

THE 2003-04 BUDGET AND BEYOND

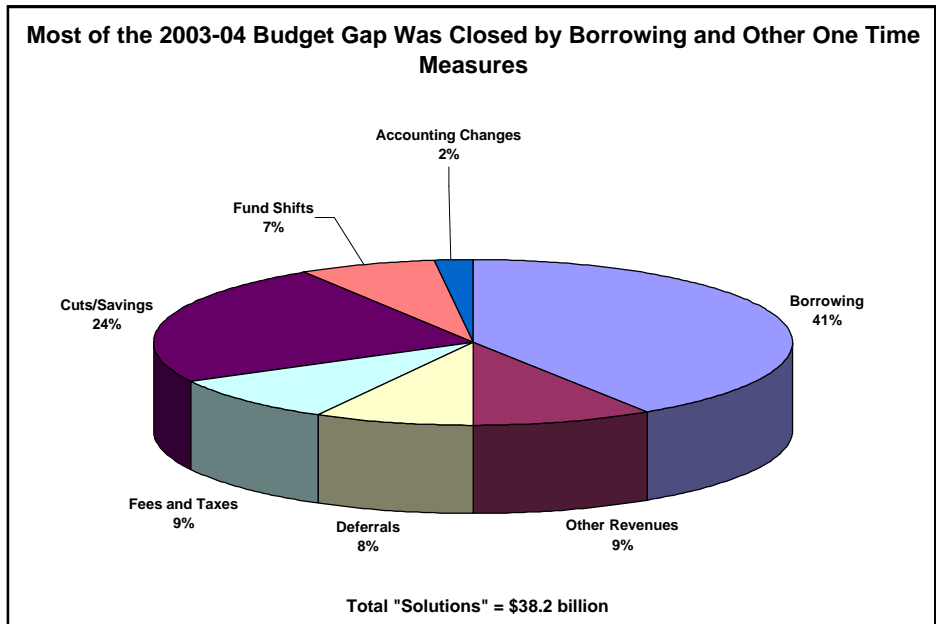
After an all-night session, the Assembly passed a 2003-04 spending plan on July 29. The Governor signed the budget into law on August 2. The record \$38.2 billion budget gap was filled by a combination of loans and other borrowing, spending reductions, taxes and fees, other revenues, and one-time measures. The budget agreement includes:

- \$16.1 billion in loans and borrowing, both internal and external. The budget assumes that the state will issue \$10.7 billion in deficit retirement bonds, \$2.0 billion in additional tobacco settlement bonds, and \$1.9 billion in bonds that will be used to finance the state's contribution to employees' pension funds.
- \$9.4 billion in program reductions and related savings.
- \$3.8 billion in taxes and fees. A \$3.4 billion increase in Vehicle License Fees (VLF) accounts for most of the increase in taxes and fees. The budget scores the VLF increase as a \$4.2 billion savings, since the state will no longer reimburse counties and cities for revenues lost as a result of the 1998 reduction. The \$825 million difference between the proceeds of the increased VLF and the savings scored will be treated as a loan to counties and cities that the state will repay by August 15, 2006.
- \$3.2 billion in savings from deferring payments, primarily for education, from 2003-04 into 2004-05. The education changes have the effect of lowering spending for purposes of calculating

the Proposition 98 guarantee both in the current year and lowering the base in future years while holding the individual line items harmless.

- \$3.5 billion in "other revenues," including \$1.2 billion the state will receive in federal fiscal relief and \$680 million per year in ongoing revenues by renegotiating tribal gaming compacts.
- \$2.7 billion in fund shifts. The largest of these shifts is an increase in the federal government's share of Medi-Cal costs. These funds are part of the one-time package of aid to states included in the 2003 federal tax bill.
- \$813 million in net one-time savings from shifting the accounting method used in the Medi-Cal program from accrual to cash.

As enacted, the budget provides a reserve of \$1.4 billion. This report focuses on the "big picture" impact of the budget agreement. A detailed list of provisions contained in the budget agreement can be found on the CBP web site.



State Spending Down Nearly 9% Since 2000-01 Peak

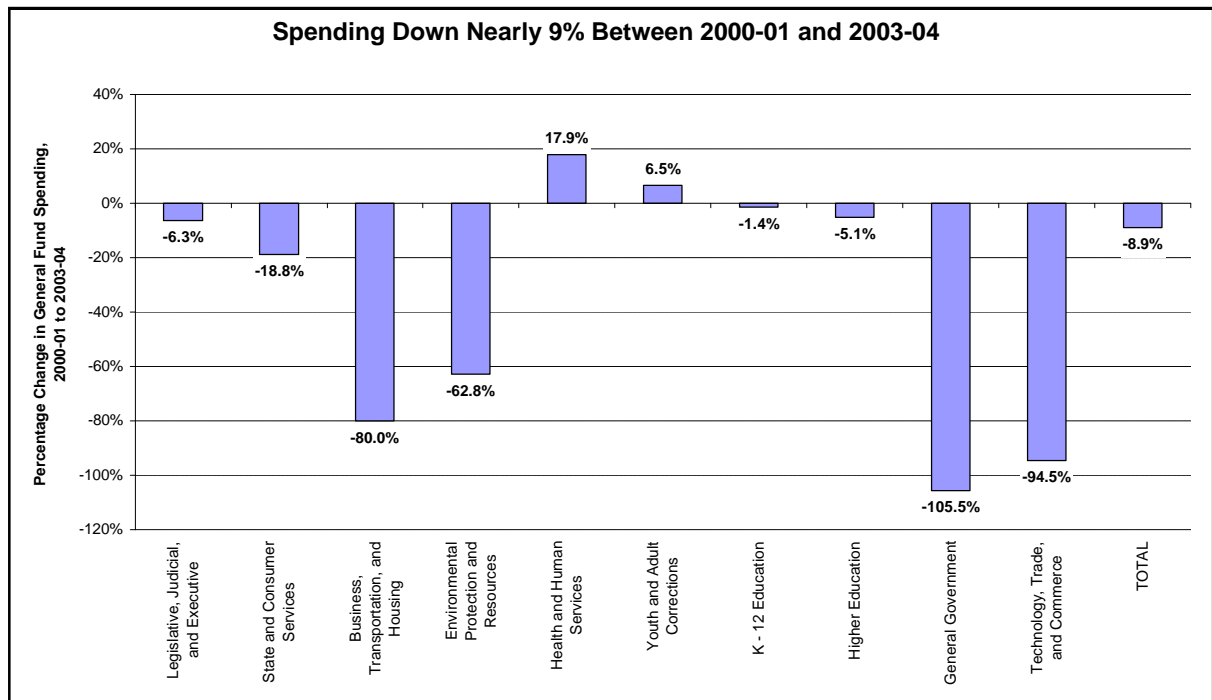
The 2003-04 budget spends 8.9 percent (\$6.9 billion) less than was spent in 2000-01. Since that time, the state's population has increased by 1.8 million and inflation has increased by 8.3 percent. Taken together, population and inflation have increased by 14.1 percent, resulting in a 23 percent reduction in population and inflation-adjusted state spending.

In percentage terms, the largest portion of the drop in spending results from the elimination of the state's backfill of local governments for revenues lost as a result of the 1998 VLF reduction. The backfill is no longer required due to the October 1, 2003 increase in the VLF rate. Spending has also declined in K - 12 Education; Business, Transportation, and Housing, reflecting the large amounts of one-time spending on transportation and housing in 2000-01; and Technology, Trade, and Commerce, reflecting the elimination of the agency. Health and Human Services spending increased 17.9 percent between 2000-01 and 2003-04 reflecting an increase in enrollment, primarily for children and low-income working parents, and cost increases in the Medi-Cal program.

What Was Cut?

In addition, as noted earlier, the 2003-04 spending plan includes \$9.4 billion in spending reductions. These reductions include \$944.9 million in cuts to 2002-03 spending, largely made during two rounds of mid-year reductions approved by the Legislature in March and May, and \$8.5 billion in 2003-04 reductions. The scoring used in this report differs from that used in the Governor's Budget documents. This report, for example, treats the increase in the VLF rate as taxes and fees, rather than as a spending reduction.

K - 12 Education accounts for nearly half (47.5 percent) of the spending reductions in the budget agreement. Major reductions within the K - 12 education budget include elimination of cost-of-living adjustments (\$800.5 million); adjustments to child care reimbursement rates, eligibility, and caseloads and other Proposition 98 General Fund savings (\$341.7 million); and reductions in the state's contribution to the State Teachers Retirement System (\$500 million). An additional 17.1 percent of the reductions occurred in Higher Education, including significant reductions in base support for the University of California (UC) and California State University (CSU) systems.



The reductions in Higher Education are, in part, offset by higher revenues from student fees, which were increased by approximately 30 percent in the UC and CSU systems, and from \$11 to \$18 per unit in Community Colleges.

State Government Cut Deeply

The 2003-04 budget agreement assumes a total of \$1.1 billion (\$585 million General Fund) in employee compensation reductions, equivalent to roughly a 10 percent reduction in state worker salaries. The budget authorizes the Department of Finance (DOF) to eliminate 16,000 civil service positions in order to achieve these savings; positions may be reinstated if the required savings are achieved through collective bargaining. Although position reduction proposals previously excluded “essential” services, such as public health and safety, the 2003-04 budget provision does not include any exemptions. Vacant positions eliminated under the “six month rule” (which requires elimination of any position that has been vacant for six consecutive months), as well as those eliminated under the Governor’s July 1 Executive Order eliminating all remaining vacant positions, can be counted toward the

16,000-position reduction. DOF director Steve Peace has stated that the payroll reductions are not likely to occur until at least mid-October – after the recall election – because the DOF needs time to review reduction plans.

Finally, the budget agreement assumes \$100 million (\$50 million General Fund) in savings in state contracting costs, to be achieved through “entrepreneurial activities.” The budget agreement grants the Department of General Services, which oversees state contracting practices, increased powers to achieve these savings.

In preparation for next year’s budget debate, the DOF sent a letter to all departments and agencies on September 5 calling for a 20 percent reduction in 2004-05 departmental budgets. The letter suggests several actions to help achieve the 20 percent target for each agency, including reorganization, consolidation and/or reduction of statutorily required programs, elimination of discretionary programs, and “restructuring program responsibilities between the State and local government entities.” The Governor issued an Executive Order on July 1 extending the state hiring freeze until June 30, 2005.

| How Were the Spending Reductions Distributed? | | | | |
|---|--|-------------------------------|--|---|
| | Two Year Total General Fund Reductions | 2002-03 General Fund Spending | Two Year Reductions as a Percentage of 2002-03 General Fund Spending | Agency Reductions as a Percentage of Total Reductions |
| Business, Transportation, and Housing | \$ 1,283,369,000 | \$ 211,000,000 | 608.2% | 13.6% |
| Environmental Protection | \$ 21,993,000 | \$ 174,000,000 | 12.6% | 0.2% |
| General Government | \$ 583,532,000 | \$ 5,330,000,000 | 14.7% | 6.2% |
| Health and Human Services | \$ 811,115,689 | \$23,150,000,000 | 3.5% | 8.6% |
| Higher Education | \$ 1,612,680,000 | \$ 9,543,000,000 | 16.9% | 17.1% |
| K - 12 Education | \$ 4,475,135,000 | \$29,469,000,000 | 15.2% | 47.5% |
| Legislative, Judicial, and Executive | \$ 283,809,000 | \$ 2,486,000,000 | 11.4% | 3.0% |
| Labor and Workforce Development | \$ 8,369,000 | \$ 177,000,000 | 4.7% | 0.1% |
| Resources | \$ 8,063,000 | \$ 1,243,000,000 | 0.6% | 0.1% |
| State and Consumer Services | \$ 86,299,000 | \$ 480,000,000 | 18.0% | 0.9% |
| Technology, Trade, and Commerce | \$ 46,675,000 | \$ 46,000,000 | 101.5% | 0.5% |
| Youth and Adult Corrections | \$ 209,063,000 | \$ 5,833,000,000 | 3.6% | 2.2% |
| TOTAL | \$ 9,430,102,689 | \$78,142,000,000 | 12.3% | 100.0% |

Power Shift to the Governor

AB 1765, passed as part of the budget package, gives the Director of Finance (DOF) sweeping powers to adjust 2003-04 appropriations in the event of a shortfall. "Notwithstanding any other provision of law" the DOF is authorized to 1) reduce appropriations or reallocate funds within a department; or 2) "impose any other savings strategies as determined appropriate to ensure that each department's planned expenditures are consistent with the appropriations authorized by the Budget Act of 2003." This provision is based on a proposal advocated by Senate Republican leader Jim Brulte and traditionally opposed by legislative Democrats. Questions have already arisen as to whether the new provision allows the DOF to make changes to programs - such as benefit and eligibility levels - that would otherwise require statutory changes. The budget bill also authorizes the DOF to transfer funds between departments to cover "unfunded employee compensation increases" or to avoid mid-year deficiencies (e.g., cases where programs run out of funds). It appears that this authority would enable the DOF to divert funds from a department that is staying within its budget to a department that does not make sufficient cuts or spends too much.

Where Are the Risks?

A number of the components of the 2003-04 spending plan are subject to considerable risk. Conservative legal groups have announced plans to challenge the deficit retirement bonds on the grounds that the bonds violate the state's debt limit and should be submitted to the voters for approval. The same organizations argue that bonds are restricted to a single type of "work" and that the general operating expenses of the state cannot be financed using long-term debt. The state is already engaged in litigation over the \$1.9 billion in proposed pension obligation bonds. State Senator Tom McClintock and others have also filed suit over the so-called trigger mechanism that administratively restored the VLF rate to its 1998 level. Finally, market conditions could affect the state's ability to sell \$2.0 billion in additional tobacco settlement bonds

and federal law limits the state's ability to require payments from tribes engaged in gaming.

On a positive note, revenue collections have surpassed forecast levels by \$443 million for the months of May through July, led by higher than anticipated personal income tax withholding.

What Might the Future Hold?

The Legislative Analyst estimates that if all of the assumptions in the 2003-04 budget agreement are achieved, the state will face an \$8 billion shortfall in 2004-05. The gap will be larger if savings are not utilized; anticipated revenues, including those from borrowing or tribal gaming, fall short of anticipated amounts; or expenditures exceed budgeted amounts.

Much of the 2003-04 budget gap was closed using one-time measures, including the borrowing and federal funds described above. State officials argue that the state has reached the limits of its ability to borrow to finance ordinary operating expenditures and that, in fact, current debt may limit the state's ability to issue bonds for traditional uses, such as infrastructure financing. Congress has not committed to additional aid for ailing state governments and federal budgetary pressures, including escalating deficits and costs related to the war in Iraq, are likely to crimp spending on domestic programs.

In short, the range of options available for balancing future gaps will be more constrained than in the current year. The anticipated 2004-05 gap is largely structural. In other words, it represents an ongoing gap between program costs and revenues that will not be bridged through economic growth alone.

CALIFORNIA ECONOMY IN A MUCH STRONGER POSITION THAN AFTER 1990S RECESSION

The California economy, like that of the nation, has formally entered a period of recovery. While the most recent recession officially began in March 2001 and ended in November of the same

year, economists have branded the recovery a jobless one due to continuing job loss at both the national and state levels. The California economy, however, has surpassed that of the nation during the jobless recovery. The relative strength of the state's economy stands in contrast to the recession of the early 1990s, when California lagged far behind the rest of the country. California has surpassed the nation with respect to both employment and wage growth:

- In July 2003, 20 months after the beginning of the national recovery in November 2001, California's unemployment rate was 6.6 percent while the national rate, at 6.2 percent, was only slightly lower. This contrasts with the situation in November 1992 – 20 months after the official start of the last national recovery in March 1991 – when California's unemployment rate stood at 9.7 percent, a full 2.3 percentage points above the 7.4 percent national rate.
- California lost 52,800 jobs between November 2001 and July 2003, a 0.4 percent reduction. This compares favorably, however, to the 0.8 percent job loss for the US over the same period. In stark contrast, 20 months after the beginning of the recovery in 1991, national employment was up 0.6 percent while employment in California had fallen 2.5 percent, reflecting a loss of 308,600 jobs.

Nonetheless, in California – as in the nation as a whole – renewed economic growth has not been accompanied by a significant growth in employment or decline in unemployment.

California Wages Outperform Nation

Since 2000, wage gains of the typical California worker have significantly outpaced those of the typical US worker. The inflation-adjusted hourly wage of the California worker at the middle of the earnings distribution rose 6.8 percent between the first half of 2000 and the first half of 2003. This compares to 3.4 percent growth in hourly wages for the typical US worker. The hourly earnings of low-wage Californians posted even stronger growth. Inflation-adjusted wages for the California worker at the 20th percentile

increased 8.1 percent between the first half of 2000 and the first half of 2003. Hourly wages for the typical US worker at the 20th percentile, in contrast, grew only 2.2 percent. High-wage workers in California also made gains exceeding those of their national counterparts. Hourly wages for the California worker at the 80th percentile rose 6.2 percent between the first half of 2000 and the first half of 2003. This compares with a 4.2 percent gain in the inflation-adjusted hourly wage for the US worker at the 80th percentile.

Jobless Recovery Hits African Americans and Less Well-Educated Workers Hardest

African American workers have been especially hurt by the recession and the jobless recovery. The average 2002 unemployment rate for black Californians was 12.0 percent – a sharp 4.6 percentage point jump over the 2000 average of 7.5 percent. Unemployment was also high in 2002 for California workers with less than a high school degree (11.7 percent). During the boom year of 2000, the average unemployment rate for this group was only somewhat lower (10.3 percent) than it was in 2002.

Long-Term Income Gains Highly Concentrated at the Top

Over the past year, substantial attention has focused on the drop in investment earnings among high-income Californians, and the impact of these losses on the state budget. It is important to put this issue in longer-term context:

- Between 1993 and 2000, the average adjusted gross income of the top fifth of taxfilers rose by more two-thirds (67.1 percent). Adjusted gross income (AGI) of the top 1 percent of taxfilers, meanwhile, rose 181.1 percent, from \$645,252 in 1993 to \$1,813,885 in 2000.
- Meanwhile, tax data show that the incomes of the remaining four-fifths of California taxfilers rose slightly during this same period. The average AGI of the middle fifth rose by just 8.5 percent.
- While the AGI of taxfilers in the top fifth of the distribution dropped 20.6 percent be-

tween 2000 and 2001, wealthy Californians enjoy far larger incomes than they did before the boom of the 1990s. The incomes of the wealthiest fifth of Californians were a third (32.7 percent) higher in 2001 than in 1993, after adjusting for inflation.

- The top 1 percent of taxfilers accounted for 27.5 percent of total AGI in California in 2000, nearly double the comparable 1993 figure of 13.8 percent. In 2001, however, the share of income earned by the top 1 percent of taxfilers dropped to 19.9 percent.

SENATE COMMITTEE PASSES TANF BILL

The US Senate Finance Committee approved a bill to reauthorize the Temporary Assistance for Needy Families (TANF) block grant on September 10. Similar to the House-passed TANF bill, the Senate bill increases work requirements for TANF cash assistance recipients, while freezing federal TANF block grant funding and providing a minimal increase in child care funding. However, the Senate bill, passed on a party-line vote of 9 to 8, is less strict than the House bill with respect to work hours and sanctions. Congress failed to reauthorize the TANF block grant before it expired on September 30, 2002, but has continued funding on an interim basis.

The Senate bill maintains the TANF block grant at its current level of \$16.5 billion per year. California would continue to receive \$3.7 billion annually. The House bill also freezes TANF funding.

The increased work requirements proposed in the Senate bill would impose significant additional costs on California. For example, the Senate plan could require counties to move some recipients into costly “make-work” positions to meet the increased work participation rates, but would not provide sufficient additional resources to meet these demands.

A comparison of the Senate bill and other TANF reauthorization proposals, including the House

bill – HR 4 – is available on the California Budget Project web site at www.cbp.org. Major provisions of the Senate bill are summarized below.

Child Care Funding Modestly Increased

The Senate bill increases mandatory child care funding by a total of \$1 billion over five years, a provision also included in the House bill. This figure may not cover the full costs of child care associated with the work requirements included in the Senate bill and is not sufficient for states to maintain current levels of child care assistance to low-income working families, let alone meet rising child care demands. The Finance Committee rejected amendments that would have provided \$11.25 billion in mandatory child care funding and shifted funding for proposed marriage promotion programs to child care. Senator Olympia Snowe (R-ME) is likely to offer an amendment on the Senate floor to substantially increase child care funding.

Work Participation Rate Increased

The Senate bill gradually increases the proportion of welfare recipients required to participate in work activities from 50 percent to 70 percent by 2008, a provision also included in the House bill. The participation rate would be partially offset by an employment credit, based on the number of former welfare recipients who are working. This employment credit would replace the current caseload reduction credit, which rewards states for caseload decline that has occurred since 1995, and would take effect in 2005, although states could delay full implementation of the employment credit for one year. Regardless, credits would be capped at 40 percent in 2004 and would decline to 20 percent by 2008.

These provisions would substantially increase California’s “effective” work participation rate, which is the statutorily required rate minus any credits a state has earned. California’s effective rate is currently less than 10 percent. Under the Senate plan, the state’s effective rate would increase to 50 percent in 2008, even if California qualified for the maximum employment credit.

This would be a difficult standard for the state to meet without creating costly “make-work” positions. However, the House bill would put the work participation rate even farther out of reach. HR 4 includes a redesigned caseload reduction credit that would only reduce work participation requirements for states whose caseloads continue to decline. California’s effective participation rate would increase to 70 percent if caseloads rise or remain relatively flat.

Weekly Work Hours Increased

The Senate bill increases the minimum work requirement from 20 to 24 hours per week for single parents with a child under age six and from 30 to 34 hours per week for other single-parent families to be fully countable toward the work participation rates. The Committee defeated an amendment that would have maintained the current standard of 20 hours per week for single parents with young children. In addition, the Senate bill increases the number of hours that single parents must spend in “core” work activities from 20 to 24. In contrast, the House bill requires almost all families to work 40 hours per week, 24 of which must be spent in core work activities.

The Senate plan allows states to receive partial credit when recipients work less than the required number of hours and extra credit when they work more than the minimum requirement. For example, states could claim a partial credit for single parents who have children older than age six and who work between 20 and 33 hours per week. States could claim extra credit if these parents work between 35 and 40 hours per week.

Core Work Activities Expanded

The Senate bill expands the activities that count toward the 24-hour core work requirement. The House, in contrast, adopted a more limited set of core work activities. Under the Senate plan, certain activities designed to address barriers to employment, such as substance abuse treatment and adult literacy programs, could count toward the 24-hour requirement for three out of 24

months, with an additional three months when combined with work or job readiness activities. The Senate bill also allows individuals caring for a child or adult family member, including a spouse with a medically verified physical or mental impairment, to count as meeting the work requirement. In addition, the Committee passed an amendment by Senator Snowe to allow college attendance to fulfill the work requirement.

Less Expansive “Superwaiver” Included

The Senate bill includes a “superwaiver” provision that would allow up to 10 states to modify regulatory requirements in TANF, Child Care and Development Fund, and Social Services Block Grant programs. The stated objective is “to provide for improved program integration,” but this provision could allow states to alter fundamental aspects of low-income programs, including eligibility and the level of assistance provided. HR 4 includes a more expansive superwaiver provision.

State Flexibility on Sanctions Maintained

The Senate plan maintains current law allowing states to apply either partial or full-family sanctions when an adult does not comply with welfare program requirements. The House bill requires states to apply full-family sanctions, which eliminate all cash assistance to families when an adult does not meet program requirements. California has a partial sanction policy, which provides a subsistence allowance to children when adults are not in compliance.

Some Benefits May Be Restored for Legal Immigrants

The Senate bill maintains the five-year ban on using TANF benefits and services for legal immigrants entering the country after 1996. However, Chairman Grassley agreed to include an amendment to allow states to extend federal eligibility for Medicaid (Medi-Cal in California) and the State Children’s Health Insurance Program (Healthy Families Program in California) to legal immigrant children and pregnant women,

RETURN SERVICE REQUESTED

regardless of their date of entry. Since California uses state funds to provide health services to these immigrants, this provision would partially offset state costs with federal dollars. This provision is not included in the House bill.

Significant Funding Provided for Marriage Promotion

The Senate bill provides \$500 million through 2008 to fund research and technical assistance, primarily for marriage promotion activities, and up to \$1 billion through 2008 for competitive grants to implement marriage promotion and education activities, including public advertising

campaigns, high school education, and marital skills programs. The House bill contains similar provisions.

Next Steps

The full Senate may not vote on the bill until October. Sixty votes are required for passage. A conference committee would then reconcile differences between the final Senate bill and the House bill. It is uncertain whether Congress will send a final bill to the President's desk before the temporary extension of the TANF block grant expires on September 30. Congress may continue to extend current funding for one or more quarters if agreement on a bill cannot be reached.

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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