

# UC Berkeley

## California Journal of Politics and Policy

**Title**

What Do Debt Loads Say about California's Fiscal Condition?

**Permalink**

<https://escholarship.org/uc/item/89d2z8d8>

**Journal**

California Journal of Politics and Policy, 1(1)

**Author**

Decker, John

**Publication Date**

2009-03-10

**DOI**

10.5070/P23W32

Peer reviewed

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

---

Volume 1, Issue 1

2009

---

**What Do Debt Loads Say about California's  
Fiscal Condition?**

John Decker

California Debt and Investment Advisory Commission

**Abstract**

For the past seven years, the state spent more from the General Fund than its tax structure generated. To help cover the difference, the state borrowed from institutional investors. Should Californians be concerned? More broadly, how does debt fit into the annual budget debate? Evaluation of debt loads help Californians assess the fiscal prudence and sustainability of the state's fiscal structures.

**KEYWORDS:** debt, budget deficits, California fiscal condition

**Acknowledgements:** I am thankful to Jerry Lubenow for his continuing interest in this topic and his careful editing. Thanks, too, to my colleagues at the State Treasurer's Office for their review, Steve Coony, Paul Rosenstiel, and Tom Dresslar.

## **What Do Debt Loads Say about California's Fiscal Condition?**

John Decker\*

California Debt and Investment Advisory Commission

On September 23, 2008, Governor Schwarzenegger signed the state's 2008-09 budget, ending nine months of enervating wrangling and dispirited debate. This budget, like many of its immediate predecessors, was not intended to resolve or even manage the bitter differences that delayed its passage. Nor did it address the state's chronic imbalance between revenue and promised services. At the start of 2009, the state's fiscal problems loom as large as they did the year before—or the year before that.

In this light, recent university graduates might wonder if the state weren't better managed when Governor Davis could sign a budget that simultaneously generated a multi-billion dollar surplus and cut college fees. Do mid-career professionals who look back at Wilson-era budgets vaguely recall that the legislature and governor could collaborate to bridge a budget deficit even larger than the 2008 problem? As for baby boomers, they might long for the days when Governor George Deukmejian could announce that his budget would take the state from "IOU to A-OK." To be sure, if the opposite of IOU is A-OK, the state is a long, long way from A-OK in 2009.

In a poll taken during the 2008 delay, 90 percent of Californians reported a "negative" perception of the state budget to the Public Policy Institute of California. Little wonder they should despair, when the budget is framed as an annual race against time and as a forum for waging internecine rivalries.

Californians might be excused for reviewing with dismay the succession of recent imbalanced and troubled budgets, but can they evaluate the consequences of these budgets? To what extent do the state's fiscal problems presage a compromised future for the state? Can the budget problems be measured for magnitude and consequence? This article explores one measure of fiscal stress often cited by public finance experts and Wall Street debt-rating firms the debt load of the state.

---

\*John Decker is Executive Director of the California Debt and Investment Advisory Commission, State Treasurer's Office, Sacramento.

## **Measuring the Budget**

Newspapers and analysts assess budget developments using various rough measures. One of the more popular ways to monitor budget developments is to track delays in passing the annual spending plan. A budget passed on or near the constitutional deadline is deemed “better” than a later budget. Delays into late August signify failure and inadequacy. Timeliness, in this way, is used to measure the political or pragmatic acumen of the state’s top political leadership.

The media often report the budget as a kind of rarified sport. Like a professional sports league, the annual budget cycle comes complete with preseason, regular season and postseason play. The budget “preseason” starts with the governor’s budget announcements, followed by the “regular season” of subcommittee hearings. The “postseason playoffs” begin in the budget conference committee. In this view, the budget may have five “teams”: Each of the legislative caucuses and the governor.

As a sporting event, budget developments can be analyzed as they affect each caucus’s postseason chances. Budget proposals are tactical advances or retreats. Political leadership is scrutinized and handicapped. Are fiscal conservatives keeping their no-tax pledge? Can moderates fashion compromises on a probusiness agenda? Have liberals found a way to expand environmental protections and broaden support for social programs? Over the years, each budget develops a story line and context, almost as sporting events take on a meaning from highlight reels replaying the thrill of victory and the agony of defeat.

Budget analysts, like those employed by the Department of Finance, provide context by measuring proposals against spending levels in prior years. For them, budget allocations gain meaning as solutions to a differential equation. Using their calculations and statistics, Californians can assess how much the current budget differs from last year’s budget. These data help identify the immediate impact of the implementation of a new budget: Will fees at the family campsite go up? Will class sizes at the local grammar school increase? Speaking more broadly, reviewing differences provides context by identifying which programs are growing or shrinking.

Each of these measures—whether identifying the budget’s timeliness, box score or year-over-year changes—will help explain budget decisions. They are popular because they help the public monitor the legislature’s progress toward completing its annual deliberations. Though useful for describing budget progress, they do not yield much information about whether the budget plan is prudent. They do not help gauge the financial strength of the state’s annual spending plan, nor do they calibrate its sustainability.

Budgets are not the measure of great societies. By themselves they cannot comfort the sick or shelter the poor. They do not build world-class universities or pave

roads. Budgets are not an end in themselves. They serve as a kind of financial plan that identifies how the state pays for services. In evaluating the budget as a financial plan, Californians need measures of its viability.

### **Debt and the State's Fiscal Equation**

Central to the meaning of a budget as a financial plan is the notion of “balancing” revenues and expenditures in any fiscal year. Balance can be described as the identity  $\text{Revenues} = \text{Expenditures}$ .

Bringing “Expenditure” to the left side of this equation yields the expression

$$\text{Equation 1} \qquad \text{Revenues} - \text{Expenditures} = 0$$

In practice, the governor and legislature find it hard to exactly match revenues and expenditures, so they expect that the difference between revenue and expenditures will be positive, such that:

$$\text{Equation 2} \qquad \text{Revenues} - \text{Expenditures} > 0$$

These equations are in the same spirit as the constitutional provision prohibiting the state's legislature from creating any debt or debts, liability or liabilities, which shall, singly or in the aggregate with any previous debts or liabilities, exceed the sum of three hundred thousand dollars (\$300,000).

This prohibition, known as the “debt clause,” has been read to prevent the legislature from paying for this year's costs with tax dollars received in later years. It would seem to require the legislature to spend no more than it takes in. By constraining spending to whatever taxpayers are willing and able to pay, the debt clause could act as a powerful spending limit.

The debt clause also seems to promote what public finance experts sometimes refer to as “intergenerational equity.” Treating each year's set of taxpayers as a collective with a common interest in financing and receiving government services, each group can be thought of as a unique “cohort” to whom the costs and benefits of government services accrue. By requiring each year's cohort of taxpayers to pay for the services they receive, the debt clause seems to prohibit fiscal policies that allow one set of taxpayers to beggar a later cohort.

Put another way, it seems to require that the “average” Californian receive no more in services than he or she pays for in any given year. By balancing revenues and expenses, the legislature ensures that each taxpayer cohort may be said to be “fair” to future taxpayers who neither benefit nor have a say in the amount of taxes

**Table 1. Comparison of General Fund Tax Collections and Expenditures, 2000-01 through 2008-09 (Dollars in Billions)**

	<b>2000-01</b>	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>
<b>General Fund Expenditures</b>	\$71.4	\$72.2	\$80.6	\$76.8	\$82.2
<b>General Fund Tax Collections</b>	75.7	62.7	64.9	70.2	80.1
<b>Difference</b>	\$4.2	-\$9.6	-\$15.7	-\$6.5	-\$2.1
	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	
<b>General Fund Expenditures</b>	\$93.5	\$95.4	\$101.2	\$102.9	
<b>General Fund Tax Collections</b>	90.5	93.2	93.6	100.4	
<b>Difference</b>	-\$3.0	-\$2.2	-\$7.6	-\$2.5	

Note: Numbers may not add due to rounding.

inherited. There may be other ways of measuring equity, between taxpayer cohorts—or indeed within a taxpayer cohort—but these measures of equity are not bounded by the constraint imposed by Equation 2 or the Constitution.

At times, the state has balanced its budget with the constraints imposed by Equation 2. For example in 2000-01, the state generated \$75.4 billion in General Fund taxes and spent \$71.4 billion, for a tax surplus of about \$4.2 billion.

Though General Fund tax revenues exceeded expenditures in 2000-01, in each year since then the state spent more than it took in, generating a tax deficit for each year of the entire period. For example, in 2001-02, the state spent \$72.2 billion, while it took in \$62.7 billion, spending \$9.6 billion (after rounding) more than it took in. While some of this deficit could be paid for out of the prior year’s surplus, the state still spent more in the 24 months starting July 1, 2001 than it took in during the same period.

Californians find their state government running chronic tax deficits despite constitutional prohibitions, equity concerns and public finance theory. The persis-

tence of the tax deficit begs the question: How does the state finance its budget in the face of continued shortfalls in tax revenues? After it exhausts its reserves, as it did in 2001-02, the state may seek “nontax revenues,” such as revenue from the sale of state property. When it sells an asset, such as unused real estate, it deposits the sale proceeds in the General Fund. These revenues, not directly derived from a tax levy, are available to the legislature for financing General Fund expenditures.

What happens if, after the state uses all its tax and “nontax” revenues, it still has insufficient revenue? In recent years, it has turned to borrowing to fill the difference between expenditures and revenues. To account for this possibility, Equation 2 can be expanded to include debt, such that:

$$\text{Equation 3} \qquad (\text{Revenue} + \text{Debt}) - \text{Expenditures} > 0$$

Typically, this debt is short- or medium-term in nature. Mostly, the borrowing is for a period of less than a year, but it may be extended for seven years.

The legislature employs many different strategies for this kind of borrowing. Sometimes, as in 2004, the legislature asks voters to approve the issuance of a bond to finance prior deficits. Propositions 57 and 58, approved by the voters in November 2004, authorized the state to issue a bond of up to \$15 billion. The proceeds of this bond will be used to pay off accumulated operating deficits. Bondholders will be repaid their principal and interest over a period of about seven years.

Beyond voter-approved debt, the state may borrow by other means. For example, for the 2008-09 budget, the legislature requires taxpayers “to accelerate” their tax payments. That is, taxpayers prepay their taxes and thereby shift tax payments from 2009-10 to 2008-09. This is a way of taking taxes due in the next year and making them available for spending earlier. It is a way of making next year pay for this year’s services. It is done in the belief that such an acceleration does not violate the constitutional prohibition on debt.

Often, the state borrows deeply from its own funds outside the General Fund. On June 30, 2008, the Department of Finance reported that the General Fund had borrowed over \$950 million from assorted special funds, including the bottles and cans recycling fund, the Public Utilities Commission, the dental board, the accountability board, and the Department of Housing and Community Development. These “loans,” as the legislature constructs them, are considered outside the constitutional debt provisions.

The state can also borrow from private investors on a short-term basis without voter approval. Under certain circumstances, rather vaguely permitted by judicial interpretation, the state can incur such debt without violating the debt clause prohibition.

The state can issue short-term debt to manage its finances in two ways:

- **Manage cash-flow needs.** The state collects its General Fund revenues in fits and starts. For example, the state's predominate revenue source, the personal income tax, is due in full on April 15. Yet, state costs are continuous, so there is a mismatch between outflows and inflows during the year. In particular, the state's first fiscal quarter (from July 1 through September 30) is a lean revenue quarter. To cover expenses during these lean periods, the state may borrow for a time until the revenues are paid.
- **Manage cyclical revenue shortfalls.** The state's tax system responds to the economy. When employment is high and incomes are growing, the state experiences healthy revenue streams. During recessions, tax streams will be more anemic. As the economy tends to cycle through expansions and contractions, the state can expect periodic recessions. During these economic contractions, the state can expect economic recovery, so the legislature may not want to make permanent reductions in its spending patterns. It may, in fact, be important to continue to provide full assistance to Californians, especially during recessions.

Rather than create dislocations in programs and services, the legislature and governor may decide to borrow to keep services at prerecession levels and protect those dependent on services. However, the state's recent history of deficit financing has been sustained through an upward tick in the business cycle.

For these two short-term phenomena, the state might wish to borrow to balance its budget in a given year. In both cases, the long-term, or structural, balance between revenues and expenditures is balanced. The conditions in Equation 2 are fulfilled.

In contrast to these two short-term conditions, however, the state has adopted the practice of using short-term borrowing to finance the difference between revenues and expenditures. By using short-term debt to make up the difference from insufficient revenues, the state has been able to sustain spending above what its tax base can support. To bring the budget into balance without incurring debt, the state will have to either raise taxes or reduce services. In this way, short-term debt patterns can be useful in helping Californians assess the sustainability of spending patterns within the existing revenue streams.

### **Long-Term Debt Is Different**

When the state issues longer-term debt, such as 30-year General Obligation bonds, the analysis changes. The state deposits the proceeds into a bond fund for allocation by the legislature. The borrowed money is allocable in a single year or over many years, even though the bondholders will be repaid over the life of the bond.



The state repays the bondholders over the term of the bond with annual appropriations from the General Fund. Thus, the direct price of borrowing in any given year to incur debt is the cost of paying the bondholders, known as paying the “debt service.”

The state uses the proceeds of debt to finance its capital, such as structures and property acquisition. Based on data reported to the state’s debt commission, state-level entities issued \$70.3 billion in debt (all types) for the period 2000 through 2006. Education facilities, primarily K-12 school districts, received \$35.6 billion (51 percent) of this debt financing. The state allocated another \$14.3 billion (20 percent) to housing, while issuing \$6.6 billion (nine percent) for health facilities. The state sold the remaining amount, about \$13.8 billion, to finance all its other capital projects for the period. Table 2 displays a year-by-year breakdown of issued bonds by major purpose. Long-term debt does not show up in the General Fund budget equation, except as debt service.

There are two practical considerations for evaluating long-term debt.

1. Does the debt practice reflect spending priorities? According to the Legislative Analyst, debt service costs will grow from \$3.9 billion to \$7.7 billion over the next five years. This is an average annual growth rate of 12.2 percent, by far the fastest growing aspect of the budget. The analyst expects total General Fund spending to grow at less than half that rate, about 5.4 percent.

If the legislature permits debt service costs to grow faster than other programs, then Californians may rightly view debt costs as the highest priority call on new spending. For them to evaluate whether this is the appropriate priority, they might consider two policy issues:

- Are the capital projects acquired through the use of debt cost-effective? Will they produce a return that exceeds their cost? Do they produce the highest return among alternative capital projects?
- Is capital acquisition the highest priority for the money spent? Or, should other programs or services have a higher claim on this money?

In these ways, when Californians evaluate the debt service spending, they can evaluate both the use of capital spending, and whether it is most appropriate to allocate the funds to infrastructure or operating expenses. To answer these questions, the legislature will have to set standards for the amount of long-term debt it approves and the kinds of facilities it finances with debt.

2. Long-term fiscal health. Long-term borrowing locks in state expenses to service the debt over the life of the bond. It reduces the legislature’s flexibility to reduce the state’s future costs. As State Treasurer Bill Lockyer warned in his 2007 Debt Affordability Report, the state’s long-term General Fund budget is out of balance on a permanent basis by 3-to-4 percent. For the foreseeable future, the state

**Table 2. Bonds Issued for Financing Capital by Major Purpose and Year, 2001 through 2005 (Dollars in Millions)**

	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06</b>
<b>Health</b>	\$512	\$414	\$1,074	\$1,716	\$1,583
<b>Housing</b>	2,176	2,110	2,628	2,621	2,707
<b>Education</b>	3,199	3,527	8,895	5,571	8,775
<b>Other Capital</b>	1,442	2,880	3,052	3,073	2,038
<b>Totals</b>	\$7,329	\$8,931	\$15,649	\$12,981	\$15,103

  

	<b>2006-07</b>	<b>2001-02 through 2006-07</b>	
		<b>Amount</b>	<b>Percentage</b>
<b>Health</b>	\$1,305	\$6,604	9%
<b>Housing</b>	2,059	14,301	20%
<b>Education</b>	5,639	35,606	51%
<b>Other Capital</b>	1,302	13,787	20%
<b>Totals</b>	\$10,305	\$70,298	

will be unable to balance its budget unless it either raises taxes or lowers discretionary spending.

As Californians evaluate their future debt loads in light of the state’s on-going budget imbalance, they must consider whether it is possible to raise taxes to finance both the capital and operating costs, or whether it is possible to lower spending on the state’s operating budget.

### **Conclusion**

Too often the costs associated with servicing debt are considered incidental to state finances, such as Governor Schwarzenegger’s strange characterization of debt secured with future lottery ticket sales. In July 2008, he called the bond “a gift,” as if a multi-billion bond were so much swag left in a rock star’s dressing room. Even more strange is that the giver—unnamed and paying in the future—cannot be consulted about the “gift” she pays for.

California’s budget situation can be understood in many contexts. Too often, the budget is framed as an annual race against time and as a forum for waging internecine rivalries.

However, a budget does not happen as an isolated “event.” Each adopted budget has implications for those that follow. By monitoring the kind and amount of short-term debt, Californians can assess whether spending patterns are sustainable within existing revenues streams. By evaluating long-term debt levels, they can assess whether debt patterns are sufficient for financing the desired level of services out of the operating budget and the necessary infrastructure out of the capital budget.