CALIFORNIA
• BUDGET PROJECT •

Budget Brief

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WHAT WOULD PROPOSITIONS 57 AND 58 MEAN FOR CALIFORNIA?

Proposition 57, which will appear on the March 2 ballot, would authorize the state to issue up to $15 billion in bonds to finance the state's budget deficit. Proposition 58 would amend the constitution to clarify the legal status of these bonds and make a number of other changes to state budget practices. Both measures were placed on the ballot by the Legislature acting in special session in December 2003. In order for either measure to take effect, both Propositions 57 and 58 must be approved by the voters.

What Does Proposition 57 Do?

Proposition 57 authorizes the state to issue up to $15 billion in bonds to finance the state's budget deficit.[1] The bonds would be repaid out of the proceeds of a ¼ cent state sales tax rate at an annual cost of $1.2 billion in 2004-05, rising modestly thereafter. Proposition 57 uses a repayment mechanism referred to as the "triple flip," a three-step transaction which transfers a ¼ cent of local governments' sales tax authority to the state, shifts property taxes from schools to cities and counties to make up for the lost sales tax proceeds, and reimburses schools out of the state's General Fund for lost property tax revenues. The bonds would be repaid over a period of 9 to 14 years. The variation in the repayment period results from a) uncertainty regarding the amount of revenues that would be generated by the sales tax in future years, and b) a provision in Proposition 58 that would use a portion of the monies deposited in a budget reserve for early retirement of the deficit bonds.

What Does Proposition 58 Do?

Proposition 58 amends the state's Constitution to clarify the legal status of the bonds authorized by Proposition 57 and makes a number of changes to state budget practices.[2] The major provisions include:

1. Establishing a Process for Consideration of Midyear Budget Adjustments

Proposition 58 would establish a process for the Legislature to consider midyear spending reductions proposed by the Governor. Beginning in 2004-05, if General Fund revenues decline "substantially" below the estimate used in the budget as enacted, if expenditures increase "substantially," or both, the Governor may declare a fiscal emergency, call the Legislature into special session, and submit legislation to address the emergency. If the Legislature fails to act on the Governor's proposal or an alternative within a 45-day period, it may not recess or act on any other bill.

What this means: The Legislature does not have to approve the Governor's proposal nor does the Governor have to sign a bill approved by the Legislature. It simply requires the Legislature to act on a measure (any measure) and, absent action within 45 days, forbids the Legislature from recessing or acting on other matters. Proposition 58 does not define "substantially" for purposes of triggering this provision.

2. Balanced Budget Requirement

If Proposition 58 is approved by the voters, the Legislature would be prohibited from approving and the Governor would be prohibited from signing a budget that spends more from the General Fund than it brings in in revenues beginning in 2004-05. Specifically, the Legislature could not pass, and the Governor could not sign, a budget bill that, in combination with any other appropriations made prior to the passage of the budget act, appropriates more than estimated General Fund revenues plus transfers from the reserve.

The estimate of revenues would be stated in the budget bill and would include any transfers from the reserve.

What this means: The Constitution currently requires the Governor to introduce a balanced budget no later than January 10, or, if expenditures exceed anticipated revenues, to recommend sources from which to raise additional revenues. In practice, the Legislature has passed spending plans that are "balanced," that is, a budget where estimated revenues equal or exceed estimated expenditures. Problems have arisen when economic conditions changed during the budget year or when budgets have assumed revenues or cost savings that have not materialized.

Proposition 58 is silent with respect to how the revenue estimate shall be determined. Thus, the Legislature could simply set estimated revenues at the level needed to support budgeted expenditures. Proposition 58 would not address situations where assumed revenues or savings are not achieved and does not apply to bills passed by the Legislature or signed by the Governor after the passage of the budget act.

3. Clarifying the Status of the Bonds Issued to Finance the Deficit

Proposition 58 amends the Constitution to allow the state to issue bonds to pay off the state's estimated negative balance as of June 30, 2004 and other General Fund obligations incurred prior to June 30, 2004. After issuing the bonds authorized by Proposition 57, the state would be prohibited from borrowing to fund a year-end budget deficit using general obligation bonds, revenue bonds, or bonds or similar instruments in which there is no legal obligation of repayment. Legislative analyses of Proposition 58 state that it is not intended to prohibit the use of short-term borrowing, such as Revenue Anticipation Notes (RANs) or Revenue Anticipated Warrants (RAWs).[3]

What this means: This provision clarifies the legal status of bonds issued to finance the state's deficit for purposes of the constitution's restrictions on the issuance of state debt. It also prohibits the state from issuing similar bonds in the future, absent a change in the state constitution.

4. Funding a Budget Reserve

The measure establishes a mechanism for funding a budget reserve by requiring the Controller to transfer to the reserve:

a. 1 percent of estimated 2006-07 General Fund revenues;
b. 2 percent of estimated 2007-08 General Fund revenues; and
c. 3 percent of estimated General Fund revenues in 2008-09 and annually thereafter.

Transfers would continue until the balance in the reserve reaches 5 percent of estimated General Fund revenues or $8 billion, whichever is greater. Funds could be transferred out of the reserve for any purpose by statute. Fifty percent of the annual transfer to the reserve, up to a total of $5 billion, would be used to pay off the bonds ahead of schedule.

Proposition 58 allows the Governor to suspend or reduce the amount transferred to the reserve by a proclamation issued no later than June 1 of the preceding fiscal year.

What this means: The Constitution currently requires the state to have a "prudent reserve," but does not establish a mechanism for funding it or a target funding level. This measure does require funds to be transferred into a reserve, but it also allows monies in the reserve to be used for any purpose.

5. Contingent Operation

Both Propositions 57 and 58 must be approved by the voters in order for either measure to take effect. If one measure is approved by the voters, but the other fails, neither measure would take effect.

6. Ballot Language

ABX5 8, a measure approved by the Legislature as part of the package including Propositions 57 and 58, required the Secretary of State to call Proposition 58 the "California Balanced Budget Act" and to use specified language to describe the measure on the ballot. ABX5 8 also limited the period for public review of the title and summary of the measure to as little as a day, rather than the minimum of twenty days in current law. Generally, the Attorney General prepares the title and summary of measures that appear on the ballot. ABX5 8 required the ballot to describe Proposition 58 as follows:

- *Requires enactment of a balanced budget where General Fund expenditures do not exceed estimated General Fund revenues.*
- *Allows the Governor to proclaim a fiscal emergency in specified circumstances, and submit proposed legislation to address the fiscal emergency.*
- *Requires the Legislature to stop other action and act on legislation proposed to address the emergency.*
- *Establishes a budget reserve.*
- *Provides that the California Economic Recovery Bond Act is for a single object or work.*
- *Prohibits any future deficit bonds.*[4]

How Do the Bonds Authorized by Proposition 57 Differ from the Bonds Authorized as Part of the 2003-04 Budget Agreement?

ABX1 7, enacted as part of the 2003-04 budget agreement, authorized the state to issue bonds to finance the deficit accumulated as of June 30, 2003. These bonds, which would not be submitted to the voters for approval, would be repaid using a similar mechanism to that used in Proposition 57. However, since the bonds authorized as part of the budget agreement would be repaid from the proceeds of a ½ cent sale tax rate, they would be repaid more rapidly. ABX1 7 authorized an estimated $10.7 billion in debt that would be repaid over five years at a cost of $2.4 billion in 2004-05, which would grow modestly in future years.[5] Short-term loans, which come due before the end of 2003-04, are currently financing the accumulated shortfall.

The constitutionality of these bonds has been challenged by the Pacific Legal Foundation. At issue are the questions of whether bond proceeds can be used to pay the state's general operating expenses and whether the bonds can be issued without seeking the approval of the voters.[6] A decision is not expected prior to the March 2, 2004 election.

The annual cost of the bonds authorized by Proposition 57 would be half that of the bonds authorized by ABX1 7. However, the total cost for repayment would be significantly higher since the state would pay interest on a larger bond over a longer period. If the state issues the originally proposed $10.7 billion in bonds, rather than the $12.3 billion assumed by the Governor, the 2004-05 budget gap would widen by $2.85 billion.[7] This difference results from the fact that Proposition 57 would generate $1.6 billion more in bond proceeds at $1.25 billion lower annual debt service costs.[8]

How Would Propositions 57 and 58 Affect the Budget?

Governor Schwarzenegger's Proposed 2004-05 Budget assumes that the voters will approve Proposition 57 and 58 and that the state will issue bonds yielding $12.3 billion in proceeds. The Governor's Budget proposes to allocate $9.2 billion of the bond proceeds to pay off the budget deficit accumulated as of June 30, 2003. The remaining $3.1 billion will be used to:

- Pay the state's share of employee retirement costs in 2003-04 ($1.9 billion);
- Repay $188 million in loans from special funds to the General Fund;
- Cover the $325 million 2004-05 cost of the expansion in Net Operating Loss deductions;
- Make $100 million in state debt service payments;
- Pay $209 million in state employee compensation costs; and
- Add $300 million to the state's reserve.

However, the allocation of bond proceeds is not specified in either Proposition and would be subject to negotiation with the Legislature. Administration officials have said that they plan to move ahead with the $10.7 billion in bonds authorized as part of the 2003-04 budget agreement, which do not require voter approval, if either Proposition 57 or 58 is not approved by the voters.

The state faces a budget gap of approximately $15 billion in 2004-05. If the Governor's bond proposal is not approved, the gap would widen by approximately $11 billion.

What Policy Issues Do Propositions 57 and 58 Raise?

Proposition 57 raises a number of significant policy issues for voters to consider, including:

- **Should long-term debt be used to pay off the state's budget deficit?** The fundamental issue raised by Proposition 57 is whether long-term debt should be used to finance the state's accumulated budget deficit.

- **How should the budget be balanced in the absence of anticipated bond proceeds?** The state's budget gap would widen significantly if either Proposition 57 or 58 fails and the courts reject the $10.7 billion bond authorized as part of the 2003-04 budget agreement.

- **How much should be borrowed and how should it be allocated?** The Governor's Budget proposes to use some of the proceeds from the bonds authorized by Proposition 57 for ongoing operating costs of the state. Alternatively, the state could borrow less; or allocate all of the proceeds to repaying outstanding loans and obligations, such as deferred reimbursements of local governments for mandated costs or loans from special funds to the state's General Fund. Similarly, the Governor's Budget proposal would borrow to deposit funds in the state's budget reserve. The allocation of bond proceeds can be addressed during negotiations over the 2004-05 budget and is not specified in either ballot measure.

Policy issues raised by Proposition 58 include:

- **Should restrictions be placed on the use of the state's budget reserve?** Proposition 58 allows the reserve to be used for any purpose. Proposition 56, which is also on the March ballot, restricts the use of funds in the reserve to closing a budget gap or addressing an emergency declared by the Governor and it explicitly states that the reserve could not be used to increase spending.[9]

- **Should future deficit bonds be prohibited?** Proposition 58 would authorize the use of deficit financing bonds to help the state out of the current budget crisis, but prohibit the use of such bonds in the future. While voters could overturn the provision at the ballot box in the future, this provision would deny future lawmakers a tool used to address the current shortfall.

ENDNOTES

[1] The Legislature placed Proposition 57 on the ballot by the Legislature with the passage of ABX5 9 (Chapter 2, Oropeza).
[2] The Legislature placed Proposition 58 on the ballot by the Legislature with the passage of ACAX5 5 (Resolution Chapter 1, Oropeza).
[3] Senate Rules Committee, *Third Reading Analysis of ACAX5 5* (December 12, 2003).
[4] ABX5 8 (Chapter 1, Oropeza).
[5] Legislative Analyst, *California Primary Election Official Voter Information Guide Supplemental - Analysis of Proposition 57* (2004).
[6] Pacific Legal Foundation, *Pacific Legal Foundation Challenges Massive Indebtedness of State Budget—Sues State over Illegal Bond Financing Scheme* (September 24, 2003) downloaded from www.pacificlegal.org/list_PLFNews.asp on February 11, 2004.
[7] Department of Finance, *Governor's Budget Summary 2004-05* (January 2004), p. 3. The Governor's Proposed 2004-05 Budget assumes that the state will sell bonds generating $12.3 billion in net proceeds.
[8] Legislative Analyst's Office, *2004-05 Overview of the Governor's Budget* (January 13, 2004), p. 6. However, the state would be required to make debt service payments for two to three times as long if the bonds authorized by Proposition 57 are enacted.
[9] California Budget Project, *What Would Proposition 56 Mean For the State's Budget Process?* (February 2004).

Jean Ross prepared this brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. Support for the CBP comes from foundation grants, publications, and individual contributions. Please visit the CBP's web site at www.cbp.org.