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## California Journal of Politics and Policy

### Title

Must Constitutional Change Precede Budget Improvement? A Note on State Deficits and Procedural Change

### Permalink

<https://escholarship.org/uc/item/0ds9p4r2>

### Journal

California Journal of Politics and Policy, 2(3)

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### Publication Date

2010-10-05

### DOI

10.5070/P2PP4N

Peer reviewed

THE CALIFORNIA *Journal of*  
**Politics & Policy**

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Volume 2, Issue 3

2010

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Fiscal Advisor to State Treasurer Bill Lockyer

**Abstract**

Passing a workable budget is so fundamental to governance that Californians can be forgiven their disappointments and search for “reform.” But change does not have to rely on voter-ratified constitutional proposals. The California legislature could improve budgets by changing its internal procedures. The legislature could use internal rules and processes to condition how it reviews, negotiates, and amends the budget document. After all, the legislature has great flexibility in setting its own rules for considering how any legislation is considered and approved—and the budget bill is a statutory measure.

**Keywords:** California budget, fiscal oversight, taxes, spending

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# Must Constitutional Change Precede Budget Improvement? A Note on State Deficits and Procedural Change

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Can California's politicians budget without new institutional procedures? As the 2010 budget delay entered its third month on August 1, Californians had a fresh reason to despair about how well their state leaders could craft a budget compromise. Appearing before a business group in Los Angeles, Governor Schwarzenegger announced he was prepared to leave office without negotiating a budget settlement. The annual task of passing a workable budget is so fundamental to governance, Californians can be forgiven their disappointments and search for "reform."

But must change come from voter-ratified constitutional proposals? Rather, can the California legislature improve budgets by changing its internal procedures? Could the legislature use internal rules and processes to condition how it reviews, negotiates, and amends the budget document? After all, the legislature has great flexibility: it sets its own rules for considering how any legislation—and the budget bill is a statutory measure—is considered and approved.

Many constitutional constraints appear to limit the legislature's ability to manage the budget through its own procedural innovation. Elsewhere in this volume, authors consider whether imposing external constraints on the legislature will better direct budget deliberations and outcomes. Cain and Noll in particular consider changing the two-thirds vote requirement in response to rising levels of partisanship. But the question of internal change is not idle. Proposition 25 could reduce the minimum vote requirement for enacting the budget from a two-thirds vote to a majority. Proposition 26 could raise the threshold for enacting fees.

The legislature, too, is considering a package of bills proposing statutory and constitutional change for the way the legislature and governor budget. Senate Bill (SB) 1020 (Wolk) requires the governor to detail three years of General Fund revenues and expenditures and identify how any proposed budgetary expansions would be financed. SB 1426 (DeSaulnier) requires the governor and legislature to construct performance-based budgets for all state entities, beginning in 2014–15. Both measures place their requirements in statute. As statutory measures,

the legislature and governor can waive the requirements in a trailer bill for any particular budget year.

The constitutional change, included in Assembly Constitutional Amendment (ACA) 4 (Feuer), would, as presently drafted, reduce the vote requirement for passing the General Fund budget, impose standards on the content of the budget bill, and require that proposals to expand programs identify a funding source for additional costs. When the legislature adjourned, however, it had not passed the budget reform measures.

Even so, voter approval of any of these proposals may not be sufficient to achieve the changes the proponents desire. The last legislatively negotiated budgetary reform appeared on the 2009 Special Election ballot (May 19, 2009) and was rejected by nearly 2 to 1. Will voters be more favorably inclined toward change in 2010? Even if ACA 4 is approved, the legislature may still wish to consider additional ways to change the way it puts together the budget. This is because the legislative process is dynamic and flexible, and it can adapt to accommodate externally imposed directives.

If no constitutional change is approved this fall, the next time a constitutional change could affect the legislative budget process would likely be through a successful measure on the 2012 primary ballot—affecting the 2012 budget at the soonest. Internal change, therefore, may still be the most direct and viable way to affect legislative decision making in the immediate term. This article considers the possibility and inherent limitations of adopting substantive procedural changes internally. We divide the discussion into sections:

To what end? Good-government advocates propose to change the way the legislature constructs and passes the budget in the interest of accomplishing an array of sometimes contradictory fiscal or management goals. For example, changes to expedite passage may discourage public disclosure or broad consensus. This discussion focuses on one of the more fundamental and urgent goals.

How well does the legislature “balance” the budget? Has the legislature shown a capacity to make changes in the way it budgets? This section assesses recent efforts to balance the budget.

### **What Are the Limits to Procedural Change?**

If the legislature were to adopt change to affect “budget balance,” what would it be? How would the legislature enforce adherence to the procedural change? Since the legislature can “unbind” itself from its own rules—and does so on a regular basis—how can internal rules be enforced?

### **Bringing the Budget into Balance**

Budgets may be constructed to achieve many fiscal or policy goals.<sup>1</sup> Many interests and coalitions have studied the state's fiscal problems and recommended procedural changes.<sup>2</sup> California Forward, representing a broad coalition is perhaps currently the most visible among these groups. Its proposed budget changes include a constitutional amendment to reduce the vote requirement for the budget from 2/3rds to majority and several statutory changes that would increase the amount of information reported by the legislature and governor.<sup>3</sup> In addition to balancing the budget, these proposals may seek a variety of changes to the budget process, intended to facilitate the following:

- Rigidity to limit spending. Californians have attempted to direct and limit government spending through appropriations limits, sometimes spending caps or earmarks of General Fund revenue.
- Transparency to improve public accountability. In an age of broadly distributed information, the standards for timely and clear accessibility are high. The public expects the legislature to facilitate public review of budget decisions by providing adequate accounting.
- Efficiency to encourage cost-effective allocations. Though it may not be possible to ensure that the last budgeted dollar is allocated to its highest and best use, prudent spending can be expected.
- Predictability for purposes of facilitating planning. Few budget appropriations are one-off allocations. For the continuing support of public assistance or operating departments, a particular budget year's allocations follow from expenditures made in prior years. In so doing, they imply a certain continuing commitment and support for the program in subsequent budgets. Even so-called one-time appropriations for capital improvements are made as part of a series of prior appropriations. A road system takes years to complete. A one-time appropriation to build an office building implies ongoing support for the departments housed in the structure. In these circumstances, the allocations in the annual budget reflect prior spending decisions and imply continued support. To fulfill this objective, the legislature looks beyond a single year to ensure that the revenue stream can sustain the spending commitments.
- Flexibility to help the government to adapt to changing fiscal conditions. Budgets reflect changing economic and political conditions. The affordability and prudence of any particular budget depends on external factors, such as changes in the state's revenue streams and evolving political considerations. The recall of Governor Davis and election of Governor Schwarzenegger were seen as indica-

tors that the public wanted the car tax to remain low. This tax cut implied a \$5 billion corresponding cut in state spending.

If implemented all at once, the California Forward changes would facilitate achievement of many of these goals simultaneously. Rarely, however, can a legislature pursue these goals simultaneously with equal vigor and success.<sup>4</sup> A budget designed to provide departments and the public with a predictable level of service is unlikely to be flexible in the face of economic downturns. A legislature facing a highly transparent budget structure may respond to popular pressure to change spending beyond an efficient level. To be sure, multiple policy or fiscal goals increase the difficulty of constructing a budget.

Recognizing the difficulty of pursuing several goals simultaneously, the following discussion focuses on changes to facilitate balancing the budget.

### **Estimating the Deficit Problem**

On October 1, 2009, State Treasurer Bill Lockyer, reporting on the state's long-term fiscal future, assessed the affordability of the state's rising debt loads. He assumed that neither spending nor revenue patterns would change substantially over the next 20 years. His estimate<sup>5</sup> showed debt payments rising from 6.7 percent of the General Fund budget in 2009-10 to nearly 11.0 percent in 2017-18, then falling to a long-term rate of about 9.3 percent. While any such long-term estimate will have a number of significant estimating errors, the treasurer's estimates point to the fiscal problem the state faces: Even assuming that the state will collect enough money to address its needs, debt costs will become a larger portion of the budget, increasing their share by about 40 percent. For all other programs, the implication is clear: If the legislature would keep the budget balanced, accommodate rising debt costs and not raise taxes, it would have to cut all other programs by about 2.5 percent to make room for rising debt payments.

Finding room in the already-strained budget to accommodate further cuts suggests that the legislature cannot be sanguine about the state's ongoing budget balance. Failure to address the deficits makes the state more susceptible to the kind of cash-crunch it experienced in December 2008. Then, having borrowed from its internal accounts over many years, it no longer had sufficient cash reserves to cover short-term infrastructure loans. Capital projects stopped as the state waited to refill its accounts or sell its general obligation bonds in the Spring of 2009. By failing to balance its current accounts for several years, the state's cash balances fell below manageable levels. (The concurrent worldwide liquidity contraction made access to the private capital market difficult, but the state suffered disproportionately because of its fiscal difficulties.)

Failure to address the deficit distracts the legislature and governor from anticipating substantive policy and fiscal needs. In the last ten years, the legislature's fiscal management has been skewed toward securing an end-of-year budget balance, leaving little room for discussion or consideration for planning or setting long-term priorities.

Finally, the deficit can distort fiscal choices. For example, in the 2010 May Revision proposal, the governor proposed eliminating welfare programs, even though doing so meant giving up a significant amount of federal matching funds.

### **Assessing Recent Efforts To Balance the Budget**

In the face of a rising deficit problem, has the legislature shown a capacity to bring the budget into balance? To the extent it has adjusted its internal procedures, how well have legislatively initiated procedural changes worked?

For about ten years, the legislature and governor faced a fiscal environment in which General Fund revenues consistently underperformed expectations. As revenues fell, the prospects for a ballooning operating deficit rose. In seeking to more closely align revenue and expenditures, the governor and legislature were constrained by a general reluctance to raise taxes. They brought the budget into balance primarily by cutting expenditures from the baseline and acquiring debt to finance continued spending.

The state's fiscal extremity can be traced in part to the last period of rapid revenue growth during the rising revenues associated with the technology boom from 1996 through 2000. In November 1999, before the technology bubble burst, revenue estimators had a notion that the revenues fueled by the technology bubble might be temporary, but they could not predict the extent of the temporary revenue bubble or how quickly it would burst. At that time, the Legislative Analyst's Office (LAO) estimated revenues would be about \$617.0 billion over the seven year period ending in 2005-06. Actual revenues for that period totaled \$542.7 billion, about \$74.3 billion below the LAO's 1999 estimate.<sup>6</sup>

Did the legislature adjust spending after revenues began to slide? We note that the Analyst in 1999 expected General Fund expenditures to total about \$590.3 billion in the LAO's forecast years after 1999. Actual cumulative expenditures were about \$553.1 billion, a reduction of \$37.2 billion. The legislature and governor did in fact reduce expenditures in response to the eroding fiscal situation. By cutting so much relative to the Analyst's baseline estimate, the legislature demonstrated a willingness to make large changes in the state's expenditure structure. Unfortunately, the cutting was not enough to offset fully the falling revenues. Though the Legislative Analyst in 1999 had estimated operating surpluses would be about \$6.0 billion by the mid-2000s, the state suffered through operating deficits in which annual expenditures

were greater than annual resources—even after expenditure cuts. To this day, the legislature and governor continue to work to bring the budget into balance.

Since the full effects of the recent recession have become apparent, the legislature and governor have struggled to find means to address the growing fiscal stress. As a measure of their response, the LAO's Fiscal Outlook provides a baseline against legislative action. In November 2007, before the depth of recession was apparent, the LAO estimated General Fund revenues for the three-year period starting in 2010-11 to be \$375.1 billion and expenditures to be \$383.7. Since November 2007—in recognition of the effects of the recession—the legislature and governor have taken several major steps to reduce General Fund expenditures on a permanent basis. In its latest Outlook, the Analyst's Office expects expenditures to total \$322.5, about \$61.2 billion less than its November 2007 estimate, which translates into about \$20 billion in cuts in each of the three years. By any measure, these are steep cuts. However, revenues have fallen even faster, by \$112.3 billion. As a result, even as the legislature made deep cuts in spending, the state's long-term fiscal balance has worsened.

Far from ignoring the growing deficit—a common characterization—the legislature and governor have taken substantive steps to bring spending into line with revenues. Since 1999, the adopted budgets have ameliorated the problems associated with the falling revenues. The recent history suggests that the legislature does respond to fiscal stress to some effect.

Nevertheless, operating deficits emerged. To avoid cash crunches and improve fiscal management, the legislature can modify its internal procedures to help it attain balanced budgets.

### **Limits to Procedural Innovation**

To what extent during the recent stress has the legislature changed the way it reviews the budget? In the years since the technology bubble burst, the legislature experimented with small and large procedural changes to ease or improve decision-making. Beginning in 2002, rather than deferring five-way negotiations on the budget until after the May Revision, it has convened joint-house budget committees as early as February. This was intended to expedite budget consensus and budget closure.

In 2003, it broadened the discussion of the budget beyond the budget year to include out-year effects and improve long-term prospects for funding transportation and transit spending. Similarly, in 2004 and 2008, it broadened the parameters of the budget discussion to include consideration, negotiation and adoption of changes to fiscal institutions, including the constitutional debt clause.



## Decker: Must Constitutional Change Precede Budget Improvement?

In 2009, the legislature conducted perhaps its most wide-ranging procedural experiment when it shifted responsibility for assessing available discretionary revenues to the Director of Finance and the State Treasurer. Through this procedural innovation, the legislature attempted to resolve the last remaining divisive differences of the 2010 budget in a way acceptable to all four caucuses and the governor. In practice, the experiment underscored the limits of procedural change.

When Governor Schwarzenegger proposed his 2009 budget on December 31, 2008, the municipal finance market was nearly shut down, the incoming Obama administration was working on an economic recovery or stimulus package and the state faced a large deficit. The governor asked for quick action on his budget proposal, hoping to secure budget savings in the current year as well as the budget year. The federal government passed its main economic stimulus bill, the American Recovery and Reinvestment and Act (ARRA), on February 17.

ARRA was expected to provide fiscal relief to the state's General Fund. The governor and legislature sought to pass the state budget immediately after the President signed the federal stimulus bill, even though they were unable to assess the full extent of the state's share of ARRA relief. State budget negotiations began to falter as disagreements arose over how much federal assistance might offset General Fund budget cuts and revenues. Unable to quickly and sufficiently assess how much federal stimulus funds were available to offset state General Fund effects, the budget writers developed an alternative budgeting process that allowed the legislature to pass a budget on February 20.

In order to pass the budget prior to determining with precision how much stimulus funds would be available to offset General Fund spending, the legislature made budget allocations contingent on a later fiscal determination by the State Treasurer and the Director of Finance. As part of the budget package, the treasurer and director were to determine how much federal-offset funds the state would receive. They were to make this determination from the broadest possible range of facts. If the treasurer and director determined that ARRA funds displaced \$10 billion in General Fund spending, then \$1 billion worth of spending cuts could be restored and \$2 billion in tax increases would be rolled back.

As a procedural innovation, this mechanism allowed the governor and legislature to explicitly recognize the fluid and uncertain nature of the state fiscal condition. Rather than get bogged down in partisan wrangling and let uncertainty delay action, they charged fiscal representatives to make necessary allocations. The legislative delegation was written to be flexible, so that when the treasurer and director--one elected and the other appointed by the governor--made a determination, they could bring a wide range of facts to the situation. If it worked, this mechanism would enable the legislature and governor to shift the budgetary impasse to a different forum and possibly achieve a more neutral decision. In the event, the legislation

was not as robust as its proponents had hoped. Its application was constrained by the State Constitution, which reserves to the legislature the power to appropriate and specifically prohibits the legislature from transferring this responsibility to another entity. When the treasurer made the determination, he concluded that:<sup>7</sup>

...the legislature, in requiring [the director and treasurer] to make the trigger determination, cannot, within the provisions of the State Constitution, delegate to the State Treasurer or Director of Finance the power to set fiscal policy. Our determination must be one that serves an executive, not a legislative, function. In making the trigger determination, our responsibility is to evaluate whether the condition meets the criteria established by [the authorizing statute], not whether legislated fiscal policy is appropriate.

In practice, neither the treasurer nor the director could be deputized to make a decision constitutionally reserved to the legislature. The treasurer's response points to an important limitation on any change—internal or external—that does not address the legislature's central role in appropriating funds.

### **Self-Regulating Incentives To Achieve Balance**

Typically, the media and the Department of Finance measure whether the budget “balances” by assessing the June 30th balance at the end of the fiscal year. By checking the balance on the same date each year, they assume that the state has a consistent year-by-year measure of inflow and outgo. It is a practical measure, irrespective of daily cash balances and seems consistent with notions of annual budget balance. It offers a comforting assurance that the state's fiscal condition can be measured and assessed. But, like many measures of fiscal performance, it is incomplete.<sup>8</sup>

Though the June 30 balance is a simple, practical and intuitive measure of budget soundness it is easily manipulated. For example, if the state's accounts are in deficit during the days before and after June 30, how confident can Californians feel that the budget is sound and free of deficit? Consider the 2008-09 budget: The Department of Finance estimated that the June 30, 2009 balance would be about \$2.6 billion, while acknowledging that the state's revenue structure could not sustain the 2008-09 funding levels in subsequent years. If no further budget changes were made, the state's operating deficits would balloon. Over time, moreover, the legislature and governor have learned to use an array of methods for propping up the balance, if only for purposes of making a positive accounting on June 30 of each year. To raise end-of-year balances, they have included borrowed resources, deferred paying off current accounts, delayed June payments into July, and transferred money from non-

General Fund accounts. These methods, often derided as gimmicks, have become an essential part of the state's budgeting.

The State Constitution reserves to the legislature the function for appropriating state revenue. Without an explicit action to appropriate, most state-financed activities—including operating budgets for state departments, grants allocated by state and local agencies—would cease. Non-constitutional reforms are limited by this primacy of the legislature. When the legislature itself adopts procedures to direct budget outcomes, it can suspend or waive those procedures if they become difficult. Even statutory directives, if adopted and approved by the legislature and governor, will not constrain subsequent action, as the legislature can repeal those statutory provisions as part of a vote on a budget package.

The legislature can, without constitutional change, create a budget that balances. When the legislature does not do so, it is presumably responding to other considerations that make balancing difficult. The hope, when revising internal rules, is to create better incentives for institutional behavioral changes.<sup>9</sup>

Because the constitution reserves to the legislature the power to appropriate, the legislature carries the primary responsibility for setting the terms of the budget package. It establishes the conditions under which the budget is deemed “acceptable.” Its responsibility cannot generally be delegated or mitigated. Given the legislature's central role in making budget appropriations, it sets the parameters for what is an “acceptable” budget prior to a final vote on the budget package. The following conditions could help the legislature move the budget to balance:

Adhere strictly to Generally Accepted Accounting Principles (GAAP) and evaluate budgets in a manner consistent with them. To the extent prior budgets adopted deviations from the standards, identify the deviations and calculate the cost for conforming with the standards. Consider these costs to be part of the carryover deficit.

Recognize and finance the carryover deficit from prior years and commit to paying down this carryover amount by June 30, 2015. In this context, “carryover deficit” includes not only negative reserve balances identified by the Department of Finance on each July 1, but any costs identified in (1) above. By identifying explicitly the carryover deficit and setting a target for paying the deficit off, the legislature will isolate the carryover deficit from the operating deficit. Practical, though not insurmountable, problems come with identifying the carryover deficit and financing it over four years. The provisions of Proposition 58 limit the legislature and governor from “rolling over” deficits.

Keep current accounts in balance. This helps limit the expansion of the operating deficit. This applies to all spending expansions, even if they are “financed” by a tax increase or a reduction in other programs, so called “pay-as-you-go” (PAYGO) financing. PAYGO financing rules, often suggested as a way to control program

expansion, tend to encourage advocates to prey on least-favored programs to finance new programs. As long as the state is running deficits, lower priority programs should be eliminated rather than swapped to finance higher-priority programs.

Prior to hearing the budget on the floor of either house, the legislature could commission an independent analysis of the budget to determine whether the budget meets the conditions described in paragraphs 1 through 3. The independent analysis would provide a review of whether the proposed budget in fact balances current revenues and current expenditures, subject to prudent budgeting standards. The independent analysis would serve the same function as a line judge in tennis. While not a participant in the match, the judge plays a critical role in determining when the play is out of bounds. The independent analysis would determine if the budget is out of balance. To ensure independence, the analysis could be conducted by a person whose compensation and continued employment is not subject to legislative control, perhaps akin to the state auditor. The analysis would not be intended to trump legislative discretion, but it would provide for a level of review not currently available.

The independent review falls into a class of institutional provisions sometimes referred to as “soft” constraint, as distinct from a “hard” constraint on budget deficits. Even with a hard constraint, there is reason to suspect that budget improvements come slowly, not so much by the imposition of rules<sup>10</sup> as an evolving “dedication” to achieving a sound budget.<sup>11</sup>

### **Conclusion**

In recent years, the legislature and governor have faced a remarkably challenging fiscal environment. Together, they addressed an eroding budget situation with substantial changes in the state’s General Fund expenditure budget. They will need to do more to bring the state budget into balance and eliminate the ongoing/structural deficit.

There is no substitute for ensuring that the difficult decisions to balance the budget—raising taxes or lowering spending—are made. Under the current constitutional framework, the legislature must make appropriations. It is, inescapably, responsible for the short- and long-term health of the state’s fisc.

Until the legislature and governor can secure the necessary consensus to align expenditures with revenues, the state’s deficits will continue. To assist the review and consideration of budgets, the legislature may wish to empower an independent critique of the budget prior to its passage.

Decker: Must Constitutional Change Precede Budget Improvement?

**Notes**

<sup>1</sup> John Decker, *California in the Balance* (Berkeley: Berkeley Public Policy Press, 2009): 128–30.

<sup>2</sup> John W. Ellwood and Mary Sprague, “Options for Reforming the State Budget Process,” in *Constitutional Reform in California Making State Government More Effective and Responsive*, ed. Roger G. Noll and Bruce E. Cain (Berkeley: Berkeley Public Policy Press, 1995).

<sup>3</sup> <http://www.caforward.org/index.cfm/projects1/the-california-forward-2010-reform-plan1/>.

<sup>4</sup> Rudolph G. Penner and C. Eugene Steurele, “Budget Rules,” *National Tax Journal* LV II, no. 3 (September 2004): 547–52.

<sup>5</sup> Bill Lockyer, “2009 Debt Affordability Report,” October 1, 2009.

<sup>6</sup> Legislative Analyst’s Office. *Fiscal Outlook*. November 1999 through 2006.

<sup>7</sup> Bill Lockyer, letter to Governor Schwarzenegger and legislative leadership. March 17, 2009.

<sup>8</sup> Howell E. Jackson, “Counting the Ways” in *Fiscal Challenges*, ed. Elizabeth Garrett, Elizabeth A. Graddy and Howell E. Jackson (Cambridge: Cambridge University Press, 2008), 217.

<sup>9</sup> Juliet Ann Musso, Elizabeth A. Graddy, and Jennifer Bravo Grizard, “Budgetary Arrangements in the 50 States” in *Fiscal Challenges*, ed. Elizabeth Garrett, Elizabeth A. Graddy and Howell E. Jackson (Cambridge: Cambridge University Press, 2008), 217.

<sup>10</sup> Thad Kousser, Matthew D. McCubbins, and Kaj Rozga, “How Does the Ballot Box Limit the Budget?” in *Fiscal Challenges*, ed. Elizabeth Garrett, Elizabeth A. Graddy and Howell E. Jackson (Cambridge: Cambridge University Press, 2008), 318.

<sup>11</sup> Stuart Young and Drew McClelland, “Implementing Biennial Budgeting for the U.S. Congress” (Harvard Law School Federal Budget Policy Seminar) Briefing Paper No. 20, 2006.