CALIFORNIA

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California is once again, my friends, on the move, thanks largely to . . . the governor of our great state, and a good friend of mine, Governor Arnold Schwarzenegger . . . and I’m proud to say of our governor that he has California back on track.

— Assembly Speaker Fabian Nuñez (Walters 2006a)

INTRODUCTION

This remarkable encomium came from a very partisan Democratic Party leader, who was once quoted as saying he had “declared political war on Schwarzenegger (Carreon 2003).” It came just a few days before the state of California managed to produce a budget by the July 1 start of the new fiscal year—the first time since 2000.

THE ECONOMIC CONTEXT

State of the Economy

The new budget, and the probably short-lived spirit of bipartisanship surrounding it, were the result of a number of factors, not least of them a multi-billion dollar windfall in tax revenues. The annual battle over the state’s budget obviously tends to be less acrimonious in good times when there is more money available, without increasing taxes, to meet the many demands for state services.

California’s economy has been on a roller coaster ride in recent years. Figure 1 shows annual percentage changes (in constant dollars) in per capita personal income from 1990 through 2005. After a recession in the early 1990s, California experienced growing prosperity throughout the remainder of the decade, brought on in large part by the “dot.com” boom in Silicon Valley and other parts of the state. When the boom went bust around the turn of the new century, the state experienced another economic downturn, contributing to the recall of Governor Gray Davis in October 2003. The economy has once again turned around, and in 2004, California entered a period of solid, if not spectacular, growth.

This trend has continued into 2006 (not shown in Figure 1). For reasons that will be explained below, California’s tax structure amplifies the impact of fluctuations in the economy on the state budget. As a result, the Governor was able to report in May that revenue for Fiscal Years 2005-2006 and 2006-2007 were expected to exceed earlier projections by a total of about $7.5 billion. Most, if not all, of the increase comes from personal income and corporation taxes (Department of Finance 2006c, 1, 18).
Source: Derived from data in Department of Finance, 2006b.

## California and the Nation

Table 1: Selected Characteristics: California and U.S.

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>California</th>
<th>Rank</th>
<th>U.S.</th>
<th>Cal. as % of U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Millionaires as % of Population (1)</td>
<td>1.7</td>
<td>8</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>% Below Poverty (2)</td>
<td>13.4</td>
<td>19</td>
<td>12.7</td>
<td>106</td>
</tr>
<tr>
<td>Gini Index of Inequality (3)</td>
<td>.475</td>
<td>5(tie)</td>
<td>.463</td>
<td>103</td>
</tr>
<tr>
<td>% 18 Years Old or Younger (4)</td>
<td>26.5</td>
<td>7</td>
<td>25.1</td>
<td>106</td>
</tr>
<tr>
<td>% 65 Years Old or Older (4)</td>
<td>10.6</td>
<td>45</td>
<td>12.4</td>
<td>85</td>
</tr>
<tr>
<td>Persons per Household (5)</td>
<td>2.87</td>
<td>3</td>
<td>2.59</td>
<td>111</td>
</tr>
<tr>
<td>% Foreign Born (2)</td>
<td>26.5</td>
<td>1</td>
<td>11.9</td>
<td>227</td>
</tr>
<tr>
<td>% Non-English Speakers (2)</td>
<td>40.8</td>
<td>1</td>
<td>18.4</td>
<td>222</td>
</tr>
<tr>
<td>Median Housing Value (2)</td>
<td>334,426</td>
<td>1</td>
<td>147,275</td>
<td>227</td>
</tr>
</tbody>
</table>

Sources:
(1) Johnson and Schreiber 1998
(2) U.S. Census Bureau 2004a
(3) U.S. Census Bureau 2004b
(4) U.S. Census Bureau 2005
(5) Morgan and Morgan 2003

Table 1 summarizes some key economic and demographic differences between California and the country as a whole that need to be kept in mind in understanding the state’s budget.
California, a state with about average wealth overall, has proportionally both more wealthy and more poor people in its population. This means that there are both more people in need of government services and more people with the means to pay taxes to support these services. The combination also creates greater potential for class conflict.

Class conflict is overlaid with ethnic conflict. While the economic costs and benefits of immigration (not to mention the social costs and benefits) are controversial, there is no dispute that California’s large immigrant population has strained the capacity of government in a number of areas, including education, public health, and law enforcement.

California’s population is younger than the rest of the country. This creates above average demand for services to children, especially in education. At the same time, federal expenditures go disproportionately to the elderly, primarily through Social Security and Medicare. This, combined with the progressive nature of the federal income tax (resulting in high federal taxes paid by California’s well-to-do citizens) helps explain the often lamented fact that California receives only about 79 cents from Washington for every dollar sent in the other direction (Weintraub 2005).

If California experienced a high-tech “bubble” in the late 1990s, it is possible that the state is now on top of a real estate bubble, with median home prices currently more than double the national average. While many experts doubt this, pointing to continued growth in demand coupled with severe political and geographic constraints on supply, the high cost of housing nonetheless makes the state’s economy highly vulnerable to even a relatively modest downturn in housing prices. It also obviously creates enormous economic pressure on families seeking affordable housing. Finally, because housing prices are highly uneven in different parts of the state (generally decreasing as one goes further from the coast), the state’s transportation system, not to mention the family life of many residents, is strained by lengthy commutes.

**THE POLITICAL CONTEXT**

**Partisan Composition of State Government**

California is not quite as “blue” a state as it is sometimes portrayed. In recent elections, Democrats have won around 55% of the two-party vote in races for the state assembly. (The assembly vote is used here because elections are held for all 80 assembly seats every two years. These elections have relatively low visibility because often the only information about the candidate is their party affiliation. This makes assembly elections a fairly good barometer of underlying party strength.)

Nevertheless, Democrats dominate elected office in Sacramento. Of nine statewide elected executives, only the Governor and the Secretary of State are Republicans, and the GOP holds the latter office only because the Democrat who had been elected to the post was
forced from office due to scandal, and Schwarzenegger was able to name a Republican replacement.

Democrats currently hold a 25-15 seat edge in the State Senate, and rule the Assembly by a margin of 48 to 31 (with one vacancy). (The Republican share of seats lags its share of votes in part because voting turnout is on average much higher in GOP strongholds.) Importantly, however, Republicans do hold over a third of the seats in each chamber, enough to block passage of the state budget.

The balance of power in the Legislature is unlikely to change anytime soon. A bipartisan gerrymandering following the 2000 Census created almost no competitive districts—so little that none of the 80 Assembly and 20 Senate seats in play in the 2004 elections changed hands between the parties.

The state legislature is highly polarized in partisan and ideological terms. A study by this writer of roll call voting in 2003 showed that, on a scale from 0 (most liberal) to 100 (most conservative), Assembly Democrats averaged a score of 9, while their GOP counterparts averaged 92. Comparable scores in the Senate were 9 and 96. The most conservative Democrats in the Assembly and Senate had scores of 50 and 29 respectively, while the most liberal Republicans had scores of 76 and 84. (These results are presented in a somewhat different form in Korey 2006b 63.)

Relationship between the Governor and the Legislature

Arnold Schwarzenegger followed his election to Governor in October 2003 with impressive political victories on a series of ballot initiatives in March and November of 2004, some bearing directly on the state budget (Korey 2006a 4-6). In last year’s budget battle, he again came out a winner, beating back attempts by Democrats to increase taxes and spending for education. As Democratic Assemblywoman Jackie Goldberg ruefully admitted, “We are, make no mistake, voting to support the Governor’s budget (Bluth 2005).”

Emboldened by these successes, Schwarzenegger sought to go over the heads of the Legislature by calling a special election in November 2005 to consider a series of ballot measures, including four on which he staked much of his reputation:

- Proposition 74, increasing the length of service for public school teachers before being granted tenure from two to five years.
- Proposition 75, making it more difficult for public employee unions to collect dues used for political purposes.
- Proposition 76, imposing a cap on state spending.
- Proposition 77, removing redistricting authority from the Legislature and assigning it to a commission composed of retired judges.
In the end, the special election proved to be a disaster for the Governor. All four of the above measures were handily defeated, with support ranging from 45% for Proposition 74 to 38% for Proposition 76 (Secretary of State 2005). Perhaps most critical to the outcome were a series of highly effective radio and TV ads sponsored by (mostly public sector) unions representing school teachers, nurses, police officers, and firefighters. In last year’s essay, I suggested that the outcome of the special election “may boil down to a question of which side can more successfully frame the issue: the Governor versus selfish public employee unions and their bosses, or the Governor versus caring teachers and nurses, and brave cops and firefighters (Korey 2006a 7).” Clearly, Schwarzenegger’s opponents were able to frame the matter to their liking. It did not hurt that they substantially outspent supporters of the propositions, $121 million to $76 million (Yamamura and Furillo 2006). Even as he was largely getting his way with the 2005-2006 budget, and despite the healthy economic growth noted above, Schwarzenegger’s job approval rating was tumbling (See Figure 2).

![Figure 2: Approval Ratings](image)

Source: Derived from data in DiCamillo and Field 2006b.

Schwarzenegger responded by admitting that calling the special election had been a mistake. He pledged to mend fences with his adversaries and work harder to cooperate with the Legislature. He backed up his words by moving left in several areas: supporting an increase in the state’s minimum wage and appointing long-time liberal Democratic political consultant, Susan Kennedy, as his new Chief of Staff.

These moves may have helped him among swing voters (see Figures 2 and 3), but have clearly upset his GOP base. At a Republican convention in February, Schwarzenegger’s supporters had to beat back an effort by some conservatives to rescind the party’s
endorsement of his bid to win reelection as governor in November of this year (Finnegan and Salladay 2006). Many conservatives continued to feel disappointed and betrayed.

Nonetheless, Schwarzenegger’s strategy seems to have worked so far. Other factors working in his favor include:

- Lack of a strong Democratic opponent. The June Democratic gubernatorial primary pitted State Controller Steve Westly against State Treasurer Phil Angelides, with the latter emerging victorious by a margin of about five percentage points. Figure 3 is derived from a series of Field (California) polls conducted between February 2005 and May 2006. When respondents were asked whether they were inclined or not inclined to vote to reelect Schwarzenegger, a fairly substantial plurality were “not inclined.” The most recent polls reduced, but by no means eliminated, the balance disposed against reelection. This vulnerability did not necessarily translate into an advantage for either challenger, but Schwarzenegger seemed to match up somewhat better against Angelides. The conventional wisdom coming out of the primary has been that the outspokenly liberal Angelides had a stronger appeal to the Democratic base, and was helped in the primary by the strong support of organized labor and (perhaps) by the Democratic Party’s endorsement at its convention in late April. The more moderate (at least stylistically) Westly was thought to have more appeal in a general election.

The Democratic primary contest got quite ugly. With little separating the two candidates on issues, there was little left for them to do but attack each other, which may have helped bloody the winner. The GOP soon began running ads quoting attacks by Westly against Angelides, and ending with the tag line, “What if Steve Westly [slight pause] was right (California Republican Party 2006)?”

- The poor image of a state legislature controlled by Democrats. As Figure 2 shows, if Schwarzenegger’s approval ratings are low, those of the Legislature are even worse.

- Special elections are not necessarily good predictors of general elections. This may be especially true of the 2005 election, where Schwarzenegger’s opponents were able to outspend him by a substantial margin, and used this advantage very effectively in framing the choices before the electorate.
Figure 3: Projected Support for Schwarzenegger

Just as it would have been premature to have written Schwarzenegger’s obituary after last November’s election, it is at this writing (early July) much too soon to pronounce his restoration to good health. Recent prognostications rate the race either a toss-up (Cook 2006; Congressional Quarterly 2006) or, based on Westly’s loss to Angelides, leaning slightly Republican (Sabato 2006).

ADDITIONAL CONSIDERATIONS

- Intergovernmental relations. Since the passage of Proposition 13 in 1978, local governments in California have been significantly more dependent on state government than is the case in the country generally. The most recent (2001-2002) Census of Governments shows that local governments in California received 41 percent of their revenue from Sacramento. The comparable figure for the other 49 states was 31 percent (U.S. Census Bureau 2004c). This dependence has resulted in a perennial struggle between state and local governments, with the state balancing its budget in lean times at the expense, and much to the resentment, of localities. In November 2004, voters approved a measure, beginning in Fiscal Year 2006-2007, limiting the state’s ability to do this unless a “fiscal emergency” is declared by the Governor and approved by a two-thirds vote of the membership of each chamber of the state legislature.

- California’s tax structure. California state government is heavily reliant on the personal income tax, and now has the highest statewide marginal rate for general
income in the nation at 10.3 percent (though the rate is slightly higher in parts of New York when local income taxes are factored in) (Tax Policy Center 2002), and when Massachusetts applies a 12 percent tax on certain capital gains (Tax Foundation 2005).

While many would, on normative grounds, support basing taxes on ability to pay, doing so has the consequence of substantially increasing the volatility of state revenues (Weintraub 2003; Legislative Analyst’s Office 2005). From Fiscal Year 1995-96 through projected figures for Fiscal Year 2006-2007, the standard deviation in annual change in state revenue was almost double that in per capita income (4.81 and 2.49 respectively). (Even if 1998-1999, when state revenues jumped by an astonishing 18 percent, is removed from the calculations, the standard deviation for change in state revenue remains 35 percent higher that that for per capita income.) (Figures based on data from Department of Finance 2006a, Schedule 6.)

In the late 1990s, taxes paid on income and stock options by newly-minted millionaires in Silicon Valley and elsewhere flooded the state’s coffers and fueled sharp increases in state expenditures. When these revenues fell off after 2000, the state, unwilling or unable to adjust spending accordingly, began to run up record deficits. Over the last couple of years, as the state’s economy has again prospered (though not at the torrid pace of the late 1990s), the state’s fiscal difficulties have eased, but the state remains especially vulnerable to fluctuations in the fortunes of its most affluent residents.

- Term limits. In 1990, Californians approved a strict term limits initiative for elected state officials. Members of the assembly face lifetime limits of three two-year terms, while senators are limited to two four-year terms. This has had the effect of radically altering career patterns of state legislators, since the average length of service in the assembly and senate prior to term limits exceeded what are now the maximum terms in each chamber. This, in turn, has given lawmakers a sharply foreshortened time perspective, since they are much less likely to be around for the long term consequences of their budgetary and other decisions.

THE BUDGET PROCESS (The standard work on this subject remains Krolak 1994)

The basic process is as follows:

- Submission of the “Governor’s Budget” to the Legislature by January 10. The state constitution has long required that projected revenues and expenditures be in balance, though projections have remained just that, and there has been no guarantee that the budget, as adopted, would actually end the fiscal year in balance.

- Review and critique by the Legislative Analyst’s Office (LAO). This office, established in 1941 and later served as a model for the Congressional Budget Office, technically reports to the Joint Legislative Budget Committee. The LAO provides the Legislature with an extensive examination of the budget and with suggestions for changes.
• The May revision. To reflect changes in the state’s economic outlook and political climate, the Governor sends a revised proposal to the Legislature in May. This, too, is then examined by the LAO.

• Adoption by the Legislature. Traditionally, the most important actors in the crucial stages of negotiations are the “big five,” consisting of the Governor, the Speaker and Minority Leader of the Assembly, and the President Pro tem and Minority Leader of the Senate.

A measure adopted in March 2004 requires that the General Fund, as enacted, be balanced. It also provides that if, during the ensuing fiscal year, it appears that there will be substantial deficit, the Governor may declare a fiscal emergency and call the Legislature into special session to rectify the problem. Since the economy has done well in the last two years, these provisions have yet to be tested.

The state constitution requires that the Legislature approve the budget by June 15. This requirement is honored more often in the breach than in the observance, and was last met in 1986 (See Figure 4). Since California moved to a full-time legislature after 1966, the record for budgetary tardiness was established in 2002 when the state Senate finally approved a budget bill on September 1. One reason for this customary delay is that passage requires a two-thirds vote of the membership of each legislative chamber. Following passage of the budget, the Legislature may consider one or more “trailer bills” needed to bring state law into conformity with budget provisions.

**Figure 4: Budget Approval, 1968-2006**

![Figure 4: Budget Approval, 1968-2006](image)

• Signing by the Governor. The budget is supposed to be in place by the July 1 start of the fiscal year, but this deadline is also missed more often than not. Like most governors, California’s chief executive possesses a line item veto, permitting the reduction or elimination of specific expenditures.

THE BUDGET OUTCOME

Table 2 shows general and special fund expenditures in the budget adopted for 2006-2007 and compares them with estimates for the current budget year. The General Fund (projected at $101 billion for 2006-2007) and special funds ($27 billion) are considered together because the distinction between the two has become somewhat artificial. Much of the General Fund is earmarked. The money in the two categories is also somewhat fungible and sometimes—for technical but sometimes for political reasons—money can be transferred from one to the other. (Such transfers may be far from trivial. During Fiscal Year 2001-2002, at the height of the state’s energy crisis, more than $6 billion was transferred from the previous year’s General Fund to the then-current year electrical power fund.) Bond funds, which are not subject to annual approval by the Legislature and the Governor, and which fluctuate widely from one year to the next, are not included, nor are federal funds or non-governmental cost funds (such as public employee pension funds).

The budget, as adopted, calls for expenditures to increase by a projected 10.5 percent overall. Almost all expenditure categories gained. Increases for K-12 education eased, at least somewhat, the rancor produced last year when guarantees for education spending were suspended. The budget also provided for early payment of some state debt for transportation and other purposes.

<table>
<thead>
<tr>
<th>Category</th>
<th>2005-2006</th>
<th>2006-2007</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Millions of $</td>
<td>% of Total</td>
<td>Millions of $</td>
</tr>
<tr>
<td>K-12 Education</td>
<td>$37,918</td>
<td>32.3%</td>
<td>$40,588</td>
</tr>
<tr>
<td>Health and Human Services</td>
<td>$33,445</td>
<td>28.5%</td>
<td>$36,071</td>
</tr>
<tr>
<td>Higher Education</td>
<td>$11,635</td>
<td>9.9%</td>
<td>$12,633</td>
</tr>
<tr>
<td>Business, Transportation, &amp; Housing</td>
<td>$8,070</td>
<td>6.9%</td>
<td>$10,683</td>
</tr>
<tr>
<td>Corrections and Rehabilitation</td>
<td>$7,840</td>
<td>6.7%</td>
<td>$8,773</td>
</tr>
<tr>
<td>General Government</td>
<td>$6,880</td>
<td>5.9%</td>
<td>$7,385</td>
</tr>
<tr>
<td>Legislative, Judicial, and Executive</td>
<td>$5,114</td>
<td>4.4%</td>
<td>$5,405</td>
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<tr>
<td>Resources</td>
<td>$3,611</td>
<td>3.1%</td>
<td>$3,475</td>
</tr>
<tr>
<td>State and Consumer Services</td>
<td>$1,287</td>
<td>1.1%</td>
<td>$1,328</td>
</tr>
<tr>
<td>Environmental Protection</td>
<td>$1,066</td>
<td>0.9%</td>
<td>$1,104</td>
</tr>
<tr>
<td>Labor and Workforce Development</td>
<td>$372</td>
<td>0.3%</td>
<td>$407</td>
</tr>
<tr>
<td>Totals</td>
<td>$117,238</td>
<td>100.0%</td>
<td>$127,852</td>
</tr>
</tbody>
</table>

Source: Derived from data in Legislative Analyst’s Office 2006.
The budget that has been approved calls for spending significantly more money than the state expects to take in. The budget is balanced only by carrying forward money from 2005-2006, but this “surplus” is the result of borrowing in previous years. Still, Director of Finance Michael Genest pointed out that the current “structural” (i.e., chronic) deficit of over $3 billion is far smaller than the roughly $16 billion shortfall that Schwarzenegger inherited (Mendel 2006a). The new budget also largely avoids new long-term spending commitments that, as happened earlier in the decade, might come back to haunt the state should revenues again dip. Most observers saw the agreement as a plus for Schwarzenegger’s upcoming reelection bid.

Another winner seems to have been Assembly Speaker Fabian Nuñez. In this year’s budget negotiations, the “Big Five” became something more like the “Little Four” or “Fab Four,” as Schwarzenegger’s involvement was relatively minimal (Skelton 2006; Mendel 2006b). At the same time, Nuñez played a quite prominent (and uncharacteristically conciliatory) role. At least one commentator has suggested that Nuñez would not be at all unhappy to see Angelides lose to Schwarzenegger in November. With terms limits, a Schwarzenegger victory this year would mean that there would be no incumbent in the 2010 election. Nuñez’s ally, Los Angeles Mayor Antonio Villaraigosa, would be a likely gubernatorial candidate, and his success would open up the mayor’s post for Nuñez, who will have been term-limited from the assembly in 2008 (Walters 2006b).

OTHER ISSUES

In May, Schwarzenegger and the Legislature reached a compromise on $37 billion in infrastructure bonds (for transportation, education, flood control, and housing) to be placed before the voters in November (Sheppard 2006). Although this represents a scaling down of Schwarzenegger’s initial request for $68 billion, questions have been raised over whether the state can afford these expenditures given already existing bonded indebtedness and the state’s annual budget deficits.

Accompanying this year’s budget was a trailer bill allowing judges to send drug offenders who have failed to satisfy rehabilitation requirements to prison. Critics contend that this alters Proposition 36, an initiative approved by voters in 2000 to provide treatment instead of jail for non-violent drug offenders. Since the state constitution requires that changes in laws passed by initiative must be referred to voters for approval, the bill is likely to be challenged in court (Gledhill 2006; Joseph 2006).

Not included in the budget were funds for expansion of health care for uninsured children. Republicans had objected that much of this money would have gone to support children who are in the country illegally. The issue is expected to resurface in the months ahead.

Finally, there is the matter of the dog that did not bark. The hardy perennial issue of taxation played only a minor part in this year’s budget battle. From the Democrats, there was no major push for increasing taxes. For his part, Schwarzenegger pushed to use a good part
of the current revenue windfall to pay down debt rather than to provide tax cuts. Among the relatively few prominent voices clearly unhappy with the budget was Phil Angelides, who called for “full funding” of education and tax increases on the rich to pay for them (Harmon 2006). The fact that voters rejected a somewhat similar idea in the June primary by a better than three to two margin would seem to bode ill for Angelides’s gubernatorial bid this fall. It is, however, a long way from June to November.

A NOTE ON SOURCES

Most of the sources cited in this essay are available online. In addition to specific URLs listed below, the Governor’s Budget and related documents are at the Department of Finance Web site (http://www.dof.ca.gov). Reports and data from the Legislative Analyst’s Office are available at http://www.lao.ca.gov. Election data are on the Secretary of State’s web site at http://www.ss.ca.gov. For Field Poll press releases, go to http://field.com/fieldpollonline/subscribers/.

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