

GOVERNOR PROPOSES 2003-04 BUDGET; LEGISLATURE APPROVES MID-YEAR REDUCTIONS

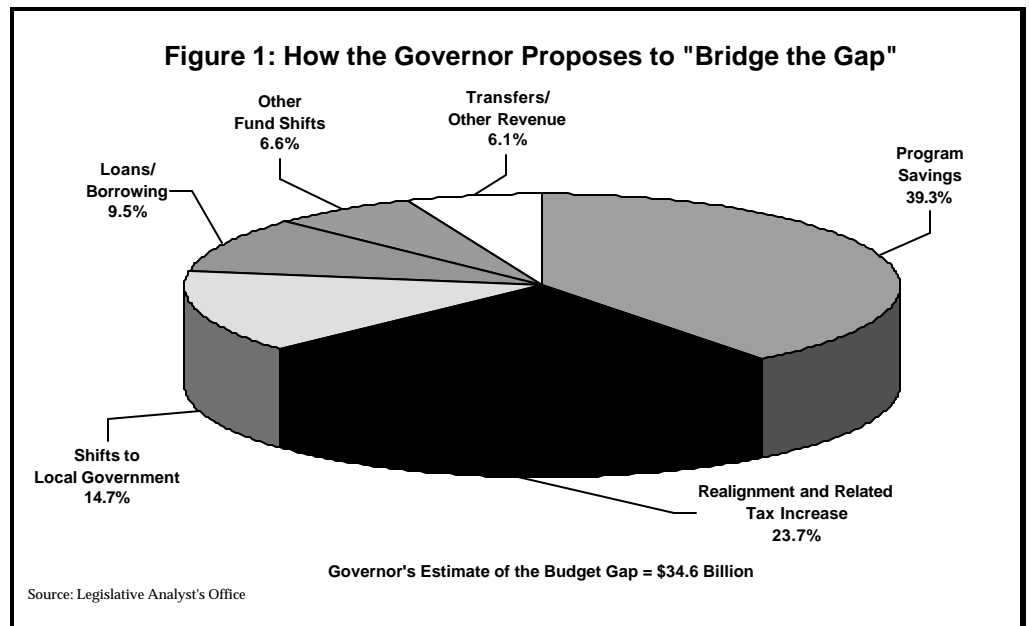
Governor Gray Davis released his 2003-04 Budget on January 10. In order to balance a shortfall estimated by the Governor at \$34.6 billion, the Proposed Budget includes \$26.9 billion in reductions, savings, and shifts to local government; \$3.3 billion in loans and borrowing; \$2.3 billion in fund shifts; and \$2.1 billion in transfers and revenues (Figure 1).

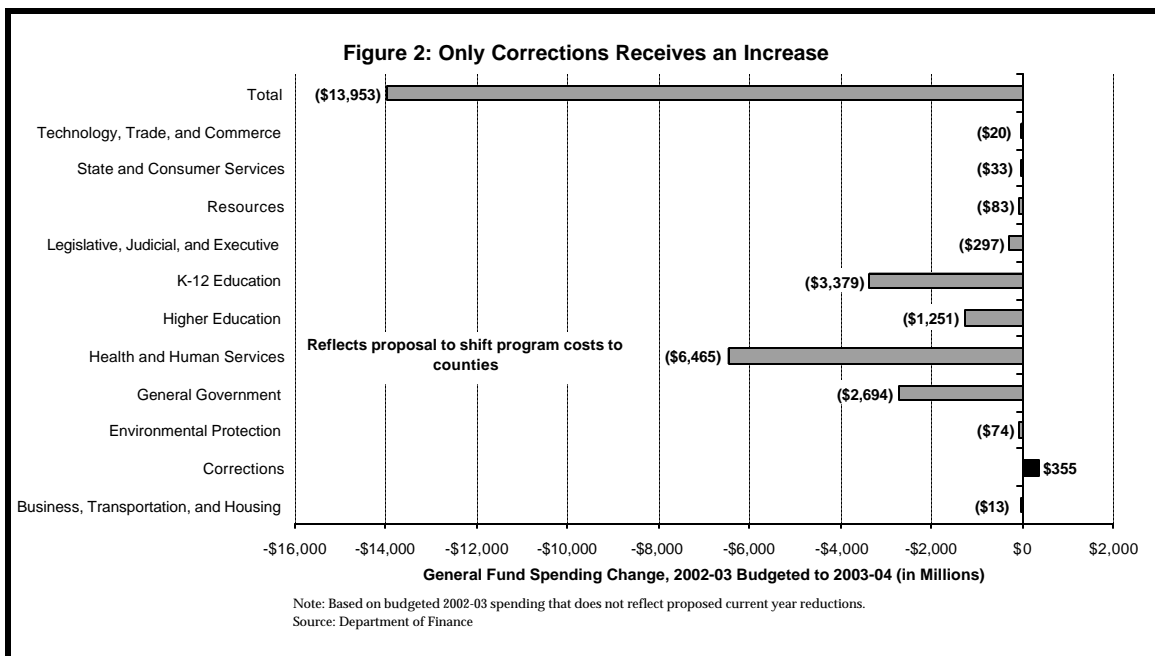
The Governor's Proposed Budget includes General Fund spending of \$62.8 billion in 2003-04, an 18.2 percent decline from budgeted 2002-03 spending of \$76.7 billion. This reflects a decline in resources as well as a proposal to shift more than \$8 billion in program costs to counties, as described below. General Fund revenues are projected to be \$69.2 billion in 2003-04, a 5.5 percent decline from estimated 2002-03 revenues. The Governor's proposal includes a \$531 million budget reserve.

The Governor's 2003-04 Budget reduces funding for all agencies except Corrections (Figure 2). Proposed funding for the Health and Human Services Agency is \$6.5 billion lower than budgeted in 2002-03, primarily due to the shift of a number of health, mental health, and social services programs to counties. Funding for K-12 Education is \$3.4 billion lower than

provided for in the 2002-03 Budget. If programs were not shifted to counties as the Governor proposes, funding for the Health and Human Services Agency would be \$424 million higher and K-12 Education funding would be \$2.4 billion lower than budgeted in 2002-03.

In perhaps the most far-reaching and significant policy proposals, the Budget would shift \$8.273 billion in costs and many program responsibilities to counties, resulting in \$8.154 billion in General Fund savings. This realignment of mental health, health, and social services programs would be paid for with \$8.334 billion in new revenues. New revenues include a one cent increase in the state's sales tax rate (\$4.584 billion); reinstatement of the 10 percent and 11 percent personal income tax brackets on the wealthiest Californians (\$2.580 billion); and a \$1.10 per pack increase in the tax on cigarettes and tobacco products (\$1.170 billion).





to the Medi-Cal program. These reductions would have reduced the number of Medi-Cal enrollees by an estimated half million and eliminated benefits not mandated by the federal govern-

The Governor's Budget includes major program reductions, some of which were proposed in December. Reductions include funding cuts for K-12 Education, decreases in cash grant levels for CalWORKs and Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients, and broad eligibility and services cutbacks in Medi-Cal. The Governor continues to propose the elimination of the Stage 3 child care program, which provides subsidized child care to former welfare recipients who are working and have been off the welfare rolls for two years or more.

The Governor's Budget also includes a "call to action" with respect to structural reform. The Governor outlines a number of proposals ranging from performing a "sunset review" of all tax expenditures to granting the Governor unilateral power to make mid-year budget reductions and suspend laws defining program eligibility.

Legislature Makes Mid-Year Adjustments – On Hold Pending Resolution of VLF Backfill Dispute

In January and early February, the Legislature responded to the Governor's proposed reductions to the 2002-03 Budget. The Legislature accepted the majority of the Governor's proposals, with a few notable exceptions. The Legislature rejected the Governor's eligibility restrictions, provider rate cuts, and benefits reductions

ment, such as medical supplies and dental care for adults. In addition, the Legislature rejected an across-the-board cut for K-12 Education and instead deferred a \$1.1 billion payment to schools from June to July 2003.

The Legislature also rejected the Governor's proposal to discontinue payments to counties to backfill for the loss of revenue from reductions in the state's car tax (Vehicle License Fee, or VLF). The Legislature opted instead to increase the VLF to 1998 levels by clarifying a statutory "trigger." This clarification directs the Governor's Department of Finance to increase the VLF when the state is unable to make the backfill payments to counties. It also exempts cars sold for \$5,000 or less from the increase. The Legislature linked enactment of the mid-year spending reductions to the modification of the VLF "trigger." As a result, the cuts would only take effect if the trigger measure is signed into law. The Governor has stated he "cannot support" the measure that modified the trigger and was linked to the spending reductions approved by the legislature.

The Legislature's actions would decrease the deficit by an estimated \$4.1 billion in 2002-03. In contrast, the Governor's proposal would narrow the gap by \$5.5 billion. As of this writing, the Legislature has not yet sent the bills to the Governor's desk. On February 24, the Senate approved a package of mid-year reductions that

was not linked to the VLF trigger. As this newsletter goes to print, action was pending in the Assembly.

Legislative Analyst Calls Governor's Plan Balanced, But Identifies Major Threats

On February 19, the Legislative Analyst's Office (LAO) released its comprehensive analysis of the Governor's proposals. The LAO called the Governor's Budget "balanced," but only if fully adopted. The LAO estimates that revenues will be \$1.3 billion above the Governor's forecast, but that expenditures will also be \$273 million higher than administration estimates, for a net improvement in the state's fiscal condition of \$1.0 billion. The LAO had previously identified a \$5.5 billion difference in assumptions regarding the baseline cost of state services. The LAO's methodology would reduce the size of the deficit by \$5.5 billion, but would also reduce the proposed "solutions" by the same amount.

The LAO identified a failure to receive assumed federal funds and failure to receive an assumed \$1.5 billion in revenues from tribal gaming activities as potential threats to the budget. The LAO notes that failure to enact proposed tax increases and/or the proposed level of spending reductions would also push the budget out of balance.

The Roots of the Deficit: California Has a Revenue Problem

The roots of the state's budget crisis lie in a dramatic drop in state tax collections, coupled with spending increases and tax cuts enacted during the late 1990s. While most reports examining the roots of the deficit have focused on the drop in personal income tax collections, a number of other tax-related trends contribute to the state's ongoing budget shortfalls.

Personal income tax revenues. The most significant factor contributing to the deficit is an unprecedented drop in personal income tax collections, which provide just under half of the state's general-purpose revenues. This, in turn, stems mostly from a decline in tax payments attributable to stock options and capital gains,

which dropped from \$17 billion in 2000-01 to under \$6 billion in 2002-03. The 2003-04 forecast of personal income tax collections is \$8.2 billion below the amount collected in 2000-01 and revenues are not anticipated to exceed 2000-01 collections until 2006-07.

Sales tax. While sales tax collections have lagged somewhat due to the downturn in the economy, the most significant trends affecting the sales tax are long-term in nature. California's sales tax, like those of most states, dates to an era when the economy was largely based on the sale of goods, and most services are not subject to tax.

California's failure to tax services has reduced the yield of the sales tax – the revenues raised by each quarter cent of sales tax – as the economy has shifted from one based primarily on goods, to a more service-oriented economy. Most states tax a wider array of services than does California – only six states tax fewer services than California. If consumers spent the same share of personal income on goods subject to the sales tax in 2002-03 as they did 30 years before, the state would collect an additional \$9.1 billion in sales tax. Internet and other mail order sales add to the erosion of the sales tax base, since these transactions are not subject to tax unless the retailer has physical presence within the state of California. Rough estimates suggest that the state loses approximately \$1 billion a year due to the inability to collect sales tax on mail order and Internet purchases.

Corporate income tax. The share of corporate profits paid in state and federal income taxes has declined over time, and corporate tax collections have been stagnant since the mid-1980s. Two factors contribute to the drop in the share of corporate income paid in taxes. First, the state enacted a number of sizeable tax cuts in the early 1990s, including creation of the Manufacturers' Investment Tax Credit, expansion of the Research and Development Credit, reductions in the special tax rate levied on Subchapter S Corporations and expansions in the number of shareholders corporations can have while still qualifying Subchapter S status (Subchapter S corporations are limited to no more than 75 shareholders), and a reduction in the corporate

income tax rate. Second, researchers argue that corporations are using offshore tax havens and other sheltering devices to reduce the amount of income that is subject to tax. If state corporate income taxes accounted for the same share of the income of profitable corporations in 2000, the most recent year for which income data is available, as they did in 1981, the state would have collected an additional \$4.7 billion in corporate income tax.

Estate tax. The 2001 federal tax bill phased out the estate tax, repeals the tax in 2010, and will reinstate the tax in 2011 absent future action. California, like other states, receives a share of the federal estate tax. This tax, which is sometimes called the “pick up” tax, does not increase the total tax that is owed, but rather acts as a credit against the federal tax. While Congress phased out the federal estate tax over nine years, it phased out states’ share of the tax over four years. Beginning October 1, 2004, California will receive no revenues from this tax, which raised \$935 million as recently as 2000-01. In 2002-03, the federal phase-out will reduce state tax collections by \$367 million.

Seventeen states have “decoupled” from the federal estate tax cut and imposed state taxes to prevent a loss of revenues from the federal tax cut. Six other states are automatically decoupled from the federal reductions. In California, however, this is not an easy option. Voters repealed the state’s Inheritance Tax in 1982 by initiative and prohibited the imposition of any similar replacement tax. Reinstatement of the inheritance tax would require voter approval.

Where Did the Money Go in the Good Years?

State spending increased during the late 1990s as the economic boom filled state coffers. Since 1998-99, the largest dollar increases have gone to K-12 Education, health care, higher education, and tax relief. In fact, nearly one-fifth (18.6 percent) of the increase in General Fund spending between 1998-99 and 2002-03 has gone to reimbursing counties and cities for revenues lost because of the 1998 Vehicle License Fee reduction. Spending for CalWORKs and related programs has remained at the bare minimum

required by federal law. General Fund spending for programs administered by the Resources; Environmental Protection; Business, Transportation, and Housing; and Technology, Trade, and Commerce Agencies actually declined over the same period, despite the fact that there were 2.2 million more Californians in 2002 than in 1998 and inflation has averaged 3.1 percent per year over the same period. The LAO forecasts that tax relief will remain the fastest growing part of the budget between 2001-02 and 2007-08 (assuming the state continues to backfill cities and counties), followed by debt service, Medi-Cal, and programs for the aged and disabled. The LAO forecasts that the percent increase in spending on CalWORKs and education will lag substantially behind total spending growth.

Why Are There Conflicting Estimates of the Gap?

The Governor estimates that California faces a \$34.6 billion gap. The Legislative Analyst’s Office’s estimates a gap of \$28 billion. Who is right? Who is wrong? And how can they disagree by more than \$6 billion? The answers to these questions lie in how each agency defines the budget gap, and how they estimate future program costs and revenue collections.

The LAO’s estimate is based on a current services budget and is based on a somewhat more optimistic forecast of revenues than that used by the Governor. The Governor’s forecast reflects additional spending, which is not mandated by current law, as well as a budget reserve, and assumes lower revenues and spending than the LAO.

The language used to describe the state’s budget problem is a common source of confusion. One tool for analyzing the state’s fiscal condition is a current services or baseline budget. A current services budget compares the revenues that would be raised by the state’s taxes and fees adjusted for population growth and changes in the economy, to the amount needed to pay for programs and policies under current law, again adjusted for caseload, population, and enrollment growth and inflation. A current services

budget reflects current law on both the revenue and expenditure side of the ledger. In November, the LAO released a report forecasting revenues and expenditures based on a current services budget at the broad programmatic level through 2007-08.

The Governor's Proposed Budget, released in January of each year, provides estimated expenditures for the current year and proposed expenditures for the budget year, but does not provide an estimate of the cost of continuing current law service levels. The lack of a current services budget at the individual program level (the LAO uses broad categories with a few exceptions) makes it difficult to identify where increases or decreases are imbedded within individual programs in the Governor's Budget. This practice is not unique to the Davis Administration, but rather continues the model used by past administrations.

Another source of confusion is the term "deficit." Strictly speaking, the deficit is the difference between available resources (balances, if any, carried forward from prior years plus revenues raised during the year) and expenditures. Budget analysts also talk about an operating deficit or surplus, which compares the revenues raised during the year with expenditures during the year, excluding balances that are carried forward from prior years. Operating deficits are a useful tool for examining the adequacy of the state's revenue system to fund services on an ongoing basis.

Finally, estimates of the magnitude of the budget problem typically reflect gaps over two fiscal years. For example, current estimates include both the shortfall in the current year, as well as the shortfall in the upcoming budget year.

PRESIDENT BUSH PROPOSES HEALTH CARE BLOCK GRANTS

Federal funding for Medicaid and the State Children's Health Insurance Program (SCHIP)—Medi-Cal and Healthy Families in California—would be converted to block grants and states

would be exempted from many current program regulations under a proposal included in President Bush's 2004 Budget. Congressional approval would be required to implement the President's plan, and many aspects of the proposal remain unclear.

The new initiative, called "State Health Care Partnership Allotments," would give states the option to receive several current Medicaid and SCHIP funding streams in two block grants, one for acute care and the other for long-term care. The Bush proposal would increase federal funding for Medicaid and SCHIP by up to \$13.0 billion between 2004 and 2010 for states that accept the block grants. States would be allowed to transfer up to 10 percent of funds between the acute care and long-term care block grants.

However, because the plan is designed to be "budget neutral" over 10 years, federal funding would be reduced below anticipated costs by about \$12.8 billion between 2011 and 2013. As a result, states would in effect repay nearly the full amount advanced by the federal government between 2004 and 2010. When asked about this steep reduction in federal funding, Department of Health and Human Services Secretary Tommy Thompson told reporters, "I'm not going to be here to solve that problem."

Moreover, whereas Medicaid is currently funded as an "entitlement," in which the federal government pays a share of the costs of medical care for all persons eligible for services, the Bush plan would cap annual federal funding for Medicaid. In other words, states would not receive additional federal funding as they enroll more individuals. Federal block grant allotments would be based on states' 2002 spending levels, inflated annually according to an undisclosed formula. In addition, states that accept the block grants would be required to spend at least as much of their own funds on Medicaid and SCHIP as they spent in 2002, adjusted annually.

States that participate in the President's initiative would continue to be required to provide certain benefits to populations whose coverage is mandated by federal law, including children

and pregnant women with incomes below federal minimum income levels. The plan does not clarify whether the block grant initiative would modify the benefits that states are currently required to provide.

However, states would be allowed to redesign benefit and eligibility packages with little federal oversight for “optional” populations that states are not currently required to cover, including many adults in families with children, children in families with incomes above federal minimum income levels, and disabled and elderly individuals whose income exceeds Supplemental Security Income (SSI) levels. For example, states would be exempt from Medicaid rules that require benefits to be comparable among beneficiaries. States could establish different eligibility levels and benefit packages for different areas of the state. Further, states would have complete flexibility to require optional recipients to pay a portion of their health care costs, such as premiums or co-payments. Current law prohibits cost sharing for children, pregnant women, and other individuals in the Medicaid program and limits allowable co-payments to amounts that are “nominal.”

States that do not participate in the block grant initiative would continue to administer Medicaid and SCHIP under existing rules and the federal government would continue to fund a set percentage of their Medicaid costs. (The federal government currently pays 50 percent of the costs of Medi-Cal in California.) However, despite the fact that most states face significant budget deficits and many states have cut Medicaid eligibility and benefits (with more reductions likely), the Bush plan would not provide additional federal funding to states that do not participate in the block grant initiative.

The Bush Administration contends that states could use increased flexibility to extend health coverage to more individuals, including childless adults and parents who are not currently eligible. However, the President’s block grant plan raises several concerns:

- States must accept the block grants in order to receive immediate federal relief for in-

creasing Medicaid expenses. In contrast to the President’s proposal, a bill introduced by Senator John D. Rockefeller (S 138) would provide an additional \$10 billion in federal funding for Medicaid to all states by increasing the federal matching rate through 2004. California would receive \$1.1 billion. This approach could allow states to avoid reducing Medicaid or SCHIP eligibility to balance their budgets or accepting a plan that would reduce federal funding in future years.

- The block grant structure would preclude federal funding from responding to unforeseen enrollment increases and health care costs driven partly by an aging population.
- States that do not achieve substantial savings in Medicaid and SCHIP by 2010 could be forced to cut their programs when federal funding drops beginning in 2011.
- The current separate funding stream for hospitals that care for a disproportionate share of individuals without health insurance would be folded into the block grants. As a result, hospitals would be forced to compete with other health care providers for a limited source of funds.

TANF RETREAD: HOUSE PASSES LAST YEAR’S BILL

On February 13, the US House of Representatives passed HR 4, which would implement the primary elements of President Bush’s welfare plan, on a largely party-line vote of 230-192. Only eleven Democrats (none from California) supported the bill, which is nearly identical to one passed by the House last year before the welfare issue stalled in the Senate. HR 4 reauthorizes the Temporary Assistance for Needy Families (TANF) block grant and makes major changes to federal welfare policy, such as imposing tougher work requirements on welfare recipients. Congress failed to reauthorize TANF before it expired on September 30, 2002, but is expected to continue funding the block grant on an interim basis until a final bill is approved.

The House defeated two Democratic substitute bills and a Democratic amendment to increase

federal child care funding by \$11 billion to pay for additional costs that states would incur if the House bill becomes law. HR 4 was brought directly to the House floor without being heard by the Ways and Means Committee or the Committee on Education and the Workforce, which have primary jurisdiction over TANF.

HR 4 would impose significant costs on states while providing little additional federal funding. The bill increases the amount of time that welfare recipients must participate in work activities to 40 hours per week and mandates that 70 percent of recipients meet federal work requirements by 2008. In order to meet the 70 percent participation rate, counties would likely have to move many recipients into costly “make-work” positions. The state would also have to make substantial investments in child care services to meet the needs of additional working parents. These new mandates would cost California up to an additional \$2.2 billion over five years, but the House bill freezes TANF block grant funding at \$16.5 billion per year through 2008 (California would continue to receive \$3.7 billion per year). HR 4 increases total mandatory child care funding by \$1 billion, or \$200 million per year over the current annual level of \$2.7 billion. This amount is not sufficient even to keep pace with rising child care costs.

HR 4 does not respond to dismal fiscal conditions that have contributed to substantial budget deficits in most states. California, which faces an estimated budget deficit of \$28 billion, is in a weak position to absorb higher welfare-related costs. Governor Davis has proposed eliminating CalWORKs Stage 3 child care, which provides child care subsidies for recipients who have been off welfare for two years or more, as well as suspending cost-of-living adjustments and reducing CalWORKs cash grant levels by more than 6 percent in 2003-04.

HR 4 differs from last year’s House bill primarily in its treatment of “full-family” sanctions. The bill would require states to stop all cash grant payments to families with an adult who does not comply with work requirements. Similar to last year’s bill, HR 4 exempts states such as California that require local governments to provide aid to

needy families. However, HR 4 includes the exemption for only one year. This change would force California to modify its adult-only sanction policy, which continues cash aid to children in families in which adults do not comply with work requirements.

The reauthorization debate now moves to the Senate, where the Finance Committee, chaired by Iowa Republican Chuck Grassley, may draft a bill by April. The committee is not expected to adopt work requirements as strict as those contained in the House bill, and may provide additional funding for child care. After the full Senate approves the bill, a conference committee will reconcile differences between the House and Senate versions, possibly in September.

A comparison of HR 4 and other TANF reauthorization proposals is available on the California Budget Project web site at www.cbp.org.

VACANCY GAME UPDATE

Last year, the CBP’s Budget Brief *The Civil Service Vacancy Game: Abusive Practices Or Underlying Structural Problems?* examined state practices regarding vacant civil service positions. A new Brief, *Budget Update: Spotlight on State Operations*, (available at www.cbp.org), highlights subsequent developments related to vacancies, as well as other various changes in state operations including position eliminations, budget cuts, and increasing retirement payouts.

Eliminating 6,000 vacant positions in 2002-03. In response to legislative pressure, the Department of Finance (DOF) eliminated 6,600 vacant positions in 2000-01 and 2001-02 that it considered “excess.” In addition, the 2002-03 budget agreement called for elimination of a minimum of 6,000 vacant civil service positions, effective July 1, 2002 (the beginning of the 2002-03 fiscal year). In November 2002, the DOF released a list of 6,129 positions to be abolished, for a savings of \$300.4 million (\$102.9 million General Fund). Of the agencies, Health and Human Services (HHS) suffered the largest numerical reduction, losing over 1,200 positions (2.9 percent of the agency’s total authorized positions). Proportionately, the

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Technology, Trade, and Commerce Agency (TTCA) was hit hardest, losing nearly one-fifth of its total authorized positions (69 out of 367 positions).

Imposing further 2002-03 reductions in state operations. The budget agreement allowed up to a 5 percent reduction in appropriations for state operations in 2002-03, reflecting a total reduction of \$750 million. The Governor's proposed mid-year cuts included reductions of \$320.8 million and 258 positions across all agencies, arguing that "only a portion of the \$750 million target can be achieved without statutory changes to programs..." Education, particularly the University of California (UC) and California State University (CSU), received the largest dollar reduction in the proposal; the Health and Human Services Agency lost the largest numbers of staff.

Eliminating 1,000 positions in 2003-04. The 2002-03 budget agreement also required the DOF to eliminate at least 1,000 civil service positions in 2003-04, with priority being given to vacant positions. The Governor's Proposed Budget eliminates more than 1,900 positions attributed to program reductions and eliminations.

The implementation of cuts to the state employee workforce and state operations, as well as the prospect of continuing cuts, raises important policy questions. Upcoming budget deliberations will need to address how to balance reductions in current levels of state services with the need to provide those services. Ultimately, policymakers face difficult choices and compromises between eliminating services and increasing revenues.

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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