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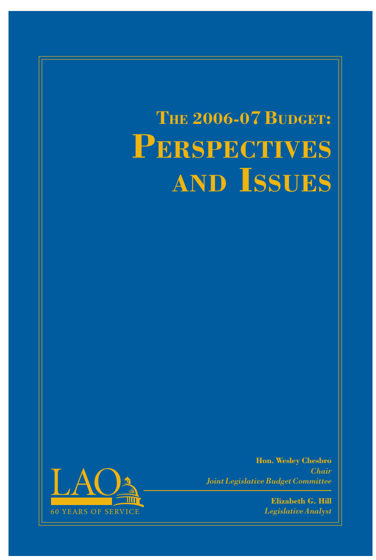
Highlights of the:

2006-07 Perspectives & Issues

ELIZABETH G. HILL • LEGISLATIVE ANALYST



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Acknowledgments

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PART I—STATE FISCAL PICTURE

- California has benefited greatly from over $11 billion in unanticipated increases in state revenues. Yet, due to its allocation of these funds, the *2006-07 Governor's Budget* would still leave the state with large structural budget shortfalls and an enormous amount of outstanding financial obligations.
- In this regard, the budget proposal misses an important opportunity to take advantage of highly favorable revenues to get the state's fiscal house in order.
- We thus recommend that the Legislature reduce the amount of ongoing spending increases proposed in this budget, and use the savings to either increase reserves or pre-pay additional budgetary debt.

PART II—PERSPECTIVES ON THE ECONOMY AND DEMOGRAPHICS

- California's economy grew at a solid pace in 2005, although the state's real estate markets softened late in the year.
- We forecast that the state's economic expansion will slow some but continue at a moderate pace through 2006 and 2007.
- This positive forecast is subject to significant downside risks, however, related to soaring energy costs and a steeper than-expected decline in California's real estate market.

PART III—PERSPECTIVES ON STATE REVENUES

- Reflecting strong revenue trends in 2005 and other factors, the budget is assuming that revenues during 2004-05 through 2006-07 will exceed the *2005-06 Budget Act* estimates by a combined total of $9.2 billion.
- We project that revenues will be even higher, exceeding the budget estimates by $1.3 billion in 2005-06 and $1 billion in 2006-07, or $11.5 billion combined compared to the *2005-06 Budget Act.*
- However, much of the current revenue strength is from highly volatile sources—such as investment income and business profits—which could quickly fade if the economy slows by more than expected.

- As an illustration, we estimate that a steeper-then-expected slowdown in California's real estate markets could translate into a $4 billion decline in General Fund revenues in 2006-07.

PART IV—PERSPECTIVES ON STATE EXPENDITURES

- The budget proposes total state expenditures of $122.9 billion, including $97.9 billion from the state's General Fund and $25 billion from its special funds.

- General Fund spending would grow by 8.4 percent between 2005-06 and 2006-07, while special funds would decline slightly due to one-time factors.

- The General Fund increase reflects program expansions in education, the prepayment of a transportation loan, and baseline increases in most other programs. Social services spending would decline slightly under the proposal.

- Despite some progress in 2005-06 and 2006-07, the state would still have $20 billion in budgetary debt outstanding at the close of the budget year. Annual General Fund costs related to repayment of this debt would rise from $3.7 billion in 2006-07 to a peak of over $5 billion in 2008-09.

- On a real per-capita basis, total state spending proposed in the budget would reach a new high in 2006-07, and total spending would be at it's highest level in the past ten years relative to the overall economy.

PART V—MAJOR ISSUES FACING THE LEGISLATURE

State Has $40 Billion to $70 Billion in Unfunded Liabilities for Retiree Health Costs

- The costs of providing health care to retired state employees and their dependents—now approaching $1 billion per year—are increasing significantly. Many other public employers (including the University of California, school districts, cities, and counties) face similar pressures. We find that the current method of funding these benefits defers payments of these costs to future generations.

- Retiree health liabilities soon will be quantified under new accounting standards, but state government's unfunded liabilities are likely in the range of $40 billion to $70 billion—and perhaps more. We recommend legislative action to (1) encourage disclosure and planning for payment of these liabilities and (2) begin to set aside funds each year that will cover future state benefit expenses and reduce or stop the growth of unfunded liabilities passed on to future taxpayers. (*P&I,* "Part V.")

(Contact: Michael Cohen, 319-8310.)

➢ Many of Governor's Emergency Preparedness Proposals Are Flawed

- The Governor's budget contains proposals for increased spending of $61 million ($54 million from the General Fund) in the budget year related to the state's emergency preparedness and response programs—primarily for public health and agricultural emergencies. While some of the proposals are warranted, most of the proposals suffer from one or more deficiencies—such as the failure to maximize funds other than the General Fund, poorly designed solutions, and the failure to follow state information technology policy. Consequently, we recommend the Legislature reject many of the administration's proposals. We also offer a number of key considerations for the Legislature as it evaluates the state's emergency preparedness. We comment on recent federal funding changes, reducing risks through land use decisions, and the creation of separate homeland security and public health departments. (*P&I,* "Part V.")

(Contact: Michael Cohen, 319-8310.)

➢ New Federal Act Will Provide Transportation Funding Through 2009

- The new federal act (SAFETEA-LU) will provide $23.4 billion to California through 2009, including $18 billion for highways, $5 billion for transit, and $452 million for safety. This represents a 40 percent increase in average annual federal funding over the previous transportation program. The act also presents opportunities for financing transportation through nontraditional sources and expediting project delivery.

- There are a number of issues for the Legislature to consider when implementing the act in California. We recommend that the state identify how federally earmarked funds align with statewide funding priorities. We also recommend that the Legislature authorize Caltrans to pursue design-build contracting on a pilot basis and to partner with the private sector in order to take advantage of SAFETEA-LU's innovative finance opportunities. (*P&I,* "Part V.")

(Contact: Dana Curry, 319-8320.)

Reorganizing the State's Energy-Related Activities Needs Jump Start

- Currently, the state has multiple entities that make and implement energy policy. Problems with the current structure include duplicative and overlapping responsibilities, and limited accountability for policy decisions. The Governor's proposal to reorganize the state's energy-related activities is contained in AB 1165 (Bogh).

- We think that the time is ripe for the state to reorganize its multiple energy entities. In contrast to the Governor's proposal, we do not recommend transferring the functions of the California Power Authority and the California Energy Resources scheduling operation to the new department, thereby avoiding a potential conflict of interest. (*P&I,* "Part V.")

(Contact: Mark Newton, 319-8323.)

Mental Health Mandates Continue to Pose Challenges

- The costs of two state-mandated programs to provide mental health services for special education children have grown significantly, and are plagued by serious weaknesses, including a lack of accountability for ensuring the quality of these services. We comment on administration's plans to repeal these mandates and the Legislature's options for addressing these issues. (*P&I,* "Part V.")

(Contact: Daniel Carson, 319-8350.)