LAO Raises Warning Flags about the Budget

As the new legislative session gets under way, the Governor's vision continues to be that of California moving forward to a bright future with no new taxes. The Legislative Analyst's Office (LAO) fiscal outlook for next year, however, takes a more sober view marked with a number of warning flags.

The LAO says that while this year's budget is expected to end with a reserve of about $3.1 billion, projected expenditures will exceed revenues by about $5 billion in each of the next two budget years. The reserve could help to balance next year's (2007-2008) budget, leaving a $2.4 billion deficit to be dealt with, but this does not solve the ongoing structural deficit.

In the last couple of years the reserve was generated by a healthy economy that produced higher than expected revenues. The Governor and Legislature used that windfall to increase spending in many program areas. Now the question is whether they can maintain that spending and deal with the ongoing deficit if, as the LAO expects, the economy is more "subdued" in 2007. The LAO's estimates do not include the Governor's "compact" with higher education, which promised increased future funding.

The LAO does include a transfer of funds to the Budget Stabilization Account required under Proposition 58, half of which is supposed to go to accelerated repayment of the deficit financing bonds. These repayments, as well as borrowing from other special funds, local governments and schools, represent the major share of the deficit and average about $3 billion a year for the next few years.

These obligations, added to the debt incurred with the passage of new infrastructure bonds approved by the voters in November, would push the debt service ratio, which is the percentage of the General Fund (GF) needed to repay debts, up sharply over the next few years to a peak of 8.1 percent in 2009-2010 before dropping back to a more normal 6 percent. The Governor and Legislature can stretch out the repayment of the deficit bonds, and may be likely to do so, given the consequences to a number of program areas that would suffer in such a budget squeeze.

The LAO notes several areas of increased costs that will squeeze the budget. One is the rising costs of pension and health benefits for retired state employees. These are now paid out of the annual GF. The administration has proposed to fund part of this liability through a pension obligation bond, but has so far been stymied by adverse court rulings. In the meantime, the LAO says the unfunded future liability is approaching $100 billion.

Another problem is the cost of improvements to the prison health care system which are now being forced by the courts, to say nothing of the fact that the courts are also pressing for improvements to the prison system in general. Other state health program costs are also rising sharply due to increasing caseloads and other factors.

Schools, on the other hand, will benefit substantially from the operation of Proposition 98 on the overall general fund and increases in the local property tax contribution. The LAO estimates K-14 funding will be 4.3 percent higher than this year.

The LAO says that in a good economy the state should be generating surpluses rather than deficits, and that a continuing failure to "address the long-term fiscal imbalance would leave the state in a precarious position."