CALIFORNIA BUDGET PROJECT

BUDGET WATCH

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BUDGET PASSED AFTER RECORD DELAY

The Legislature passed a 2002-03 spending plan early on the morning of September 1, shortly before adjourning the 2001-2002 session. The Governor signed the Budget on September 5. This year's stalemate was the lengthiest on record, breaking the previous record set in 1992, when the Legislature passed the 1992-93 Budget on August 29 and the Governor signed the Budget on September 2. Passage of the Budget was delayed by Assembly Republicans' refusal to vote for the plan passed by the state Senate in June or subsequent compromise proposals. The final deal that broke the logjam included:

- A sharp reduction in the size of the tax increase and elimination of the permanent cigarette tax increase included in the measure approved by the state Senate in June. The package also included a sizeable permanent business tax cut beginning in 2004.
- Passage of ACA 11, a constitutional amendment earmarking a portion of the state's General Fund revenues for infrastructure beginning in 2006-07. ACA 11 will appear on the 2004 primary ballot.
- Deferring $681 million in education expenditures from 2002-03 into 2003-04. The deferral reflects, in part, a reduction in the Proposition 98 guarantee attributable to a smaller tax increase than assumed in prior versions of the Budget.
- A measure stating that the Governor ***may*** (emphasis added) veto up to $750 million in state operations. The Governor vetoed $235 million from the spending plan passed by the Legislature, with the majority of the vetoes occurring in programs administered by local governments (e.g., child welfare services) or direct service programs (e.g., the Healthy Families Program).
- Capping 2003-04 expenditures at 2003-04 revenue levels.

The Basics

The final Budget provides a blueprint for $76.7 billion in General Fund spending ($98.9 billion total funds) for the 2002-03 fiscal year, a 0.2 percent decrease from 2001-02. Strategies used to bridge a gap that increased from $12.5 billion in January to $23.6 billion in May, equivalent to 30.8 percent of budgeted 2002-03 General Fund spending, include:

- $7.5 billion in program reductions;
- $2.0 billion in loans;
- $1.7 billion in education spending deferrals and reductions;
- $2.9 billion in fund shifts, accelerations, and transfers;
- $2.9 billion in additional revenues from the temporary suspension of the teacher tax credit and a temporary suspension of businesses' net operating loss deductions, as well as other tax changes;
- $1.1 billion in assumed increases in federal funding;
- $4.5 billion from borrowing against the state's future tobacco settlement funds; and
- $1.1 billion from restructuring the state's debt.

Spending is budgeted to increase in two areas. K-12 education spending rose by $830 million, driven by an increase in the Proposition 98 guarantee. Spending for General Government increased by $1.45 billion due to the rising cost of reimbursing local governments for the Vehicle License Fee reduction enacted in 1998. In percentage terms, the deepest spending reductions occurred in Environmental Protection and Business, Transportation, and Housing programs (60.4 and 64.7 percent, respectively). Spending for programs administered by the Technology, Trade, and Commerce Agency was reduced by $33 million (44 percent).

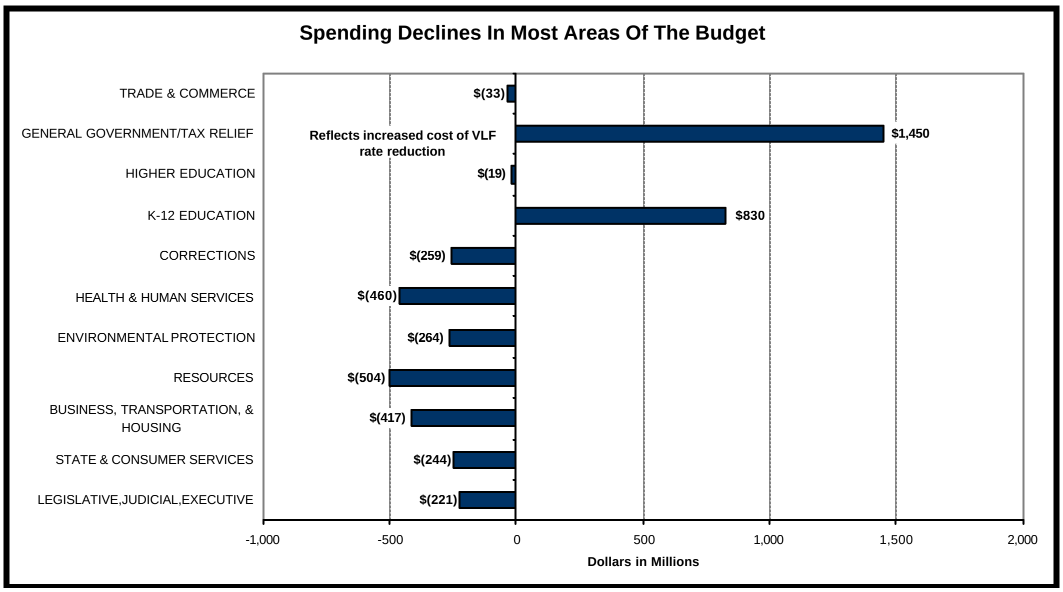
The Governor used his line item veto authority to reduce spending approved by the Legislature by $235 million. Three-quarters of the Governor's vetoes were in Health and Human Services programs, with the largest cuts occurring in county support for Medi-Cal administration ($29 million), funding for the expansion of the Healthy Families program to low-income working parents ($52.4 million), and child welfare services ($28.0 million). For a detailed discussion of the spending reductions contained in the Budget, see the CBP's Budget wrap up on the web at http://www.cbp.org/2002/e020909.pdf.

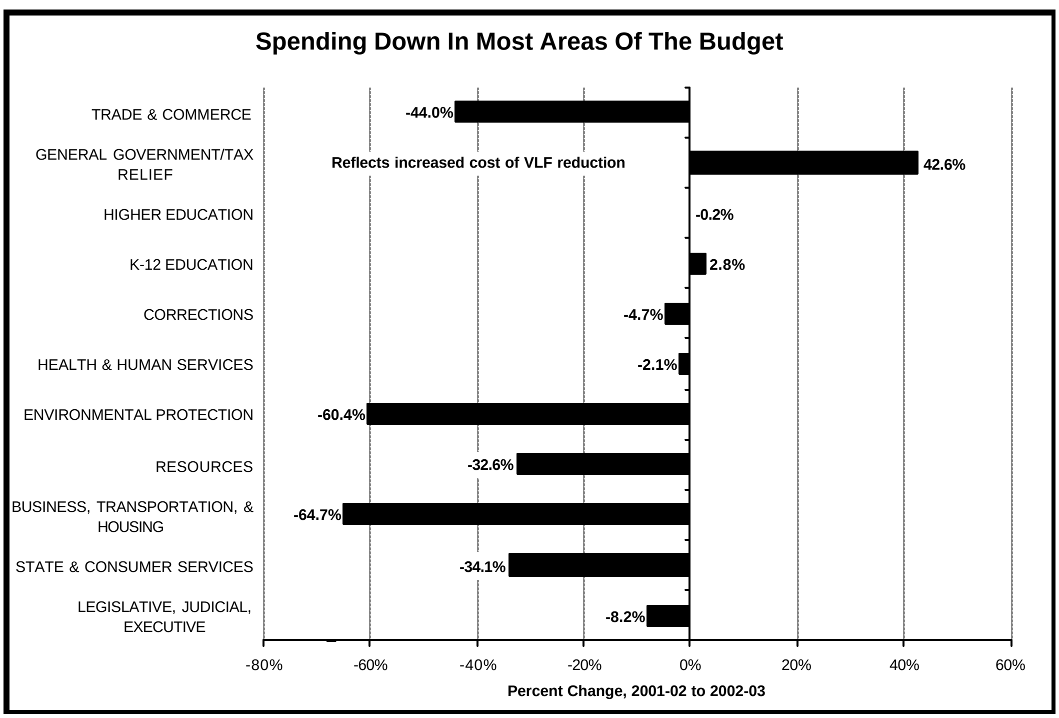
The Roots Of The Problem And What They Mean For The Future

Approximately three-quarters of the $23.6 billion deficit stems from a drop in personal income tax collections in 2001-02 and 2002-03. This drop, in turn, is largely attributable to a decline in investment related income, i.e., capital gains and stock options, which accounted for 24.7 percent of state General Fund tax collections in 2000-01. Income tax collections dropped $10.8 billion between 2000-01 and 2001-02, and forecasted 2002-03 collections are $7.6 billion below 2000-01 levels, for a total drop of $18.3 billion. Growth in sales and corporate tax revenues have slightly lagged combined growth in population and inflation during the same period.

While revenues are anticipated to post reasonably strong growth in 2002-03 and beyond, this growth will occur off a smaller base. For example, the May Revision forecast estimates that personal income tax collections will increase by 9.4 percent between 2001-02 and 2002-03. However, forecast collections for 2002-03 are still lower than actual collections in 1999-00. At the same time, the state's population has continued to rise, increasing program costs, and inflation continues to erode the purchasing power of state spending. The result is an ongoing gap between the revenues raised by the state's current tax system and the amount needed to pay for the current level of public services.

Forecasts suggest that the state will face substan-





tial deficits for at least the next several years. An analysis by the Legislative Analyst of the spending plan passed by the Senate in June estimates that expenditures will exceed revenues by $9 billion or more each year through 2007-08. The final agreement signed by the Governor makes modest changes to the June budget plan, most of which will potentially increase, rather than decrease, the gap in future years.

Supermajority Vote Requirements

Why are budget stalemates typical in California? California is one of only three states that require a supermajority, rather than a simple majority, vote of the legislature to pass a spending plan. Rhode Island and Arkansas also require a supermajority vote. Only slightly more states, 11 including California, require more than a simple majority of lawmakers to increase any state tax. The largest of the other ten states is Washington, which has approximately one-sixth the population of California, and is substantially less diverse.

The differences in the basic rules for crafting a budget help explain why at least 16 states, including a number with Republican governors and / or Republican-controlled Legislatures, increased taxes this year to help close budget gaps widespread throughout the states, and why few states experience the number and length of budget stalemates that have come to typify fiscal policymaking in California. Indiana, Kansas, Massachusetts, and Tennessee have increased taxes by more than 5 percent.

Is The Deficit Structural Or Cyclical?

Budget analysts distinguish structural from cyclical deficits. Cyclical deficits are caused by recessions that reduce revenue collections, while often increasing the demand for safety net programs, such as when individuals lose jobs and / or benefits and turn to public programs for assistance. Structural deficits occur when the long-term increase in spending exceeds long-term growth in revenues.

Current conventional wisdom holds that California faces a substantial structural deficit. However, the state's current and projected deficits are largely caused, as discussed above, by the drop in personal income tax revenues attributable to the slowdown in the economy and, in particular, financial markets. This would indicate a cyclical deficit. Nevertheless, the magnitude of the drop is so large that the state essentially faces a structural deficit, since it is unlikely that an economic recovery will produce sufficient revenue growth to close the gap between revenues and expenditures. While a new long-term forecast will not be available until November, estimates released by the Legislative Analyst suggest relatively comparable growth in revenues and expenditures through 2007-08. A substantial gap persists, since only a fraction of this year's deficit was closed with permanent spending cuts and none of the gap was closed by ongoing revenue increases.

Provisions of this year's Budget agreement with implications for future years include:

- ***Securitization of tobacco settlement payments.*** The final agreement authorizes the state to sell the rights to all or some of the payments California receives from the national agreement between state Attorneys General and the tobacco industry to raise $4.5 billion to support the state's general operating expenses in 2002-03. Estimates suggest that the state's entire annual settlement payment of $400 to $500 million will be required to repay the debt over the next 22 years. Absent securitization, settlement payments would have been available to support health and other programs in future years.
- ***Internal borrowing***. Due to litigation arising out of the state's budget balancing efforts of the early 1990s, many of the internal loans used to balance this year's Budget must be repaid with interest. While interest rates are currently low, loan repayment represents an obligation which must be fulfilled in future years. Similarly, the restructuring of the state's debt will reduce debt service costs in the short-term, but increase costs in future years.
- ***Future year tax cuts***. The Budget agreement suspends businesses' ability to deduct certain losses in 2002 and 2003 in order to raise revenues to help close the budget gap. However, beginning in 2004, businesses will be able to deduct a larger share of their losses.

While the revenue increases adopted as part of the Budget agreement are temporary, the tax cut is permanent and will reduce revenue collections by approximately $400 million per year in 2004-05, and increasing amounts thereafter.

- ***Earmarking General Fund revenues.*** For the second year in a row, lawmakers approved a constitutional amendment earmarking a portion of General Fund revenues to specific infrastructure-related purposes. Last year, the Legislature approved ACA 4, which dedicated the sales tax paid on fuel sales to transportation. The measure was approved by the voters as Proposition 42 in March 2002, and will reduce General Fund revenues by $1.4 billion when fully implemented. This year's measure, ACA 11, would allocate increasing shares of the General Fund, up to 3 percent, to state and local infrastructure. ACA 11 will appear on the 2004 statewide primary ballot. Estimates suggest that in 2006-07, ACA 11 will redirect approximately $950 million from the General Fund, increasing to about $4.4 billion in 2015-16. ACA 11 also includes various triggers that reduce the infrastructure set-aside under certain conditions.

The Bottom Line

The state will face a substantial budget gap in the upcoming fiscal year that will likely range from $10 billion to $15 billion. Some predict a larger deficit. The Senate Republican Fiscal Office, for example, estimates that the state could face a $19 billion deficit in 2003-04. As of the end of August, actual revenue collections were $672 million below the levels forecast in May. Moreover, the May forecast assumed a stronger economic recovery than has materialized to date. Finally, the widening federal budget gap will likely put pressure on programs that provide aid to states and localities.

What Are The Options For Reform?

Most observers agree that lawmakers will face tough choices in crafting next year's Budget. Many of the "solutions" used to balance this year's Budget, such as securitizing tobacco settlement payments and exclusive internal borrowing, will not be available to balance next year's Budget. The Governor has already asked state agencies and departments to submit 2003-04 spending plans that reflect 20 percent spending reductions. Short-term options include spending reductions and / or revenue increases, both of which are subject to the supermajority vote requirements described above. Both the Senate and Assembly leaderships have announced plans to convene "blue-ribbon" task forces to review the state's tax structure and examine options for long-term reform. Potential areas that should be considered as part of a discussion of fiscal reform include:

- The supermajority vote requirement for passage of the budget and tax increases;
- Local governments' ability to raise revenues; and
- The structure of the state's property tax system, particularly the taxation of commercial property.

LOCKED OUT 2002: CALIFORNIA'S HOUSING AFFORDABILITY CRISIS CONTINUES

An upcoming California Budget Project (CBP) report, *Locked Out 2002: California's Affordable Housing Crisis Continues*, updates the findings presented in previous CBP reports, *Locked Out* (May 2000) and *Still Locked Out* (March 2001). The new findings show little change in the severity of California's affordable housing crisis, as individuals and families continue to struggle to afford rental housing or a home of their own.

The new report finds that:

Renters Bear The Brunt Of The State's Affordable Housing Crisis

- In 2001, one-quarter (25 percent) of renter households in the state's metropolitan areas – 1 million out of 4.1 million – spent more than half their incomes on rent. More than half (51 percent) spent more than the recommended 30 percent of their income on housing.
- Two-thirds (66 percent) of low-income renter

households (those with incomes under $18,000) in California's metropolitan areas paid more than half their income for housing, and 88 percent spent more than the recommended 30 percent of their income for housing in 2001.
- The number of Californians in need of affordable housing far outstrips the supply of low-cost units. In 2001, the number of low-income renter households in the state's metropolitan areas exceeded low-cost rental units (those under $450 per month) by more than 2-to-1, a gap of 651,000 units.

Homeownership Is Out Of Reach For A Growing Number Of California Families

- California's homeownership rate is the fourth lowest in the nation. Only 58 percent of California households owned their own homes in 2001, compared to 68 percent for the nation as a whole.
- Between 1979 and 2001, the share of homeowner households headed by individuals in their twenties dropped by 29 percent, while the share of households headed by individuals in their thirties dropped by 17 percent. Ownership rates declined between 1979 and 2001 for all age groups except seniors.
- While 65 percent of the state's white-headed households were homeowners in 2001, just 40 percent of African-American-headed households owned their own homes, along with 56 percent of Asian- and other-headed households and 44 percent of Latino-headed households.

Housing Production Is Inadequate

- According to the state Department of Housing and Community Development, California needs to build more than 200,000 housing units per year, through 2020, in order to keep up with population growth and still be "reasonably affordable." In 2001, however, fewer than 150,000 construction permits were issued.
- In 2001, multifamily housing was less than one-third of total new construction (41,333 units) - down from a nearly two-thirds share in 1970 (124,348 units).

Job Growth Is Outpacing Housing Construction

- The state added 4.0 jobs for each new unit of housing since the economic recovery began in earnest in 1994, more than twice the 1.5-to-1 ratio recommended by housing policy experts.
- Between 1994 and 2001, job growth exceeded housing growth by at least 3.0-to-1 in 17 counties, more than twice the recommended 1.5-to-1 ratio (see table). The counties that did not see a jobs-housing imbalance (i.e., where the jobs-housing ratio was 1.5-to-1 or less) during this period were primarily rural; in most of these counties, job growth still outpaced housing construction.

Public Support For Affordable Housing Has Failed To Keep Pace With Need

- State housing spending has dropped substantially, from 0.9 percent of total General Fund

Housing Affordability: Metropolitan California
(2001)

	Renters		Homeowners	
	Percentage of Households	Number of Households	Percentage of Households	Number of Households
Paying More Than 30% Of Income For Housing	51%	2,048,000	34%	1,657,000
Paying More Than 50% Of Income For Housing	25%	1,003,000	15%	733,000
Low-Income Paying More Than 30% Of Income For Housing	88%	1,010,000	80%	444,000
Low-Income Paying More Than 50% Of Income For Housing	66%	763,000	61%	341,000

Source: CBP analysis of American Housing Survey data. Low-income households are defined as those with annual incomes under $18,000.

spending in 1990-91 to 0.1 percent in 2002-03.

- Federal support for housing has dropped dramatically since the 1970s. Many federally-assisted units are at risk of conversion to market rents. In the past seven years, California has lost more than 24,000 affordable units, a total of 16 percent of the federally-assisted inventory, with most losses occurring in Los Angeles, Santa Clara, Sacramento, San Diego, and Orange Counties.

The state Department of Housing and Community Development received almost no funds in the recently enacted Budget. Advocates and lawmakers are looking to Proposition 46, the Housing and Emergency Shelter Trust Fund Act of 2002, to help make up for the deficit in state housing spending. If approved by the voters in November, this measure will provide $2.1 billion in general obligation bonds for state housing programs in California. Housing experts understand, however, that even a large one-time infusion is not enough to solve a crisis that was over a decade in the making.

Job Growth Significantly Exceeded Housing Growth In 17 Counties, 1994-2001

County	Ratio Of New Jobs To New Housing Units
Alameda	4.2-to-1
Colusa	11.9-to-1
Inyo	13.3-to-1
Los Angeles	7.8-to-1
Marin	4.5-to-1
Napa	6.2-to-1
Orange	4.3-to-1
San Bernardino	4.9-to-1
San Diego	4.2-to-1
San Francisco	4.8-to-1
San Mateo	13.3-to-1
Santa Barbara	9.6-to-1
Santa Clara	7.6-to-1
Santa Cruz	3.1-to-1
Shasta	3.6-to-1
Sonoma	3.1-to-1
Sutter	3.4-to-1

Note: Includes counties in which job growth exceeded housing growth by more than twice the 1.5-to-1 ratio.
Source: CBP analysis of Employment Development Department and Department of Finance data.

NOVEMBER BALLOT MEASURES WOULD EARMARK FUNDS FOR TRANSPORTATION AND AFTER SCHOOL PROGRAMS

Two initiatives appearing on the November ballot, Propositions 49 and 51, would earmark an annual total of approximately $1.5 billion of the state's General Fund for new and / or expanded programs without raising additional revenues. Proposition 49 would guarantee and increase funding for after school programs, and Proposition 51 would dedicate funding for transportation infrastructure and environmental projects.

Proposition 49

Proposition 49 would:

- Increase annual funding for the Before and After School Learning and Safe Neighborhoods Partnerships Program (BASLSNPP) to $550 million and guarantee this funding level in perpetuity;
- Rename the BASLSNPP as the After School Education and Safety Program (ASESP); and
- Reduce the maximum grant level for after school programs from $100,000 to $75,000 for middle schools and from $75,000 to $50,000 for elementary schools.

In an effort to minimize the impact on the General Fund, Proposition 49 only increases ASESP funding when non-Proposition 98 General Fund appropriations exceed appropriations in a base year defined by the initiative as more than $1.5 billion. However, calculations by the CBP demonstrate that $1.5 billion is insufficient to fund inflation and population growth for existing non-Proposition 98 programs, which means that ASESP funding would increase even if other current programs have not been fully funded. The CBP estimates that in 2004-05, when the additional ASESP appropriations would first be required, approximately $3.5 billion would be needed to merely keep up with population growth and inflation for non-Proposition 98 programs. In tight budget years, Proposition 49 would require the Legislature to either raise revenues or cut funding for non-Proposition 98 programs.

Proposition 49 represents the first attempt by advocates of a particular program to earmark funds within the Proposition 98 guarantee. Currently, Proposition 98 determines the total annual amount of funds available for education programs, but the allocation of those funds to specific programs is decided during the annual budget process allowing the Legislature flexibility to adjust funding levels for different programs to reflect changes in priorities.

Proponents of Proposition 49 argue that increasing investments in before and after school programs will save the state money in the long run by reducing costs for corrections and remedial education.

Proposition 51

Proposition 51 would:

- Transfer 30 percent of the state's share of sales tax paid on the sale and lease of new and used motor vehicles from the state's General Fund to a new Trust Fund;
- Allocate these funds to 17 specific transportation and environmental spending categories;
- Provide priority funding for a number of specific projects; and
- Make statutory changes to existing programs.

The Legislative Analyst's Office (LAO) estimates that the amount shifted from the state's General Fund to the Trust Fund would be approximately $460 million in 2002-03 and $950 million in 2003-04, with the transfer increasing annually thereafter.

While Proposition 51 reduces or suspends the transfer in years in which General Fund revenue declines, or revenue growth is less than the amount that would be transferred to the Trust Fund, suspension would not occur in many instances in which the state faces a severe budget shortfall. This occurs because the measure does not take into account revenue growth needed to pay for increases in the cost of state services related to inflation; population, enrollment, and caseload increases; reductions in federal aid; and shifts in demand for state services. Although the initiative allows balances in the Trust Fund to be transferred to the General Fund in years when revenues decrease from the prior year, it provides no flexibility to address a budget shortfall in years when revenues increase by less than the amount required by inflation, population growth, or other factors.

Proponents of Proposition 51 argue that the cost of meeting the state's transportation infrastructure needs is greater than the current level of resources dedicated to this purpose, and that the initiative would provide additional resources to fund transportation systems needed to reduce congestion.

Proponents argue that additional funding is needed for both after school programs and transportation projects. There is research indicating a link between participation in after school programs and increased standardized test scores, and the state has significant unmet infrastructure needs. However, opponents argue that setting state budget priorities through the initiative process encourages voters to consider spending for one area, such as after school programs or transportation, in isolation from other state spending. While many voters may support spending for these programs, they might prefer to spend less than required by these measures if they knew that it could result in tax increases or cuts to health, education, and other after school programs.

Please visit the CBP web site at www.cbp.org (www.cbp.org/props) to read more detailed analyses of both Proposition 49 and Proposition 51 and the California Voter Foundation website at www.calvoter.org for supporting and opposing arguments for the initiatives.

TANF REAUTHORIZATION UNCERTAIN

The federal Senate Finance Committee passed a bill to reauthorize the Temporary Assistance for Needy Families (TANF) block grant on June 26.

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However, the full Senate had not voted on the bill by late September, making it unlikely that Congress would reauthorize TANF by its target adjournment date of October 4.

The Senate Finance bill differs from the measure passed by the House in May by substantially increasing child care funding over five years, proposing less strict work requirements, and restoring certain benefits to recent immigrants. The Legislative Analyst's Office (LAO) estimates that the Senate Finance bill would bring California $140 million in net federal funds over the next five federal fiscal years, while the House bill would cost the state about $2.2 billon over the same period. For a summary of these bills, see "Comparison of Key Provisions In TANF Reauthorization Proposals" at www.cbp.org/welfare.htm.

If the Senate approves the legislation, which requires 60 votes, a conference committee will reconcile differences between the final Senate and House bill. If final agreement is not reached by September 30, when the TANF block grant expires, Congress may extend funding at the current level on a temporary basis and reconvene after the November elections to pass a full reauthorization. Congress may alternatively extend funding for a longer period, possibly one or two years, and delay reauthorization until 2003 or later. Since the federal fiscal situation is expected to worsen, a TANF bill that is passed next year would be less likely to increase child care funding or maintain the current level of TANF block grant funding.

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. General operating support for the California Budget Project is provided by foundation grants and individual donations and subscriptions.

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