THE CALIFORNIA *Journal of* Politics & Policy

Commentary

Volume 3, Issue 2, 2011

How to Grow California's Economy and Restore Fiscal Sanity to the Budget

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For Democrats, at this moment in history, the challenge of governing is how do we restore fiscal reality to our state budget and, at the same time, grow our state's economy? Democrats run for public office because we believe government should play an active role in improving the lives of its citizens. Very few Democrats run for office because they want to shrink the size of government. In 2011 and beyond, Democrats will have to defer their historic ideological mission for another time and accept the responsibility of cutting government spending now.

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The duty will inevitably put a Democratic governor, democratic constitutional officers and, most especially, Democratic legislators at odds with some of the traditional Democratic constituencies and interest groups. And the elected officials can't shrink from that responsibility. California voters overwhelmingly have chosen Democrats to lead them out of this economic crisis, and if we fail the political consequences in future elections could be profound.

Governor Brown has opened the debate by coming forward with an honest budget based on real numbers, free of phony accounting gimmicks. Its basic premise is that half of the answer to erasing the deficit should come from cuts in spending and half should come by extending taxes that are scheduled to expire—a formula, by the way, that was also Governor Pete Wilson's when faced with similar problems.

This is both sound policy and good politics. As political leaders and as voters, if we do not close our budget deficits the consequences will be profound. At some point I hope there will be a published proposal of an all-cuts budget so people can actually see what it looks like. I have no enthusiasm for closing public schools an additional six weeks of the school year. That might be the low end of how much you have to shut them if you did an across-the-board 31 percent cut in all forms of spending. That assumes you can even do Medi-Cal with MOEs and other things. It assumes that, to avoid deeper cuts in K-14, you can reduce prison sentences and discharge a lot of old or short-term inmates, and other things that would not be easy.

Our inability to create bipartisan compromises in the state budget has resulted in this endless shell game that's mired California in a persistent and ever-growing budget deficit. Unfortunately, too often the expedient has trumped the prudent. Democrats must prove they are willing to make substantial cuts in government spending to have credibility in this debate with voters and with Republican colleagues. The fact is that voters are likely to again reject the governor's call to extend expiring taxes unless they see real budget cuts passed by the legislature.

I hope Republicans will begin to participate fully in the governing of California, and Democrats should welcome their participation. If Republicans fail in their responsibility, they will continue to be a shrinking minority party. They must negotiate with the governor and Democratic colleagues in good faith and take the litmus tests off the table. That would begin to make the Republican Party relevant to the future of California.

To my Republican friends, I ask this simple question: What good has all the political posturing done for the Republican Party? When you can't make progress in California during a national Republican landslide, it's time to try a new approach. When Grover Norquist, a professional anti-tax activist based in Washington, D.C., demands that every California Republican legislator sign a no-tax pledge even denying the people the right to vote on the path forward, we really are in the Twilight Zone. If Republicans are hostages to their litmus-test politics, they won't be at the table that works out the budget fix. Republican voices and ideas will not be part of the solution.

Democrats can't expect Republicans to commit political suicide in order to pass a budget. That's why Democrats must be prepared to negotiate with Republicans on spending cuts that last at least as long as the tax hike extensions. Should either party come out of the budget negotiations declaring victory, California will be the loser. Democrats and Republicans can choose another way. We can turn California around.

I loved listening to the John F. Kennedy speeches that we saw again, 50 years later. In his inaugural address, he said, "United there is little we cannot do. Divided there is little we can do." I think that's true of Sacramento.

The *New York Times* recently reported some under-the-radar activity on Capitol Hill about preparing states for bankruptcy. I have said that's impossible. No state has

DOI: 10.2202/1944-4370.1147

asked for it, and no state wants it. It's based on a fiction that states either need to, or want to, or will consider going into bankruptcy. This was a Newt Gingrich proposal, and Newt's philosophy, somewhat consistently in the last several years is that you've got to burn the house down and rebuild. That's Newt's view of the world these days, and here's his latest idea, "Let's crash the states, and we'll think about what we have afterward.

I'm the banker for the state and my reaction to the preposterous suggestion is to worry about the millions of people who have bought bonds, because it depresses the value, unnecessarily, of their property. And so for somebody who claims to be sensitive about property rights, I'm saying, "Don't injure these people who are bondholders and their property rights, unnecessarily."

Second, it increases the cost of borrowing for states and localities. People talk about debt service and how much is good or bad, and the federal debt that's paying operational expenses. I do a lot of borrowing, $10 billion or so a year, just to pay next month's bills. It's not long-term debt. It's just cash management, because there are times of the year when money is abundant, at April 15th, and times when it's slow, in July for example. So we borrow in order to bridge these gaps. Well, those kinds of worries in the investment community substantially increase the borrowing cost of short- and long-term debt, so taxpayers wind up paying more. It's irresponsible.

And, third, as someone who thought that Newt and others were sensitive about states' rights issues, to have the federal government change the law to compel states to waive their sovereign rights and go to Federal Bankruptcy Court is an abridgment of states' rights. So there are three conservative reasons why it's a bad idea and an unnecessary one.

There has been a lot of talk about expanding the tax base with some even suggesting we tax such things as gambling and marijuana. Those would not be the first two I would put on the list if I were contemplating expanding the tax base. There is a huge underground economy in which enforcement actions might bring in moneys owed. But separate from that, the traditional argument is whether there ought to be taxes on services, not just income or property.

That's an ongoing debate, and I suspect someday there will be some broadening of the sales tax base to pick up some services. I don't know which ones, and when or in what context that will happen. The most likely circumstance will be one where you broaden the base and lower the amount so that it nets out as fairer and smarter. In aggregate taxes paid per capita California is now about 14th in the country. People like to say, "We have a high rate of this sort or a high rate of that sort." We do, usually because the base is narrow. If you broaden the base, you can bring the rates down and address the optics and some of the unfair progressivity.

Some people are concerned about the fiscalization of land use, but I'd like to see the empirical evidence. I've heard the arguments, and I see, on occasion, where it's desirable to have an auto mall or a big box store or something. I'm not sure how much acreage is consumed that way that's imprudent or unwise. I would like to see more empirical analysis and less theory. I used to say to colleagues, the plural of anecdote is not evidence. Could we do a little more work on defining our policy options with some facts?

I think California is at or near the ceiling of our aggregate tax capacity, state and local, so those who would like to spend more are going to have to realize we aren't going to. It's not a function of the fact that you need a two-thirds vote, and the Republicans aren't going to agree. It's a question of the natural constraints on the amount that government can take for the public sector and what voters are willing to pay for. When you ask the question, as Jerry's pollster has and mine has for the last 12 years, "What proportion of your state taxes do you think are wasted?" and they say 48 percent, you see what the realities are. It's hard to say 48 percent is wasted when 71 percent of the state budget is transfers from the state to local agencies, where people generally think there's less waste.

If you compare the state in terms of employees and expenditures on employees, state, and local government, the numbers are something like this. Per capita we are the fourth thinnest of the 50 states, and mostly that's about economies of scale in an urban environment. Red states spend more on government than we do.

If you add in the salaries and the pensions and so on—California state government is ninth from the bottom on that list. If you look at local government spending on the list of 50 states we're third from the top—that counts schools and cities and counties and so on. So one of the interesting ironies is that local government, in which voters have the most confidence and respect, spends substantially more than similar governments in other states. And the state, which they think is wasting almost half its money, is low compared to spending in other states.

I sit on the Board of CalSTRS and CalPERS. And, on the issue of retirement security, we need a national debate to try to figure out what is expected and what's an adequate way to treat retired people. A good friend of mine, Peter Schwartz, who is a futurist and was the forecaster for Shell International, runs a think-tank. He says anyone currently alive, who can live three more years, will probably live to be 120. As for their kids or grandkids, if they're under 40, there's no upper age. This is really difficult on pensions and a lot of other things. Assuming the current actuarial predictions are reasonably reliable, there will be extended life spans, but more modest than Peter Schwartz predicts.

The problems in the public pension systems are grossly exaggerated for ideological reasons. There are people who don't like public employees. They don't like the public sector. They don't like unions. They don't like what unions do with their political money, and they frequently don't like what those pension systems do like demanding improved corporate governance from the companies they invest in. They want boards of directors elected more honestly and not just through an inside game. There may be some who think, "Here is a professional cadre of investors who are working for working people, not rich people." And there's something discomforting about that.

So for whatever reasons and motivations, we wind up with distorted analysis, most notably one by my friend, former Assemblyman Joe Nation, who pumped out a study for Stanford that is junk. A woman named Amy Brown, in the *Retirement Journal,* critiques the methodology, the assumptions, the fact that it's not a legal form of accounting that they propose, and on and on. The fundamental problem is this: they claim that PERS and other pensions should assume, relative to their future return, that it's going to be the same as investing in 10-year federal bonds. That's about 4.1% return. If I have $225 billion, and all I'm doing with it is buying U.S. Treasury Bonds I am a fool. I'm leaving potentially half or more of my earnings on the table.

Over the last 21 years, the return on PERS investments has been 8.6%. The assumption has been that it will grow 7.75%. So they've been beating the assumed rate of return for over two decades. Now, we don't know that there will be similar rates in the future, and that's a reason to be careful and prudent about those actuarial assumptions. But they aren't far off, and they shouldn't be 4 percent. That's the fundamental problem with the Stanford analysis, and it balloons the deficit.

But unpaid liabilities do exist, and the earlier you address them, the better. People should know they aren't zero. It's not a system in which the obligations have all been paid for. They are 40 years in duration and you can make small changes in benefit payouts, in retirement ages, in contributions from an employee and employer and so on, to balance the system over time. That's beginning to happen. The governor had changes made in PERS pension contributions last year. In some of the negotiated contracts there are similar changes, and there are many others in local government that are beginning to work through their system. These issues are being addressed in honest ways by competent negotiation.

The bigger problem is healthcare. Healthcare is the ballooning cost that's unpaid for. It is not like retirement pensions, where about 72 percent of the payout is from investments of employer and employee contributions that grow. That pays for almost three-fourths of the pension obligation, and employee and employer contribution are about a fourth combined. Healthcare is pay-as-you-go. And the cost grows at 7 to 9 percent a year. That's not paid for, it's not prefunded, it continues to grow, and we continue to get older.

I don't know to what extent one can claim legitimately that the federal health reforms will have some impact on the growth. I think about this a lot and talk with people about it a lot. The fundamental difficulty is that the Feds control the money, and the states control the spending. There's a disconnect between eligibility standards and rates of reimbursement to hospitals and so on. So when the state tries to save money by controlling healthcare costs, they don't get much benefit. They're saving money for the Feds. But they have to go through the fight about seismic safety standards, or nursing staff ratios, or reimbursement for hospitals, the list goes on and on. They have to put up with horrible political challenges, and there's very little financial benefit for them. In fact, there's a great disincentive because for every buck you cut here you lose three there. And why would we leave the money in Washington, D.C., rather than maximize how much we can draw down?

Somebody needs to figure that out. If the Republicans in Congress were smart, rather than health insurance accounts and other IRA mechanisms, the smart thing to do in Washington would be for them to enact a policy where there are economic incentives built into the system, both federal disbursements and what state behaviors are affected, to save costs. You rely on what might be called a market approach, but it's a sort of system market approach to get savings and reforms.

As for pensions, three-fourths of PERS employees get a pension of under $30,000 a year. I don't think anyone regards that as excessive. What they do worry about, and I think justly, is the spikes, the unfairness, the folks at the top who make enormous incomes and huge pensions and manipulate the system and game the system to walk away with more. So, the average state employee is making essentially 2,500 bucks a month from her pension. For teachers it may be a couple of times that for a lifetime of work. I don't think most people would regard that as horribly unfair.

There are those who complain about pushing the costs of services that have already been provided onto our grandchildren. I like building schools that our grandchildren will pay for. I think that's prudent. There are things that we pay for intergenerationally that are smart and wise, and obviously investing in education is the principal one that makes lots of sense.

Think of it as a banker would. Businesses amortize capital outlays. It's analogous in the human-investment sector to doing the same thing and distributing your invest-

DOI: 10.2202/1944-4370.1147

ment costs over a number of years. That's what a pension is. So it's asking for the same tax treatment that businesses get with their investments. There is a point to be made about its fundamental fairness in terms of tax philosophy.

We have to separate that from the abuses and address the abuses. What should be the correct years that you consider? I don't know. I think it's a fair debate. I'm not filled with the conviction that some people on both sides of the debate have, mostly driven by self-interest or philosophy. My friends in public employee unions don't like the rate of assumption being lowered, and I'm one who voted to do it. I think it is fair to spread losses over a number of years. I don't know the right number, but I think it's fair to distribute losses. We're obligated under the law to maintain a reasonably stable, foreseeable obligation on the part of employers as to what their future contribution will be to the system, and we try to avoid big peaks and valleys that distort their planning and fiscal stability.

There are a variety of factors that feed into the current numbers. There's an active debate underway and an interesting one. I like the fact that there is a renewed vigor in California to look at all these issues in an honest way.