-if-5679069.php>.

⁷⁴Seema Mehta, “Kashkari criticizes Schwarzenegger, says he ‘needed to be loved,’” *Los Angeles Times*, July 17, 2014. Available at <http://www.latimes.com/local/politics/la-me-kashkari-20140718-story.html>.

⁷⁵The concerns about Donnelly as an embarrassment had he gotten on the November ballot seemed confirmed when he announced a protest to a visit by the president of Mexico.

extensive redevelopment regime than the governor might accept. But ultimately no such initiative emerged. Reports surfaced about needed highway maintenance, but no new road repair programs resulted. While tuition at UC and CSU was supposed to be frozen, some CSU campuses imposed new “student success” fees. They were not penalized for doing so. Although the governor had pushed for more online education at UC as a way of holding down costs, UC president Janet Napolitano said publically that such technology was merely a tool and not a big cost saver.⁷⁶

As it turned out, online education and student fees were not the main issues that roiled the legislature in the period between the January budget proposal and the May revise. Parents were becoming concerned about admissions – particularly to UC – with reports about enrollment of foreign and out-of-state students who paid full tuition and thus helped make up for prior cuts in state spending. In the mid-1990s, voters had banned affirmative action in university admissions under Prop 209. The legislature moved toward putting a proposition on the ballot that would have repealed 209. However, there was an outcry from the Asian community that feared a loss of educational opportunity, and the legislature quickly retreated.

Brown seemed able to remain above the fray, leaving controversy to the legislature. It could be argued, for example, that concern about limited admissions of state residents to UC was a reflection of budget cuts during the previous crisis that were not being fully reversed in the governor’s budget. Certainly, Kashkari and Donnelly could have made that point – but they didn’t.⁷⁷ Brown felt free to criticize other Democrats, since he needed no help in the primary and was unlikely to need any in the fall general election.

When Lieutenant Governor Newsom – in introducing Brown’s State of the State speech – went on about the virtues of change, Brown began his remarks by saying that he personally valued “continuity.” When asked to evaluate the presidency of Bill Clinton, Brown said that Clinton in retrospect had “handled his job with a level of skill that hasn’t been met since,” thus lumping Barack Obama with George W. Bush as less skilled.⁷⁸ Similarly, he lumped former Democratic governor Gray Davis with Arnold Schwarzenegger, stating that both had left a legacy of budget problems which he (Brown) was now resolving.⁷⁹

⁷⁶Jeong Park, “Initiative for online education in California slackens,” *UCLA Daily Bruin*, April 10, 2014. Available at <http://dailybruin.com/2014/04/10/initiative-for-online-education-in-california-slackens/>.

⁷⁷Kashkari did say he opposed affirmative action during this episode. But when the legislature pulled back, the issue of affirmative action disappeared although the budget for higher education remained an issue.

⁷⁸Maureen Dowd, “Palmy Days for Jerry,” *New York Times*, March 22, 2014. Available at <http://www.nytimes.com/2014/03/23/opinion/sunday/dowd-palmy-days-for-jerry.html>. Chris Megerian, “Gavin Newsom enjoys spotlight before yielding it to Brown,” *Los Angeles Times*, January 22, 2014. Available at <http://www.latimes.com/local/political/la-me-pc-gavin-newsom-jerry-brown-state-of-the-state-20140122-story.html>.

⁷⁹Michael Finnegan, “Brown says rising sea levels could force costly move of LAX,” *Los Angeles Times*, May 13, 2014. Available at <http://www.latimes.com/local/political/la-me-pc-brown-sea-level-airports-20140513-story.html>.

The May Revise

"I am pleased to see Governor Brown once again show great caution in his revised budget plan... Time will tell if the governor can get his fellow Democrats in the legislature to embrace this same spirit of spending restraint..."

Republican Assembly minority leader Connie Conway⁸⁰

As the quote above suggests, Brown's main problem in moving from his May revise to an actual budget enactment was not with the Republicans, who were out of the loop anyway due to Prop 25. Republicans might have exercised leverage regarding their needed votes to put the rainy-day fund on the ballot, but they generally favored the concept and had agreed to a deal on the ballot proposition before the May revise was released. Brown's problem was with the Democrats who saw leverage in his high-speed rail proposal and its need for cap-and-trade money. The Democrats were also encouraged in pursuing higher spending than Brown proposed by the Legislative Analyst who projected somewhat more revenue than the governor's Department of Finance.⁸¹ The Analyst also suggested that Brown's estimates of Medi-Cal costs were overstated.

There were hints that rail funding would depend on increased social spending relative to what the May revise had proposed. Senate President Darrell Steinberg said that the rail project was "going to be a much tougher sell this time." Steinberg also said that Democratic legislators "have more than lifted to meet the governor's agenda. It's time he does a little lifting to meet our priorities."⁸² In particular, Steinberg cited a need for expanded pre-school education. Adding to the pressure to increase spending was the media release by the state controller of cash received by the state during July-April (and later July-May) of the 2013-14 fiscal year which showed receipts exceeding the governor's January projection by around \$2 billion.⁸³ The idea, present in the Legislative Analyst's forecast, that the fiscal outlook was rosier than the governor suggested was therefore reinforced.

Enacting a Budget

"We all know the governor wants high-speed rail. It becomes a bargaining chip."

⁸⁰Quoted in "Rapid response: Gov. Jerry Brown's May budget revise," CapitolAlert blog of *Sacramento Bee*, May 13, 2014.

⁸¹Legislative Analyst's Office, *The 2014-15 Budget: Overview of the May Revision*, May 16, 2014. The Legislative Analyst noted, however, that if there were extra revenues, they would be largely absorbed by K-14 under the operation of Prop 98. The report is available at <http://www.lao.ca.gov/reports/2014/budget/may-revision/overview-may-revision-051614.pdf>.

⁸²Quoted in Chris Megerian, "Senate leader says Brown's budget proposal falls short," *Los Angeles Times*, May 14, 2014. Available at <http://www.latimes.com/local/political/la-me-pc-california-budget-steinberg-20140514-story.html>.

⁸³Receipts, however, were not appreciably above the level of the prior fiscal year through April and through May 2014.

With only a simple majority needed for passing a budget, with Republicans having already signed on to the rainy-day fund plan, and with no general economic crisis to cut into revenues, budget enactment was anti-climactic. One columnist described the last-minute negotiations before the June 15th legislative deadline for budget enactment as “old fashioned horse trading, back scratching, and leveraging.”⁸⁵ Republicans, however, were not part of the deal making; one complained that their having to Google elements in the budget absent any other information source was “a terrible way to enact a state budget.”⁸⁶

What was ultimately enacted was a compromise. Brown got his cap-and-trade money for high-speed rail, but not as much as he requested. Senate President Steinberg got his pre-school augmentation, but not what he originally hoped would be a universal pre-school program. Brown’s proposed ban on overtime for home care workers didn’t fly. But limits were placed on such overtime. UC and CSU budgets were enacted more or less as Brown proposed but with a trigger added that could have resulted in an additional \$100 million (but didn’t).⁸⁷ Brown won a long-term funding deal for the underfunded CalSTRS teacher retirement plan.

Brown’s rainy-day fund had already been approved by the legislature for the ballot – later to be designated Proposition 2. But public sector unions – particularly those representing teachers – might have actively opposed it. They settled for limits on rainy-day set asides by local school districts contingent on voters enacting the state rainy-day plan.⁸⁸ School districts were upset about the deal, but had no time to reverse it.⁸⁹ And there were other last-minute additions to the budget deal such as changes in the way undocumented workers could obtain drivers’ licenses. Such arrangements led to complaints about lack of transparency, but Assembly Speaker Toni Atkins characterized the enacted budget as “building a foundation for the future.”⁹⁰

In the aftermath of the budget enactment, Brown made some token line-item vetoes. But since he had cut a deal with the majority legislative leaders, there were no major changes. There were complaints, of

⁸⁴Quoted in Chris Megerian, “Bullet train funding is bargaining chip in state budget debate,” *Los Angeles Times*, May 30, 2014. Available at <http://www.latimes.com/local/la-me-pol-state-budget-20140531-story.html>.

⁸⁵The quote is from George Skelton, “Gov. Brown, lawmakers trade goodies to reach on-time budget,” *Los Angeles Times*, June 15, 2014. Available at <http://www.latimes.com/local/la-me-cap-budget-20140616-column.html>.

⁸⁶Assemblyman Jeff Gorell quoted in Chris Megerian, “Closed-door, last-minute state budget decisions raise concerns,” *Los Angeles Times*, June 14, 2014. Available at <http://www.latimes.com/local/la-me-pol-state-budget-pork-20140615-story.html>.

⁸⁷At this writing, there are proposals in the legislature to provide the money despite the failure of the trigger.

⁸⁸The local limit was contingent on the state rainy-day fund being passed by voters.

⁸⁹At this writing, it is unknown whether school authorities will officially oppose the rainy-day fund proposition.

⁹⁰Quoted in Chris Megerian, “Jerry Brown, top lawmakers announce budget deal,” *Los Angeles Times*, June 12, 2014. Available at <http://www.latimes.com/local/political/la-me-pc-california-budget-deal-jerry-brown-20140613-story.html>.

course, notably from the court system representatives who felt their allocation remained inadequate compared to what was needed to recover from the cuts imposed following the Great Recession. But the legislature turned to other matters, some of which were follow-ons to the budget.

Incoming Senate President Kevin de León wanted to have construction of the high-speed rail start at its urban ends rather than in the “tumbleweeds” of the Central Valley.⁹¹ (He had to apologize for his tumbleweeds comment to residents of the Central Valley shortly thereafter.) It’s not clear, however, that his advice will be – or can be – followed.⁹² The water bond (described earlier) had to be renegotiated – and it was, becoming Proposition 1 on the November 2014 ballot.⁹³

Conclusion: Adult Supervision Isn’t Enough

“The government is becoming the family of last resort.”

Jerry Brown (attributed)⁹⁴

We noted that after all the drama in enacting the 2014-15 budget, net reserves (regular plus rainy-day) are slated in the official documents to fall by around \$900 million over the course of the year, in other words, a deficit. Now it could be that because the governor tends to push for conservative revenue estimates to rein in the legislature, reserves might rise rather than fall, producing a modest surplus instead. Some might argue that because the budget includes some early retirement of the Schwarzenegger-era Economic Recovery Bonds, we should not view the projected fall in reserves as a deficit.

The key point, however, that even if there is surplus rather than a deficit, at the end of the fiscal year, there won’t be much in the till to deal with an economic downturn, should one arise. Even projected out over several years, at best there is an accumulation of a modest reserve – maybe five percent of general fund spending. Past experience says a downturn would swallow any reserve of that magnitude very fast. So even with the governor perceived as the adult in the family room, California remains very vulnerable to some future crisis at some unknown date. Its revenues – especially the personal income tax – are highly volatile and reflect perturbations in the real economy and in financial markets.

There is no iron law that there has to be a recession over some period of time or even that the probability of a recession necessarily increases over time. But if you wanted to worry about external

⁹¹Quoted in George Skelton, “Next Senate leader Kevin de León wants Brown to rethink bullet train,” *Los Angeles Times*, June 22, 2014. Available at <http://www.latimes.com/local/la-me-cap-de-leon-20140621-column.html>.

⁹²State officials indicated that they might start work on a Burbank-to-Palmdale section at some point in the future, but there was nothing definite.

⁹³The legislature changed the numbering system for ballot propositions so that the water bond and the rainy-day fund would be Props 1 and 2.

⁹⁴Type this quote into Google and you will find innumerable sources that attribute it to Jerry Brown. But none cite an original source.

events that could negatively affect the economy, you can (always) look at the Middle East as a source of uncertainty in world markets. Or perhaps you might look at other international conflicts, say Russia and Ukraine.

You could also note that as the U.S. economy goes, so goes the California economy. And in the U.S., we ended the Great Recession with a legacy of banks that are “too big to fail” – but also with uncertainty over whether a gridlocked Washington would be able to pull off another financial rescue should an emergency arise. Will there be another Kashkari with a handy TARP-type bailout? Will the Federal Reserve at some future date ride to the rescue as it did under its now-departed chair Ben Bernanke?

In short, dear children, while it’s comforting to have an adult supervisor in the room as governor, he can’t guarantee you a carefree future, certainly not with a combined reserve of 3-5% of general fund spending.

Table 1: Percent of Registered Voters That Approve of the State Legislature

		Approval
Dot-com boom cycle peak	2000	48%
Recall of Gov. Davis	2003	25
Housing boom cycle peak	2007	38
Budget Crisis IOUs	2009-2010	15-14
Calendar Year	2013	38
After state senate scandal	June 2014	35

Source: California Field Poll,

<http://www.field.com/fieldpollonline/subscribers/Rls2474.pdf>

Table 2: General Fund Cash Flows and Reserves (\$billions)

Fiscal Year					Adjusted*
	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015
Starting Reserves**	-\$9.9	-\$8.2	-\$9.6	-\$2.4	+\$2.0
Receipts	95.5	87.8	103.4	104.0	107.5 [109.1]
Disbursements	93.7	89.2	96.3	99.6	111.5
Surplus/Deficit	+1.7	-1.4	+7.2	+4.4	-4.0 [-2.4]
Ending Reserves**	-8.2	-9.6	-2.4	+2.0	-2.0 [-0.4]

*Based on cash data from 2014-15 budget. Starting reserves from controller's June 30, 2014 cash data. Receipts reflect subtraction of \$104 million transfer from reserves. Disbursements reflect subtraction of \$3,183 million to rainy-day reserves. Ending reserves thus include regular general fund reserve plus "rainy day" fund. Figures in brackets [] assume that \$1.6 billion in revenue is diverted in the source table from receipts and sent directly to the rainy-day fund. The source table is unclear on this point.

**Includes "rainy-day" fund.

Source: June cash statements of the California state controller (for data from 2010-11 to 2013-14). Raw data on receipts and disbursements from California Department of Finance at:

http://www.dof.ca.gov/reports_and_periodicals/documents/BS_SCH5D_2014.pdf

**Table 3: Actual and Forecast Cash Flows and Reserves: 2013-14
(\$billions)**

\$billions	Forecast			Forecast	
	Actual	Jan. 2014	Difference*	July 2013	Difference*
Starting Reserves	-\$2.4	-\$1.4	-\$1.0	-\$2.4	0.0
Receipts	104.0	101.5	+2.5	98.4	+5.6
Disbursements	99.6	100.0	-0.4	99.4	+0.2
Surplus/ Deficit	+4.4	+1.5	+2.9	-1.0	+5.4
Ending Reserves	+2.0	+0.1	+1.9	-3.4	+5.4

*Actual minus forecast.

Source: California state controller's June 2014 cash statement,
http://www.sco.ca.gov/Files-ARD/CASH/fy1314_july.pdf

Table 4: The Stages of the 2014-15 Budget in Accrual Terms (\$billions)

	LAO Current Services** Nov. 2013	Governor's Initial Proposal Jan. 2014	Governor's May Revise Proposal May 2014	Final Budget Including Line-Item Vetoes June 2014

Beginning Basic Reserve	+\$3.1	+\$4.2***	+\$3.9	+\$3.9
Revenue & Transfers	107.6	104.5	105.3	105.5
Spending	104.4	106.8	107.8	108.0
Surplus or Deficit	+3.3	-2.3	-2.4	-2.5
<i>Revenue Excluding Rainy-Day Fund Diversion</i>	104.4	105.2	107.0	107.1
<i>Surplus or Deficit Including Rainy-Day Fund</i>	+3.3	-0.7	-0.8	-0.9
Ending Basic Reserve	+6.2	+1.9	+1.5	+1.4
<i>Ending Rainy- Day Fund</i>	<i>n.a.</i>	+1.6	+1.6	+1.6
<i>Total Ending Reserves*</i>	+6.2	+3.5	+3.1	+3.0

Details need not sum to totals due to rounding.

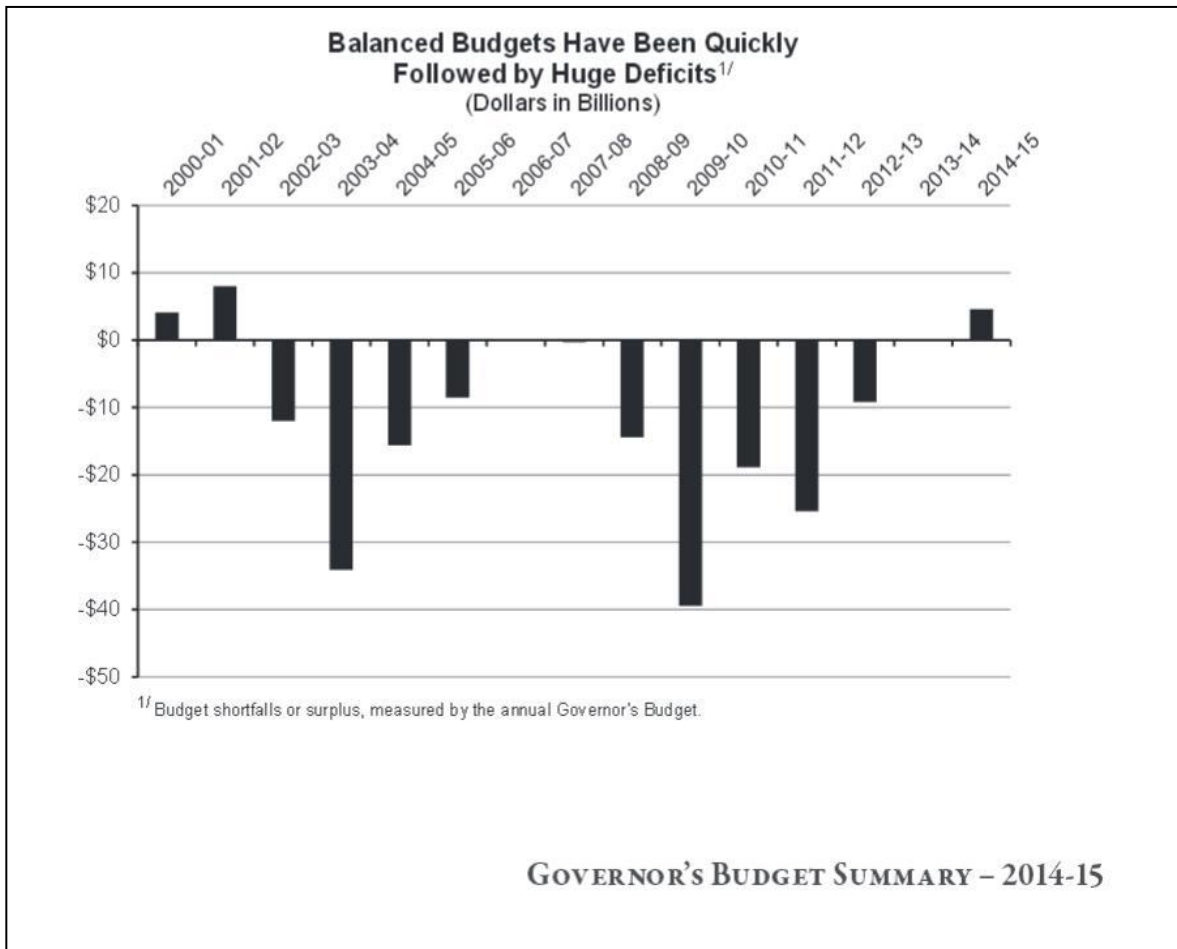
*Basic reserve plus rainy-day fund.

**Assumes all policies remain unchanged.

***The Legislative Analyst found an error in this estimate. We present the original (incorrect) number for consistency with the official proposal.

Source: California Department of Finance, January, May, and Final Budgets for 2014-15; California Legislative Analyst's Office, November 2013 fiscal outlook.

Figure 1:



Source: Reproduced from governor's January 2014 budget proposal. The same chart appears in the May Revise and the final budget summaries issued by the California Department of Finance.

Figure 2:

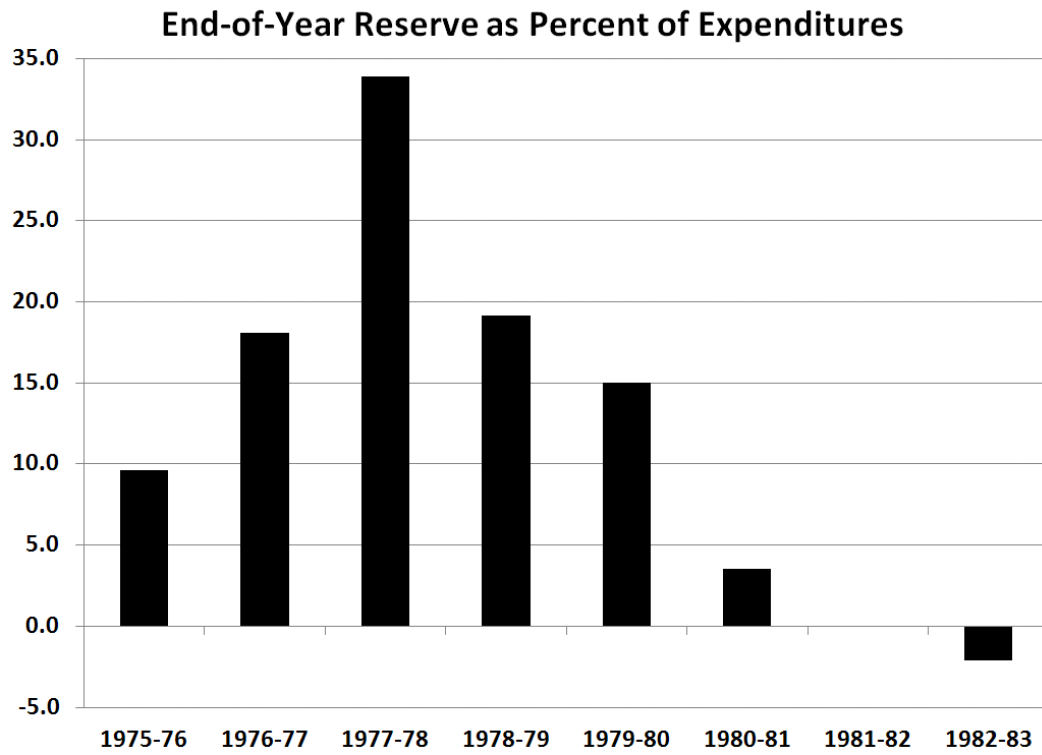


Figure 3:

