

**Bridging the Gap:
The Social and Economic Context of the
Governor's Proposed 2003-04 Budget**

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The Big Picture

- ▶ California faces a fiscal crisis of unprecedented magnitude. The Legislative Analyst estimates the gap at \$26.1 billion, while the Governor, using a different set of assumptions, pegs the shortfall at \$34.6 billion. California is not alone. Nearly all of the fifty states face substantial shortfalls.
- ▶ The economy remains mired in recession, increasing the risk to vulnerable Californians and slowing the growth of revenues needed to close the budget gap.
- ▶ The Governor's proposed solutions to the budget crisis range from deep spending reductions to tax increases to loans and other temporary measures.

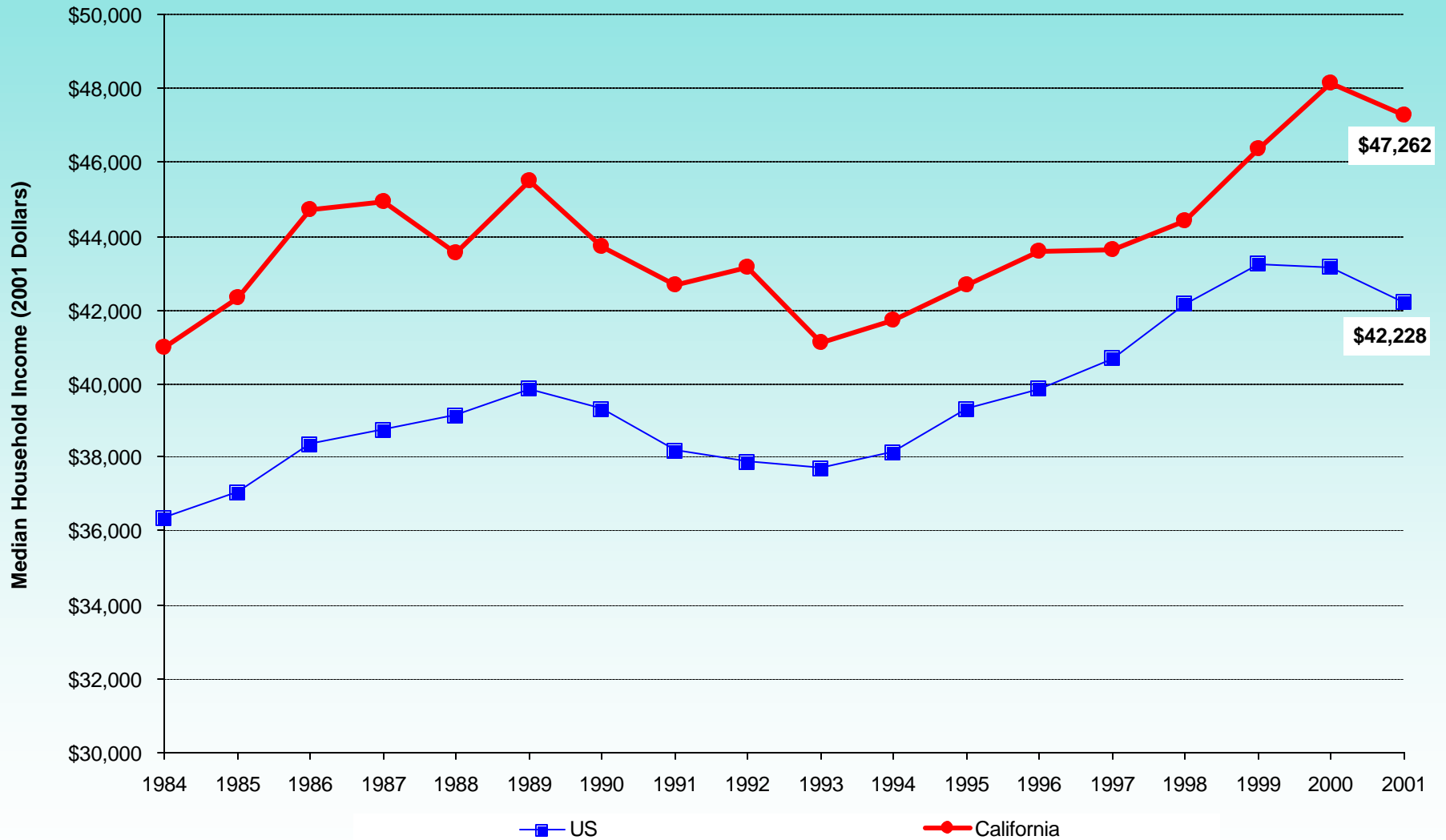
What Are the Major Policy Issues Confronting California?

- ▶ What combination of solutions to the budget crisis will best resolve the state's fiscal crisis without leaving the state ill-prepared to meet the basic needs of the state's population and the demands of a changing economy?
- ▶ What will the downturn in the economy mean for low- and middle-income Californians? How should the state help those who have lost jobs or otherwise suffered from the recession? Is the state doing all that it can to maximize opportunities for all Californians?
- ▶ Is the budget process "broken"? If so, how should it be fixed? What changes are needed to improve the stability of the state's fiscal systems, their ability to fund basic services, and the transparency of the state's budget process?

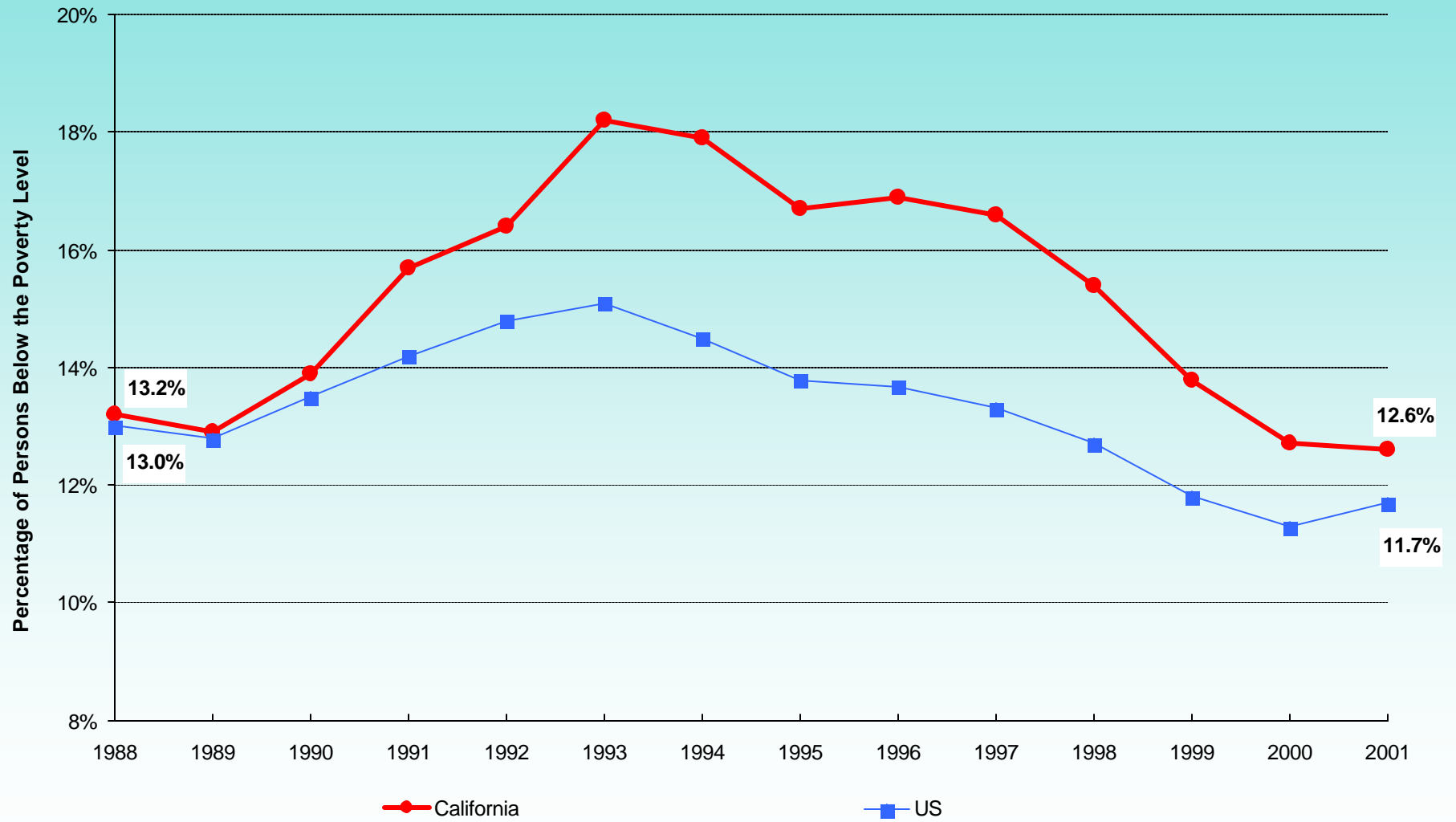
The Economy Remains Stagnant

- ▶ The economy remains stagnant, both at the state and national levels. The state's unemployment rate increased in January and there is little evidence to suggest that conditions will improve in the near future.
- ▶ High-technology industries, which led the state's economy during the boom of the late 1990s, have suffered the brunt of the recession. The unemployment rate in the Bay Area increased from 2.6 percent to 6.1 percent between March 2001 and November 2002.
- ▶ The number of working poor increased during the recession and has not returned to pre-recession levels. In 2001, over 1.8 million of California's working families had incomes at or below 200 percent of the poverty line (\$35,300 for a family of four in 2001).
- ▶ The hourly earnings of low-wage (20th percentile) and typical (50th percentile) California workers made little progress over the past decade. The current downturn will likely slow the gains made in recent years and increase the economic vulnerability of millions of low-income Californians.

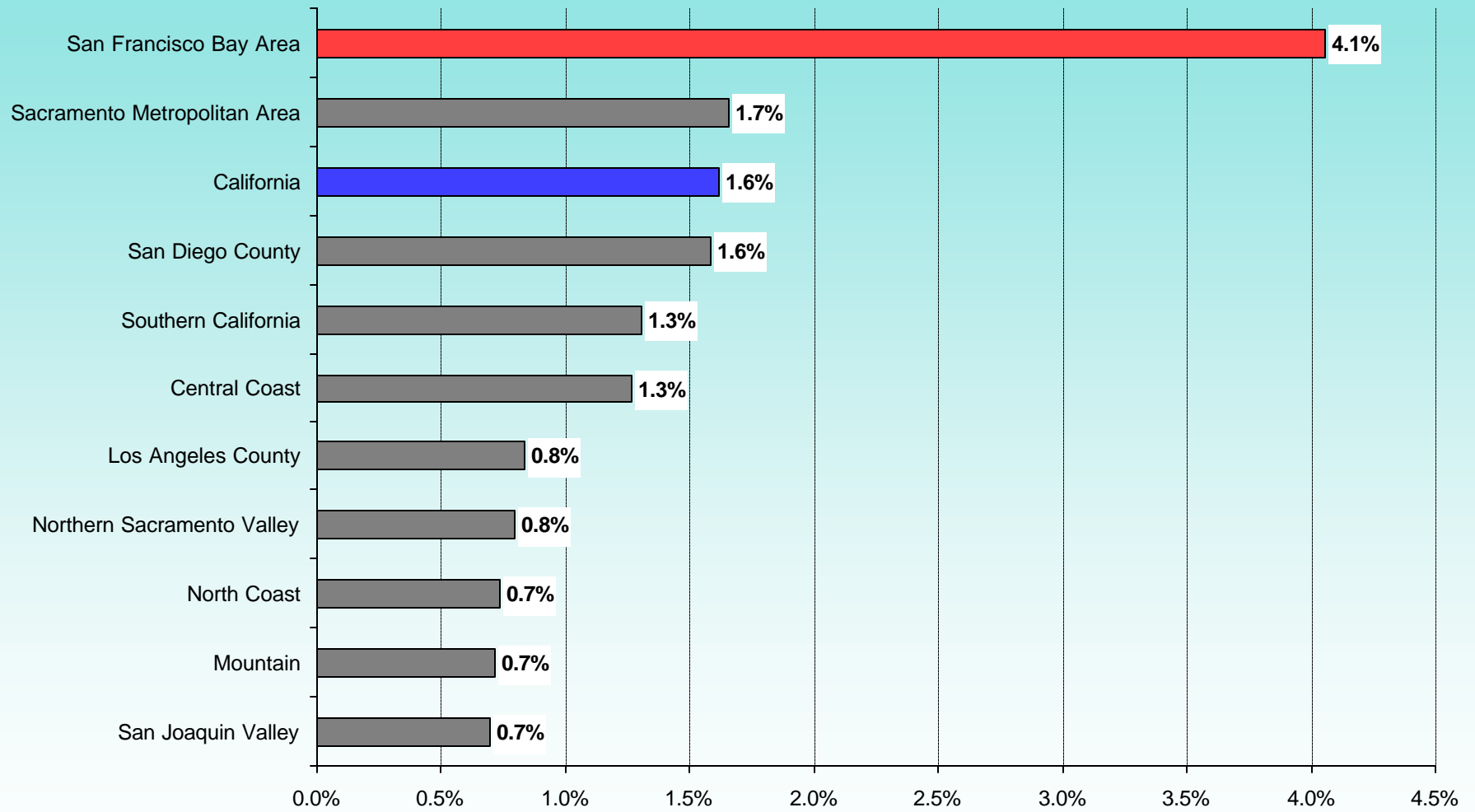
Median California Household Income Drops in 2001



California's Poverty Rate Remains Higher Than That of the Nation



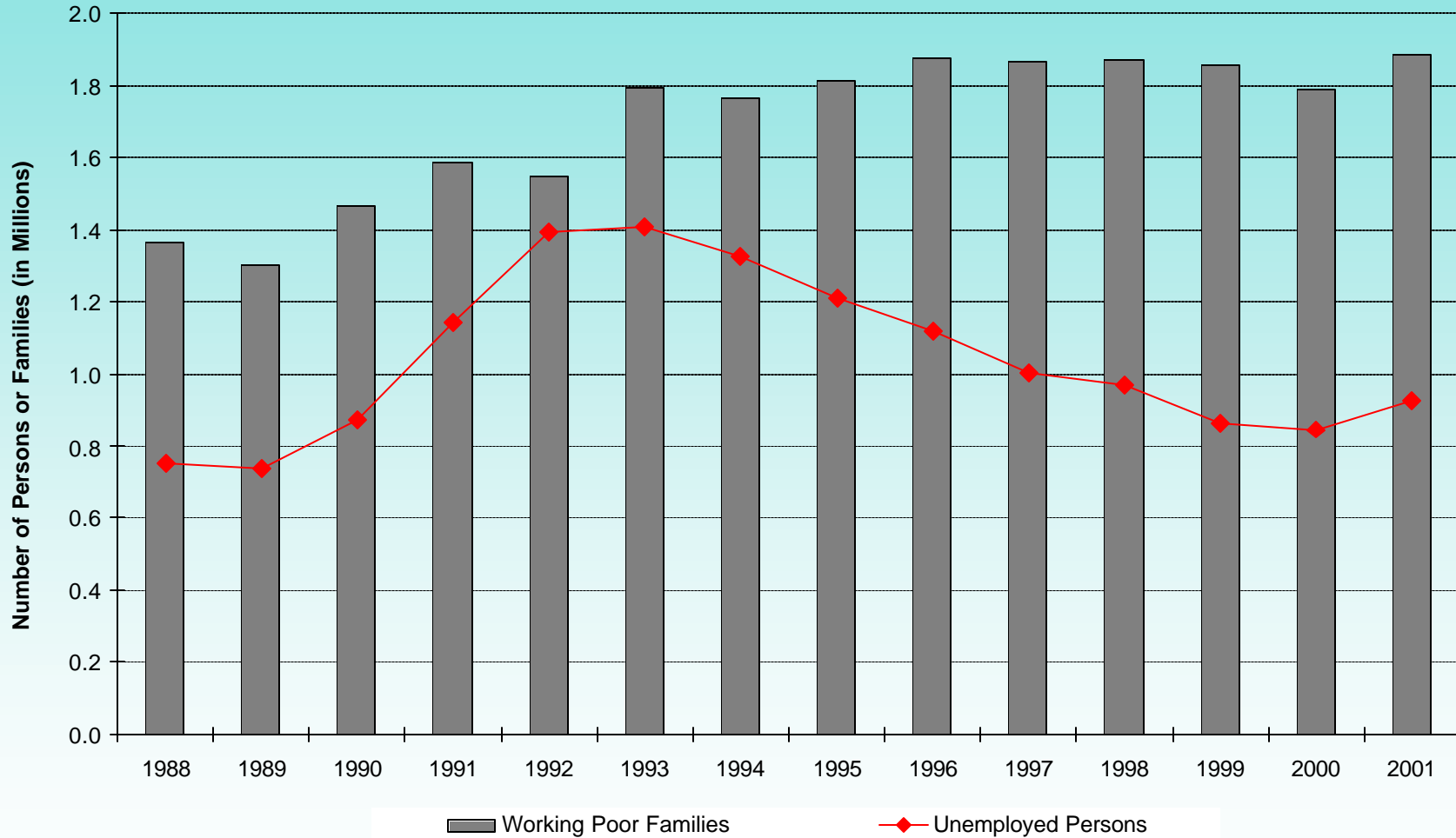
Unemployment Rate Increase Greatest in the Bay Area



Change in Unemployment Rate, November 2000 to November 2002

Note: Unemployment rate data are not seasonally adjusted.

Number of Working Poor Reaches New High in 2001



Note: Working Poor Families include only those with incomes of up to 200 percent of the federal poverty level, at least one adult between the ages of 25 and 64, and at least one adult without an illness or disability that prevents him or her from working.

Wage Growth Low for Middle- and Low-Wage California Workers



Source: CBP analysis of Current Population Survey data

The Proposed Budget Assumes Modest Economic Growth

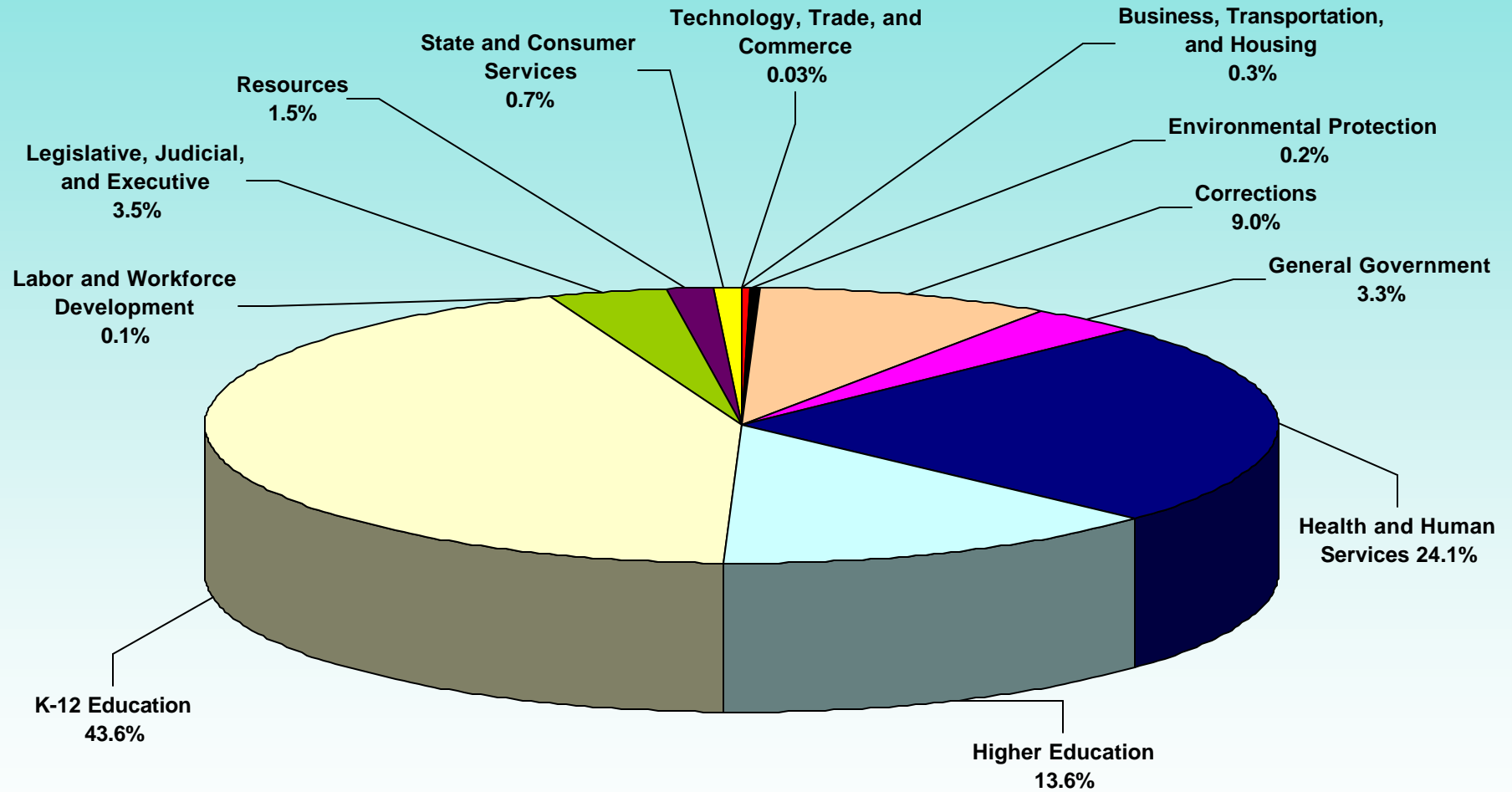
- ▶ The Governor's Budget assumes slow economic growth in 2003, with a modest recovery in 2004. Personal income growth, a key determinant of state revenues, would be modest in both 2003 and 2004. The Governor's forecast is in line with that of UCLA, but more pessimistic than most other projections.
- ▶ While the Legislative Analyst's Office (LAO) will not release a full review of the budget and its underlying assumptions until February, the LAO's initial response notes that their view of the economy is somewhat more positive than that of the Governor and more in line with that of other economic forecasts.
- ▶ Significant risks remain under either scenario. Most notably, the impact of a potential war in Iraq is uncertain and the President has demonstrated little interest in providing fiscal relief to states. The President has instead opted for substantial tax reductions aimed primarily at very high income households that would increase the federal deficit and potentially limit funds for other domestic priorities.

The Basics: Spending, Revenues Down Substantially

- ▶ The Proposed Budget reflects \$13.7 billion in current and budget year spending reductions, including \$2.7 billion in proposed 2002-03 reductions and \$11.0 billion in proposed 2003-04 reductions.
- ▶ Revenues are also down, due primarily to the large volume of one-time measures included in the 2002-03 Budget, such as the \$4.5 billion in 2002-03 revenues from the securitization of the state's payments from the national tobacco settlement. The Governor assumes that General Fund revenues would fall from \$73.1 billion to \$69.2 billion, a drop of 5.5 percent.
- ▶ Spending would fall from \$75.5 billion to \$62.8 billion, a drop of 16.8 percent (\$12.7 billion). A significant fraction of the drop reflects the transfer of \$8.2 billion in programs from the state to county governments. This transfer would be financed by new tax revenues outside the General Fund.
- ▶ The only major program area to escape significant reductions is Corrections. The Budget includes a reserve of \$531 million (0.8 percent of proposed expenditures).

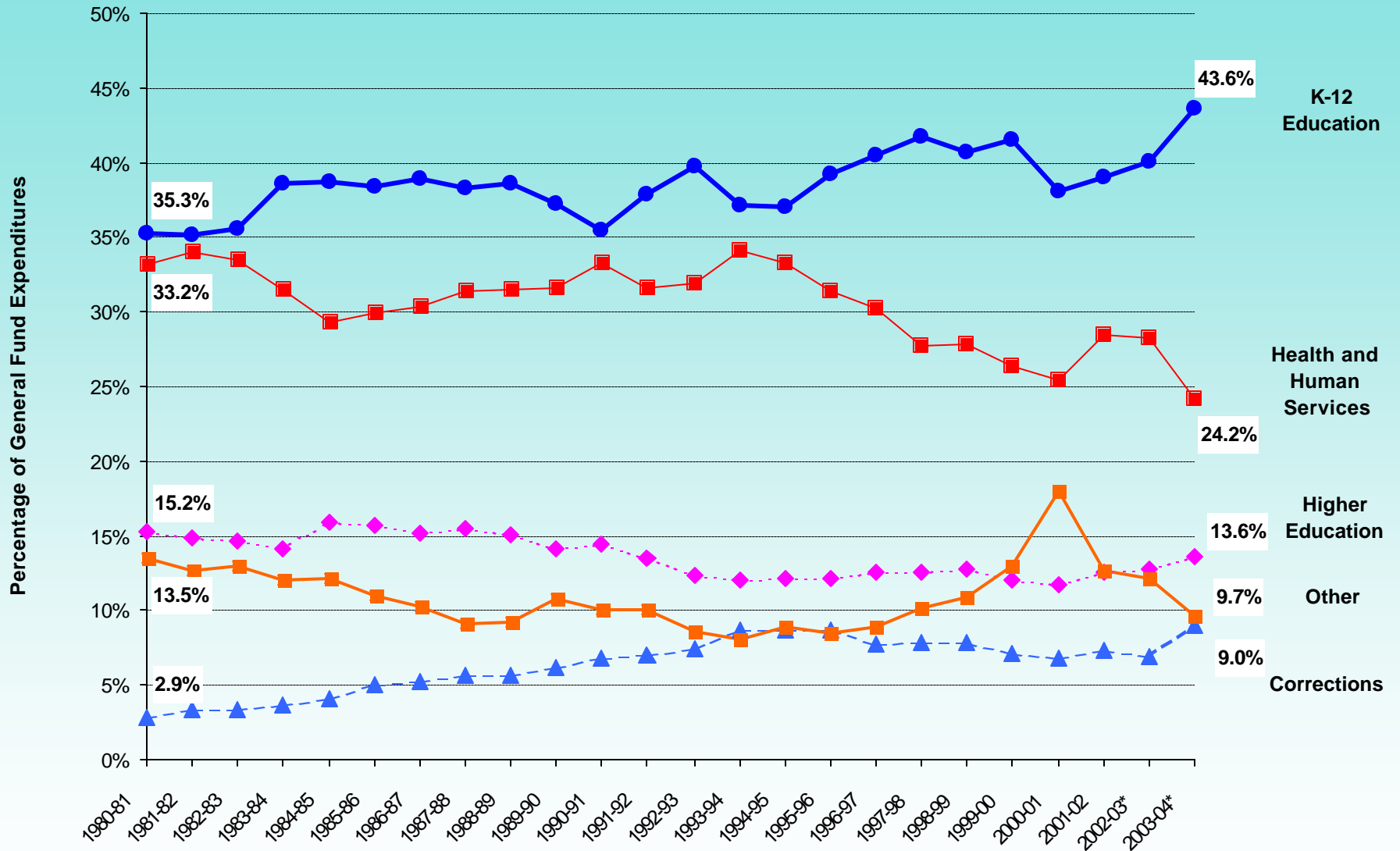
Education Accounts for Largest Share of 2003-04 Spending

General Fund Spending by Agency



Proposed 2003-04 General Fund Expenditures = \$62.8 Billion

K-12 Education Continues to Receive Largest Share of State General Fund Spending

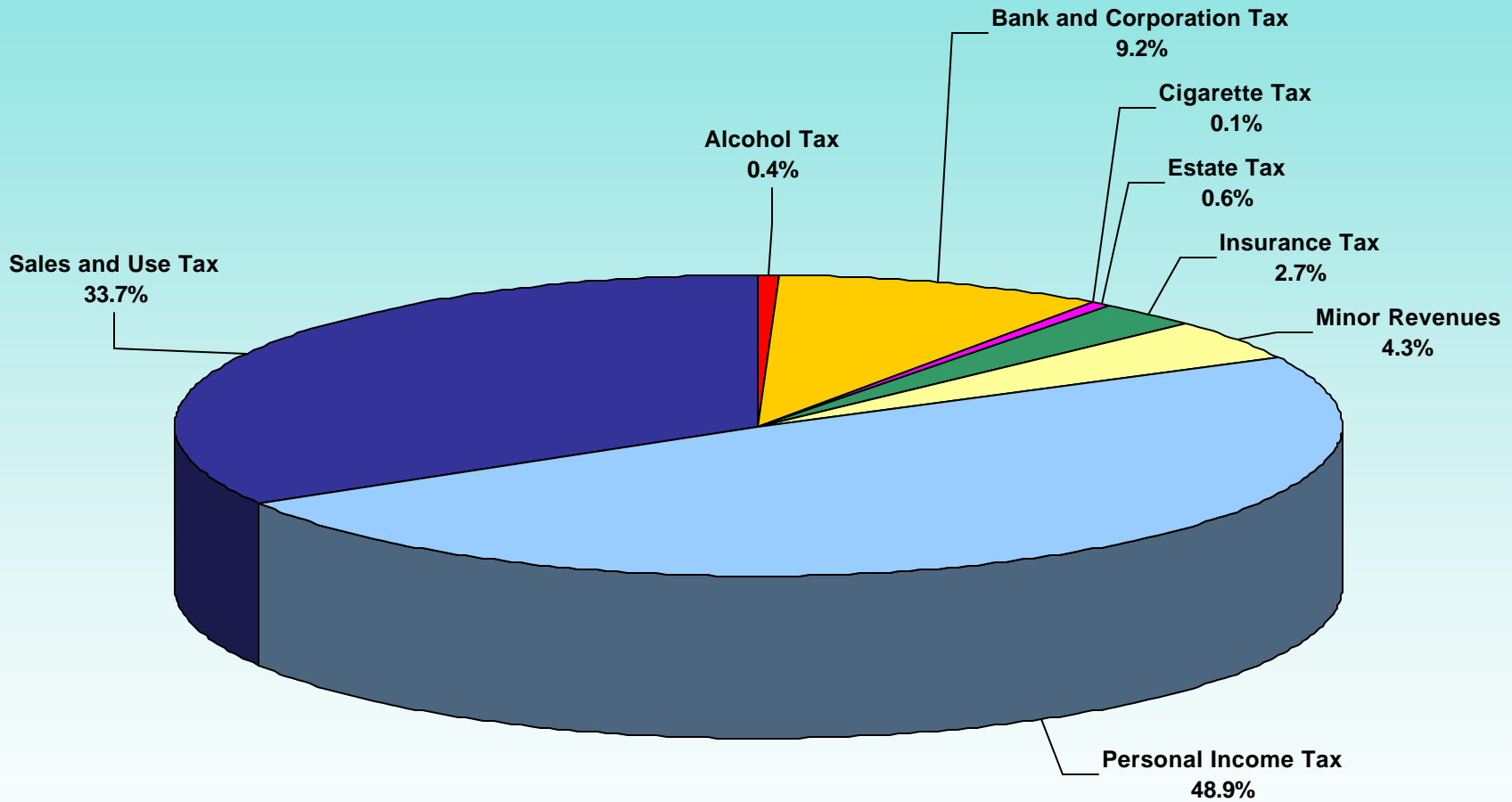


*2002-03 budgeted, 2003-04 proposed.

Note: Other includes Legislative, Judicial, and Executive; State and Consumer Services; Business, Transportation, and Housing; Technology, Trade, and Commerce; Resources; Environmental Protection; and General Government.

Personal Income Tax Provides Nearly Half of 2003-04 General Fund Revenues

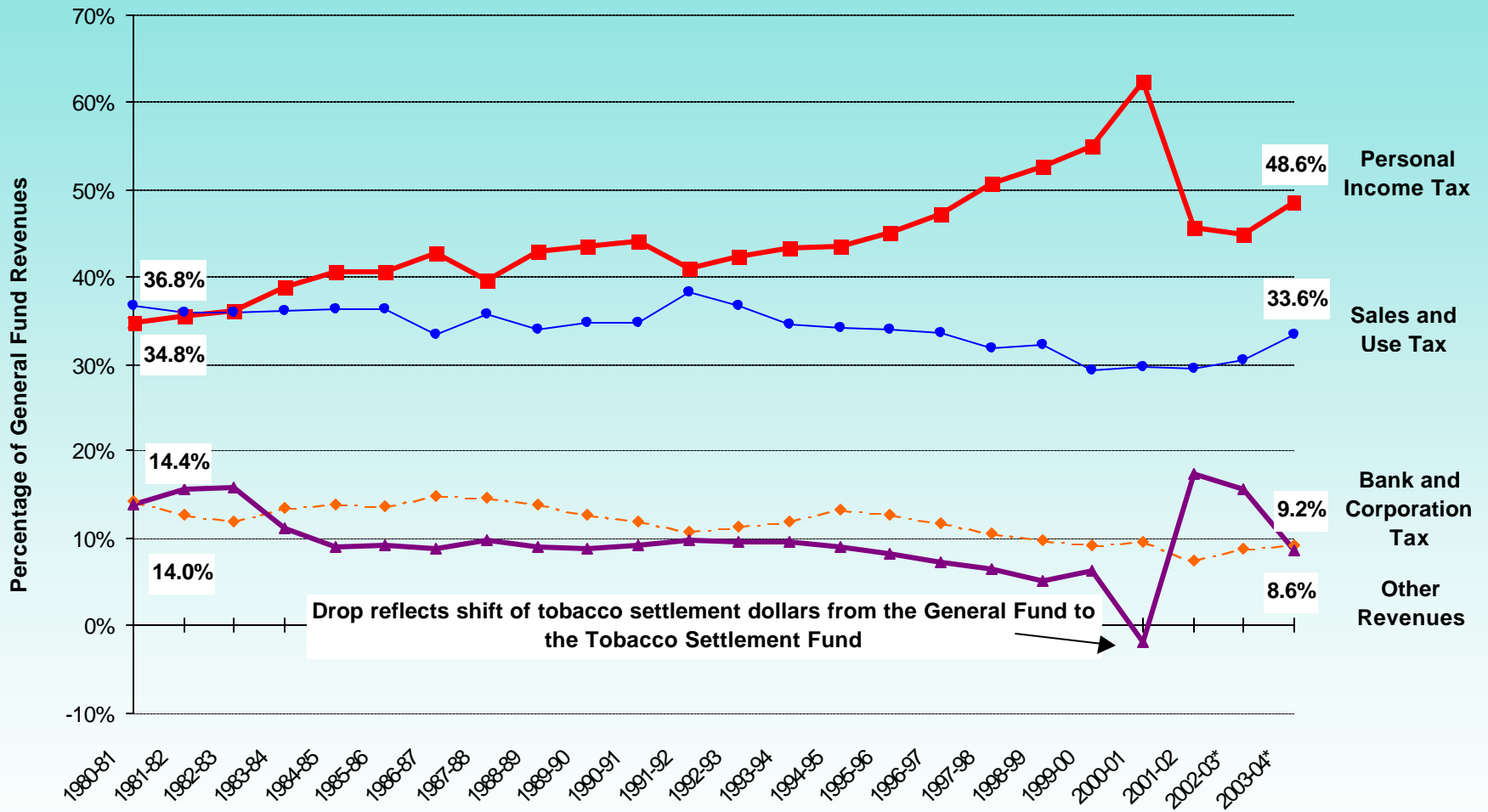
Does Not Include the \$8.3 Billion Proposed Tax Increase to Fund Realignment



Projected 2003-04 General Fund Revenues = \$68.8 Billion

Personal Income Tax Provides the Largest Share of State General Fund Revenues

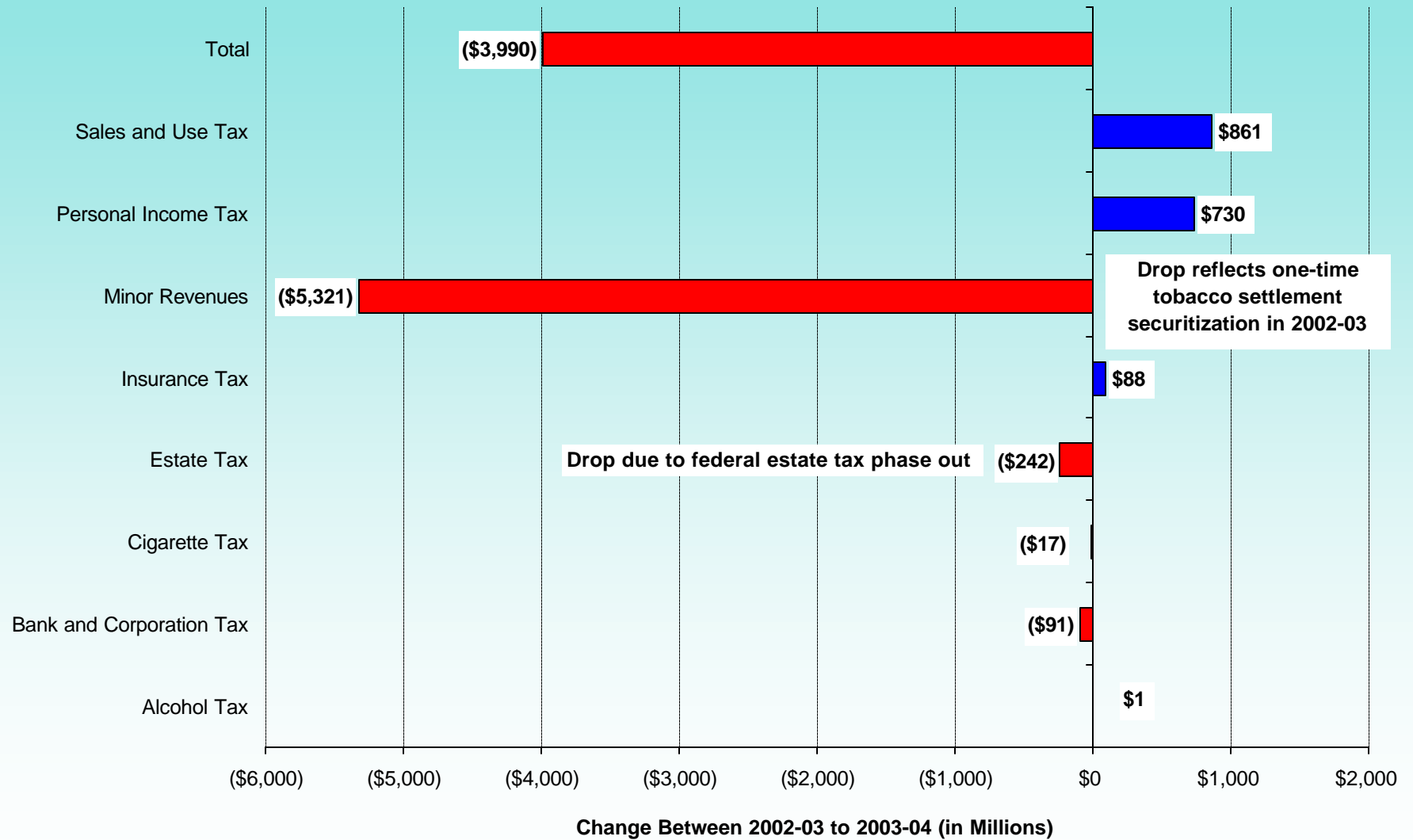
Does Not Include the \$8.3 Billion Proposed Tax Increase to Fund Realignment



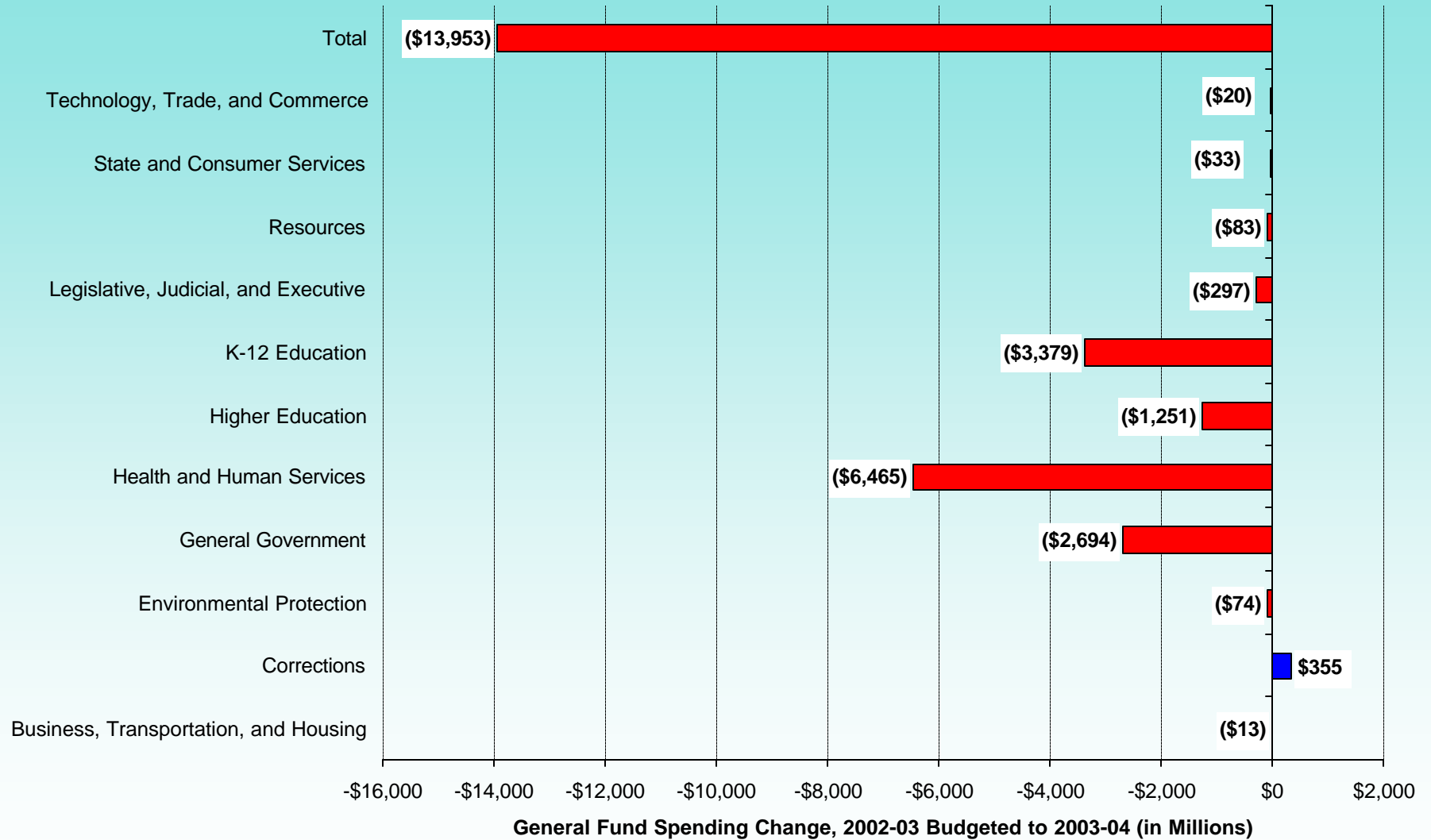
*2002-03 and 2003-04 estimated.

Note: Other Revenues include Alcoholic Beverage Tax, Cigarette Tax, Horse Racing License Fees, Estate Tax, Insurance Tax, Trailer Coach License Fees, Minor Revenues, Transfers, and Loans.

Budget Year Revenues Are Expected to Decrease

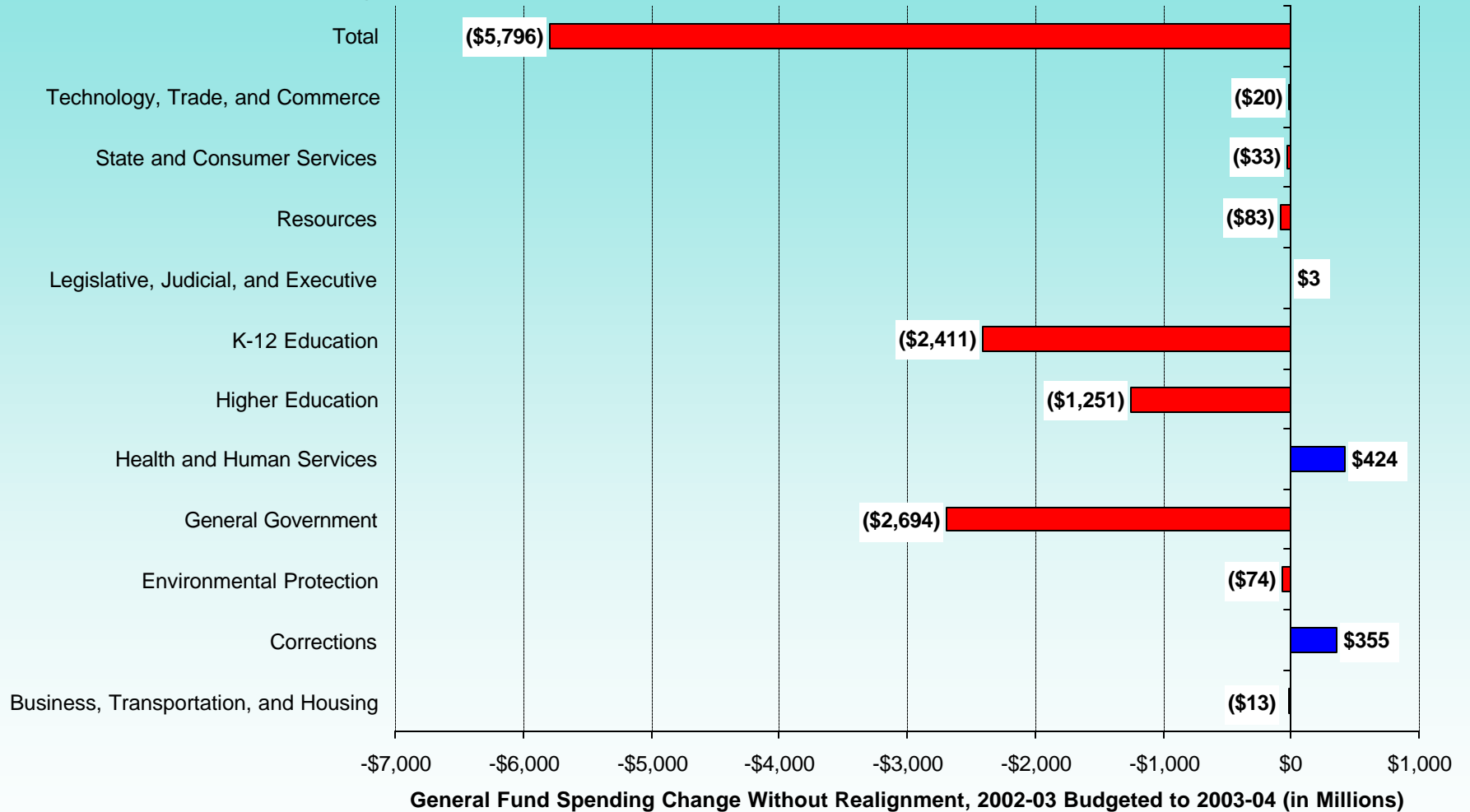


Under Realignment, Only Corrections Receives an Increase



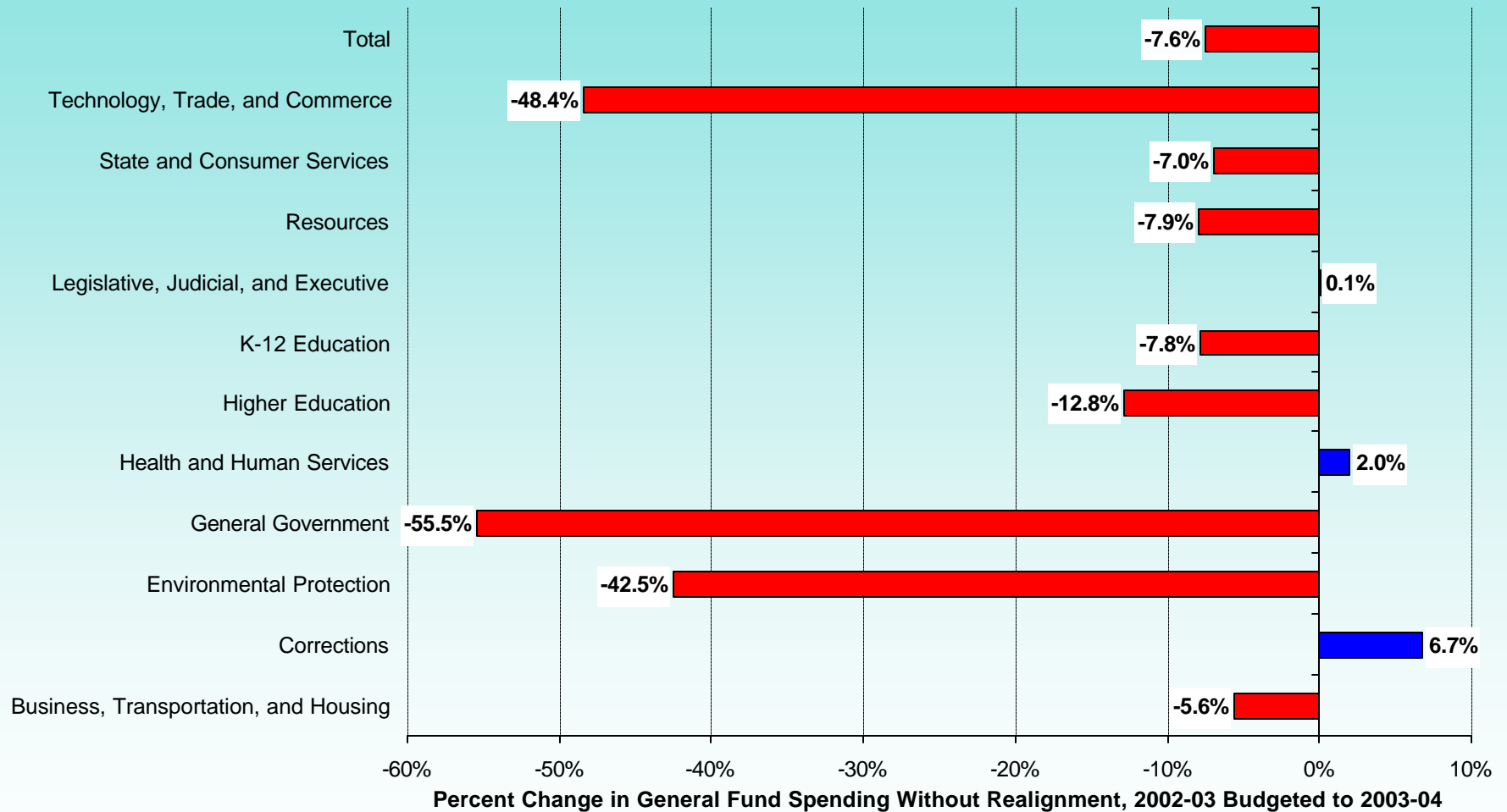
Note: Based on budgeted 2002-03 spending that does not reflect the Governor's proposed current year reductions.

Without Realignment, Only Corrections; Health and Human Services; and Legislative, Judicial, and Executive Receive Increases



Note: Based on budgeted 2002-03 spending that does not reflect the Governor's proposed current year reductions. Assumes no additional changes in realignment program funding from 2003-04 proposed levels.

Without Realignment, the Only Percent Increases Are in Corrections; Health and Human Services; and Legislative, Judicial, and Executive

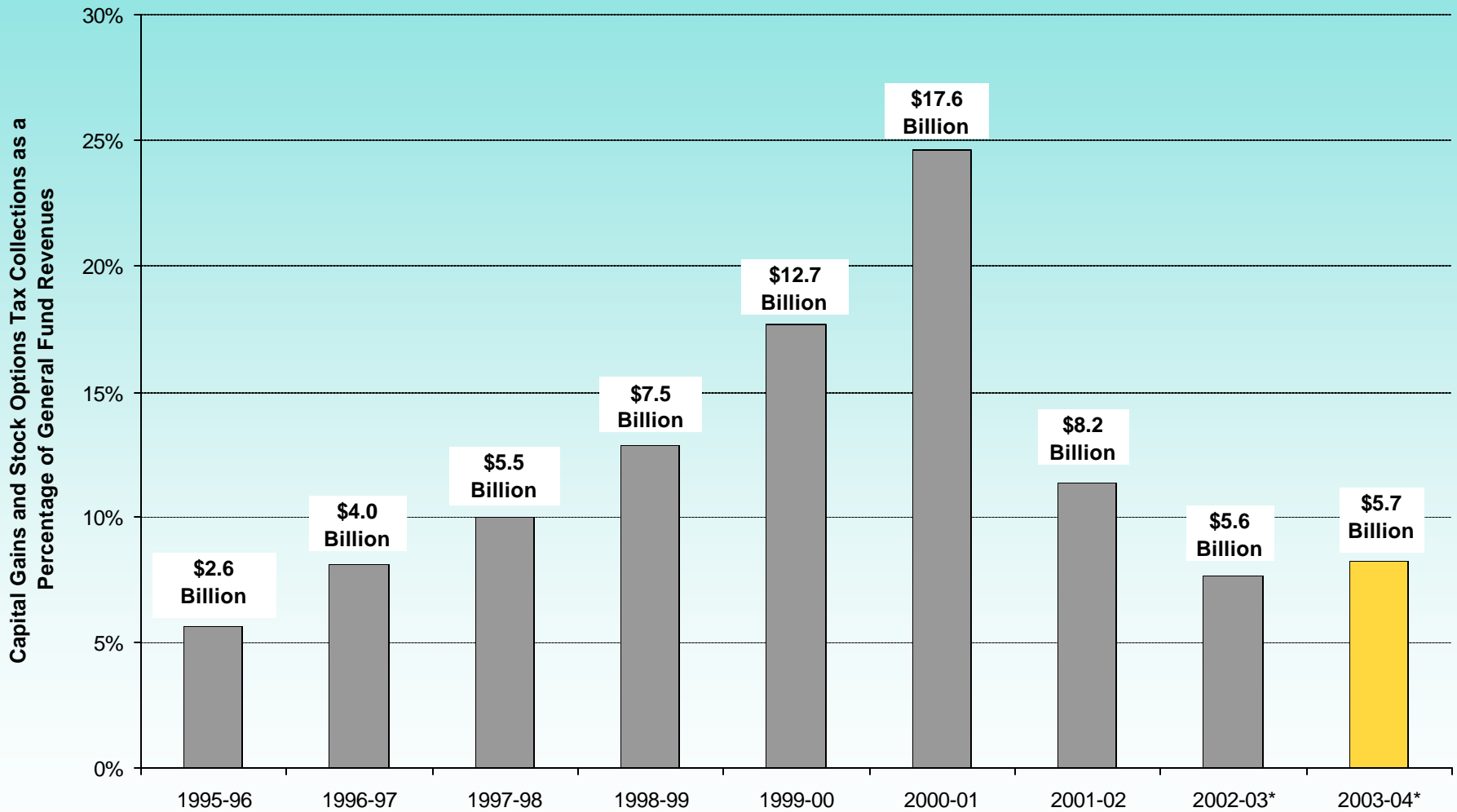


Note: Based on budgeted 2002-03 spending that does not reflect the Governor's proposed current year reductions. Assumes no additional changes in realignment program funding from 2003-04 proposed levels.

Where Did the Deficit Come From?

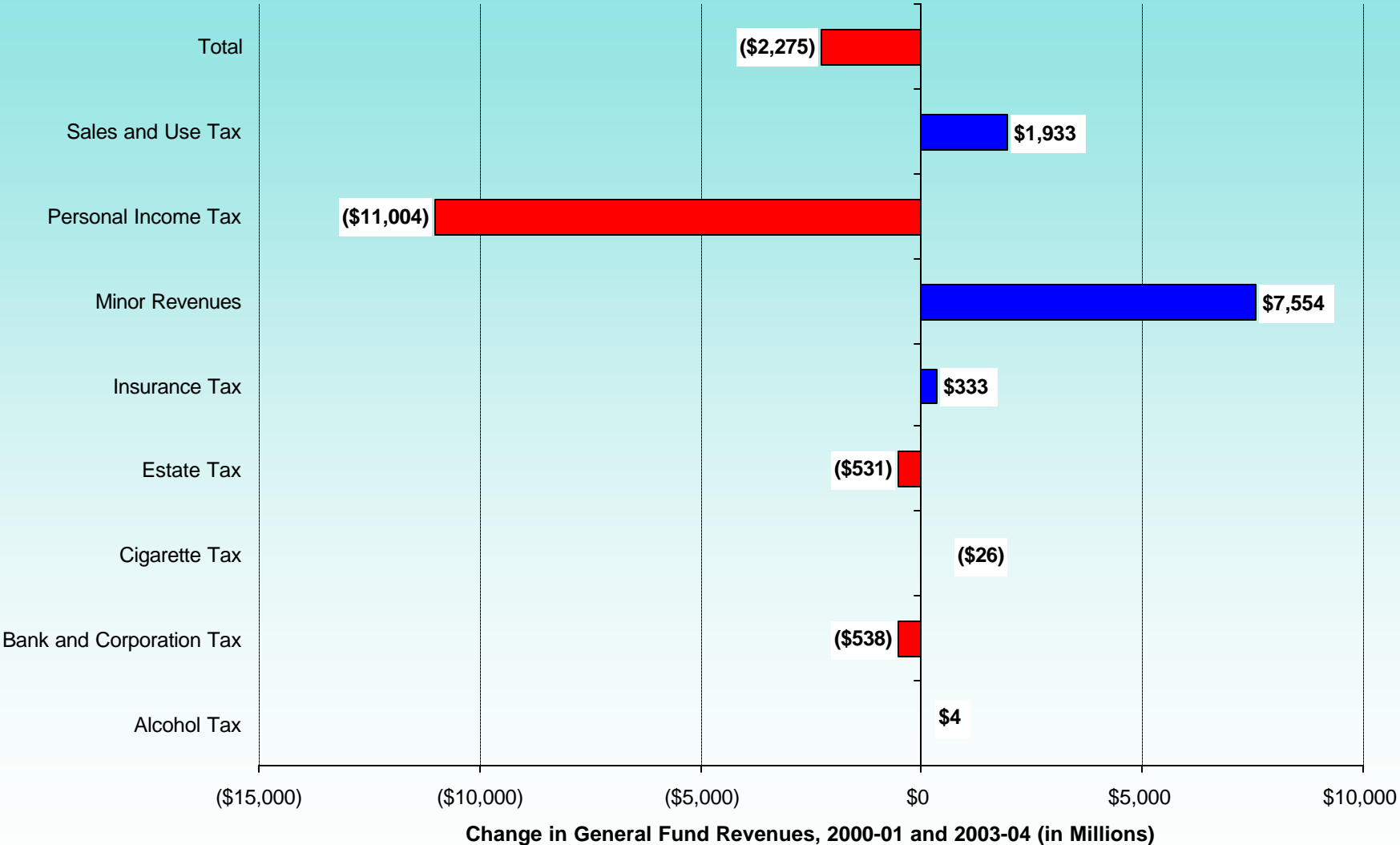
- ▶ A sharp drop in personal income tax collections, specifically taxes attributable to stock options and capital gains.
- ▶ The impact of one-time measures used to bridge the current year's deficit.
- ▶ Increased spending, primarily for education and health care during the good years, along with significant one-time spending on transportation and housing.
- ▶ Tax cuts enacted over the past decade that have reduced revenues by approximately \$7.8 billion in 2002-03.

Budget Gap Largely Due to Drop in Revenues from Stock Options and Capital Gains



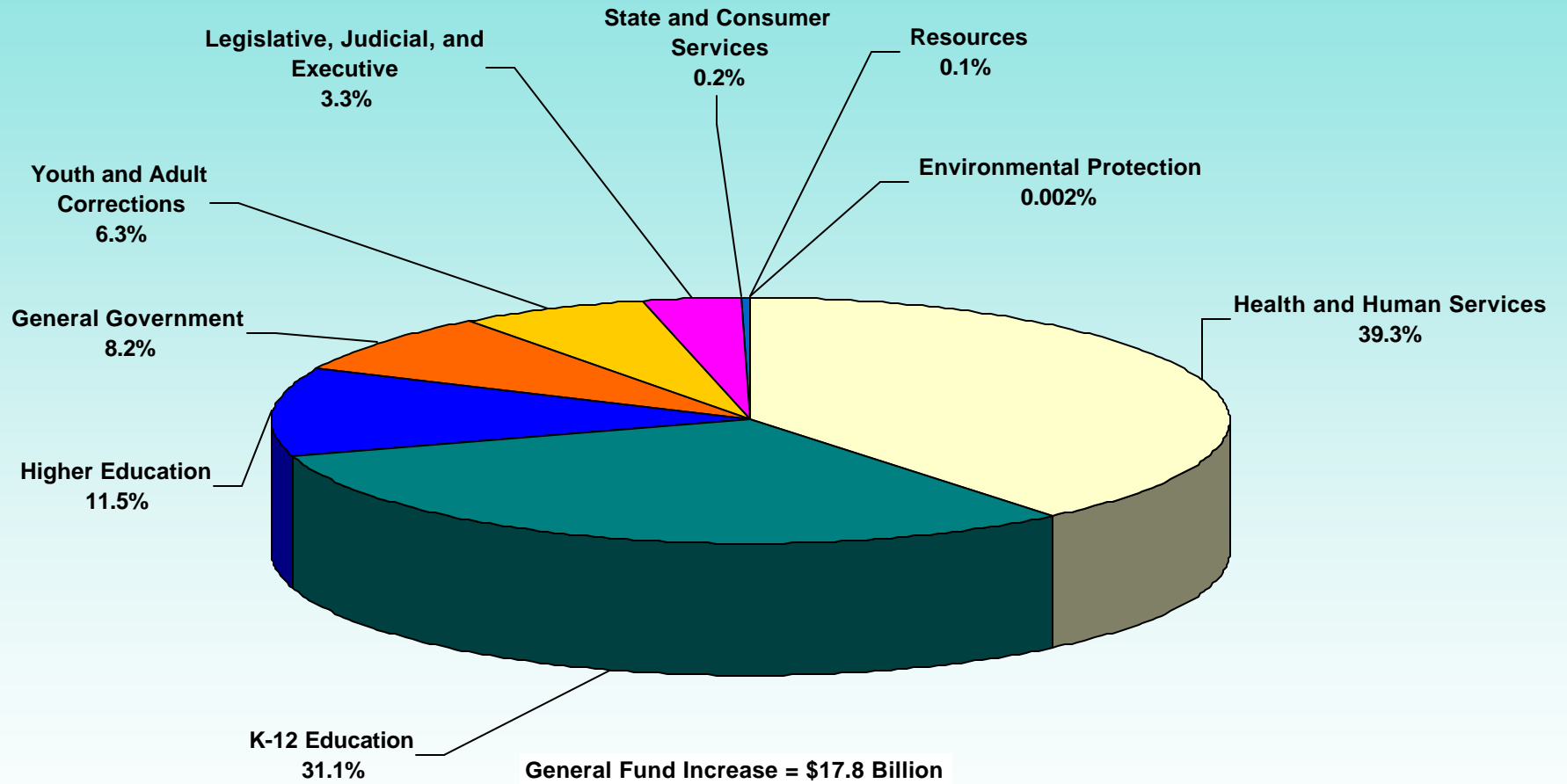
* 2002-03 and 2003-04 estimated.

Personal Income Tax Collections Down



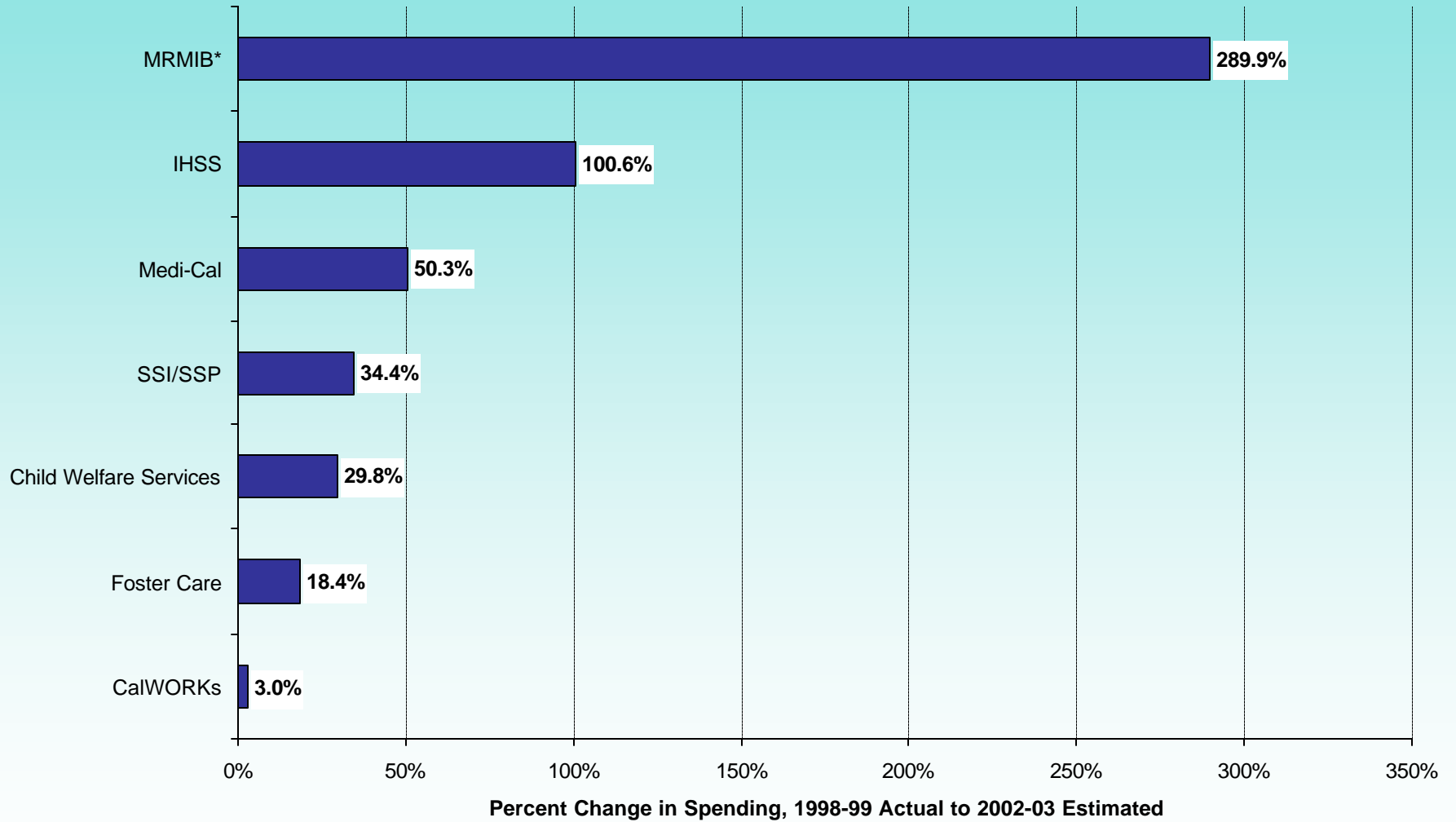
Source: Department of Finance

Where Has the Money Gone? Percentage of General Fund Increase, 1998-99 to 2002-03 Estimated



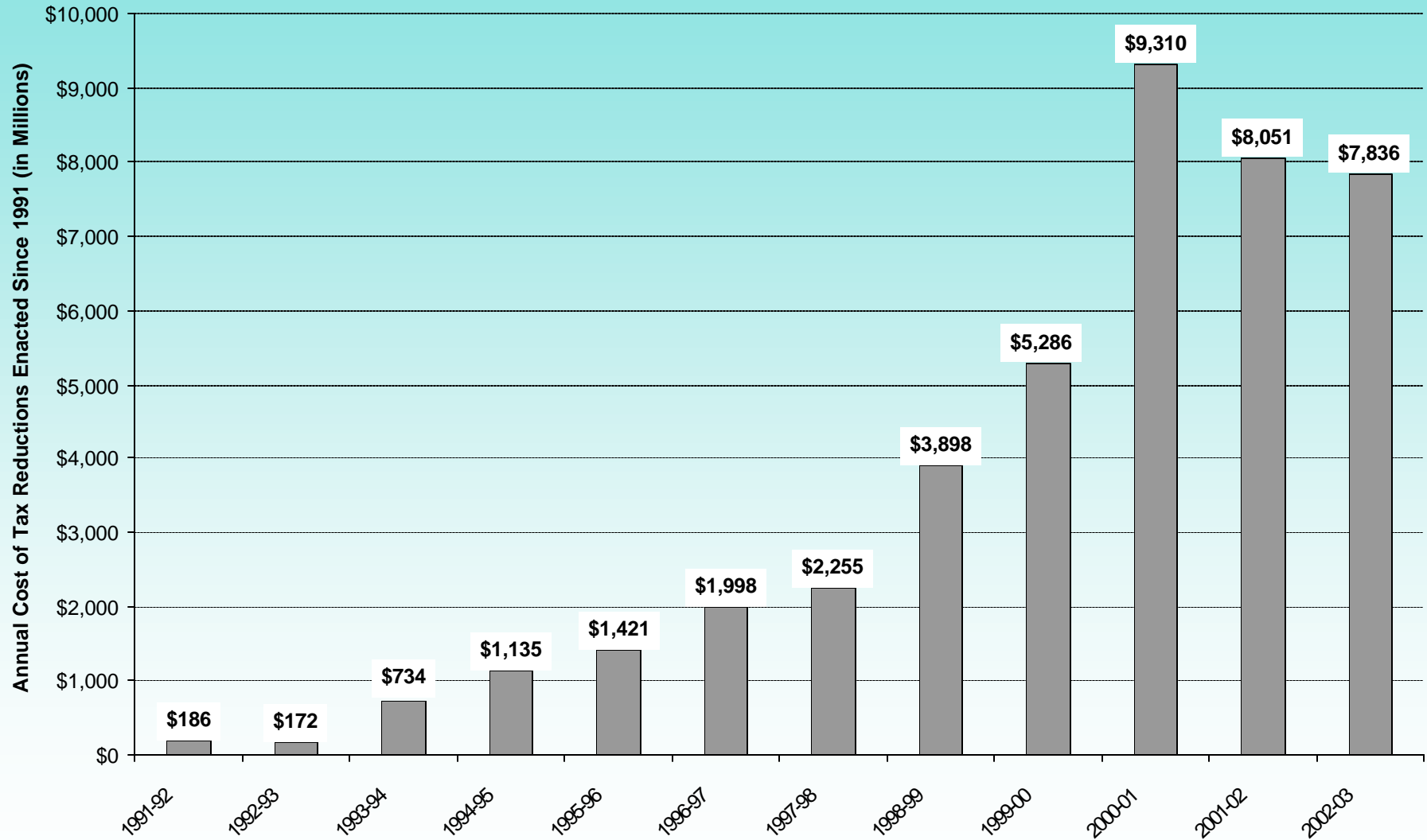
Note: General Government includes the state's reimbursement of local governments for Vehicle License Fee (VLF) reduction and other tax relief. Labor and Workforce Development Agency spending for 2002-03 is included under Health and Human Services and General Government.

Where Did the Growth in Health and Human Services Go?



*Managed Risk Medical Insurance Board, which administers the Healthy Families Program and other programs.

Tax Cuts Enacted Since 1991-92 Will Cost \$7.8 Billion in 2002-03



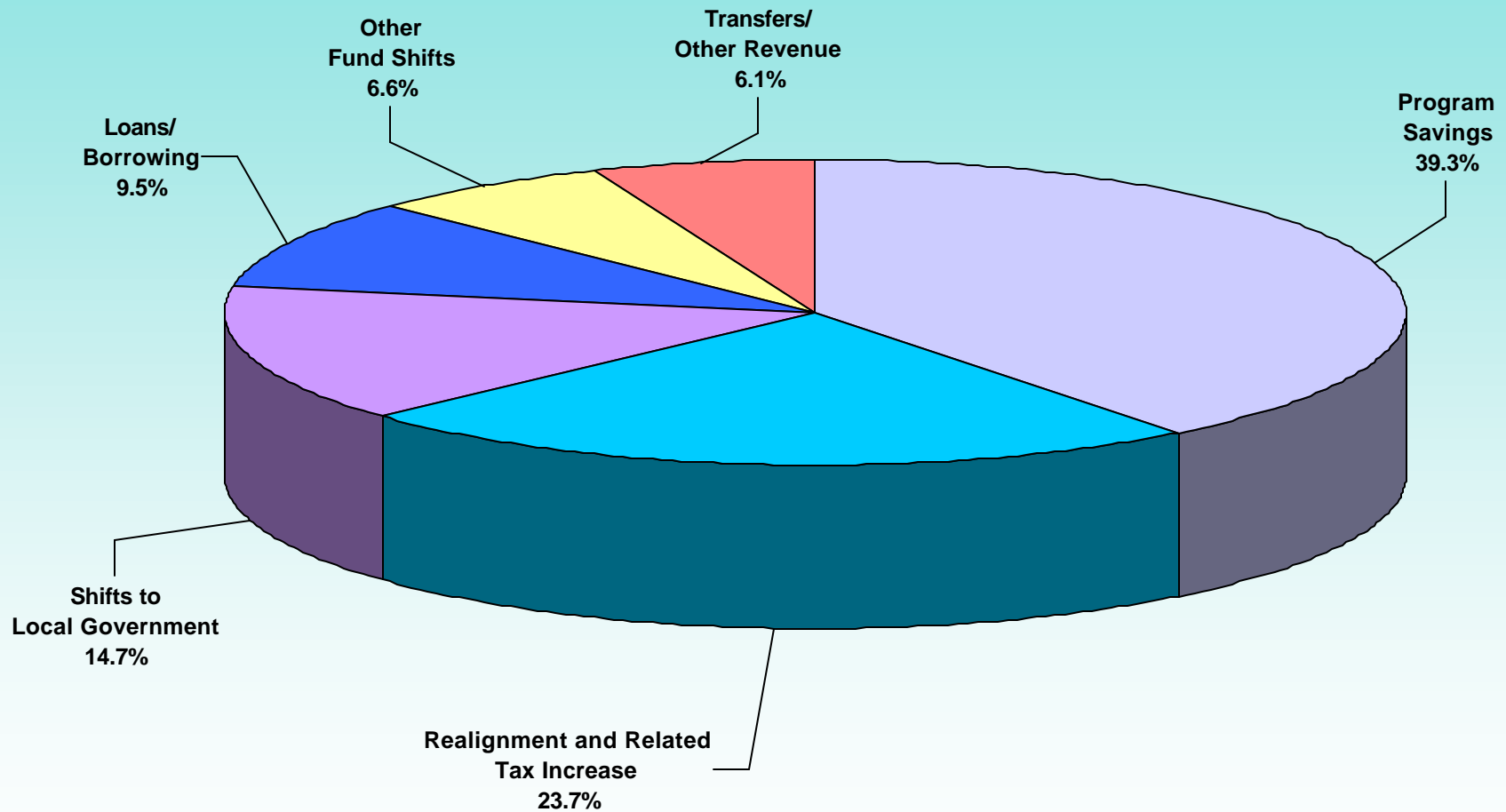
How Big Is the Gap?

- ▶ Confusion has arisen over the size of the state's budget gap and the implications of differing estimates for crafting solutions to the problem.
- ▶ The Governor estimates the gap at \$34.6 billion, while the Legislative Analyst's preliminary estimate suggests a shortfall in "the \$26 billion plus range." The Analyst's estimate is based on a "current services" budget – the sum of revenues raised by the state's tax system minus the cost of providing the current level of state services - and a revenue estimate that is approximately \$2.5 billion higher than that of the Governor. The Governor's estimate reflects approximately \$4 billion in additional baseline spending which is offset by an equivalent amount of spending reductions.
- ▶ The Analyst's revenue estimate reduces the amount of "solutions" needed to balance the budget by approximately \$3 billion.

Closing the Gap

- ▶ The Governor proposes to close the \$34.6 billion budget gap using a combination of spending reductions (\$13.7 billion); increased revenues (\$8.2 billion); elimination of aid to and other reductions affecting local governments (\$5.1 billion); fund shifts (\$2.2 billion); transfers and other revenues (\$2.1 billion); and loans and borrowing (\$3.3 billion).
- ▶ The largest single “gap bridging” proposal is a complex transfer of responsibility for health, social service, and court programs from the state to county governments that would be financed with the proceeds from a one cent increase in the state’s sales tax rate; reinstatement of the 10 percent and 11 percent brackets on very high-income taxpayers; and a \$1.10 per pack increase in the state’s cigarette tax.
- ▶ The largest component of “other revenues” is the anticipated \$1.5 billion increase in revenues from tribal gaming activities.

How the Governor Proposes to "Bridge the Gap"



Governor's Estimate of the Budget Gap = \$34.6 Billion

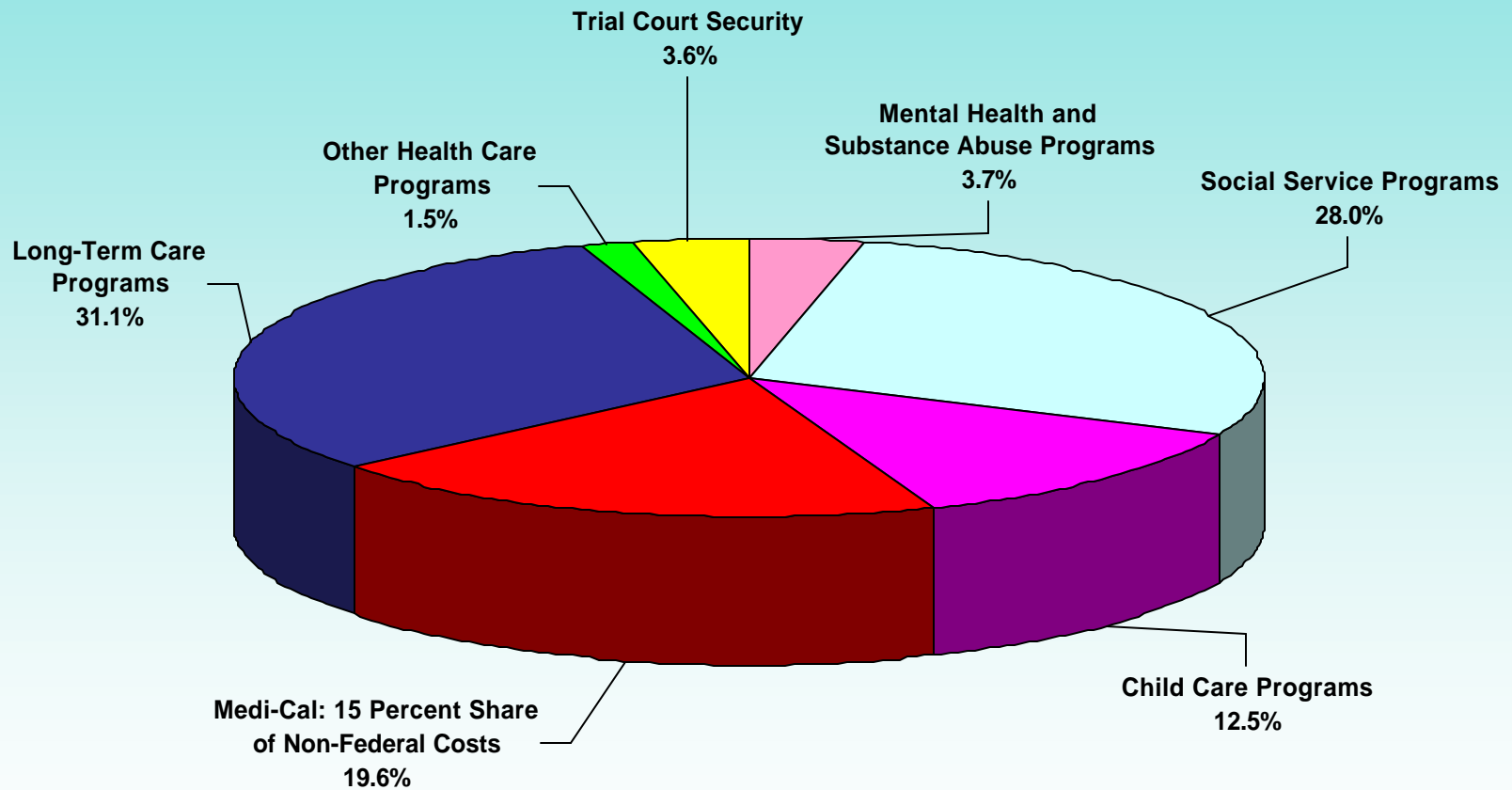
Budget Includes \$13.7 Billion in Spending Reductions

- ▶ The \$13.7 billion in proposed spending reductions include \$8.6 billion in reductions announced in December and \$5.0 billion in reductions in the Proposed Budget.
- ▶ Spending reductions over the two year period include \$2.3 billion in current year and \$2.2 billion in budget year reductions to K-12 Education; a \$919 million reduction in support for Community Colleges; \$1.3 billion in reductions in support for the University of California and State University systems; Medi-Cal cuts totaling \$1.6 billion; reducing SSI/SSP and CalWORKs grants by approximately 6 percent and suspending cost-of-living adjustments for SSI/SSP savings of \$1.1 billion and CalWORKs savings of \$500 million.
- ▶ The Governor proposes to end the policy of reimbursing cities and counties for revenues lost as a result of the 1998 reduction in the Vehicle License Fee (VLF) rate for savings of \$1.3 billion in 2002-03 and \$2.9 billion in 2003-04. Reimbursement would end on February 1, 2003 and would not apply to the share of VLF dedicated to programs transferred in the 1991 realignment of responsibility for mental health, social service, and health programs. The Budget would also shift \$500 million in redevelopment agency housing funds to the state and \$250 million in agency property taxes to schools.

Realigning Responsibilities

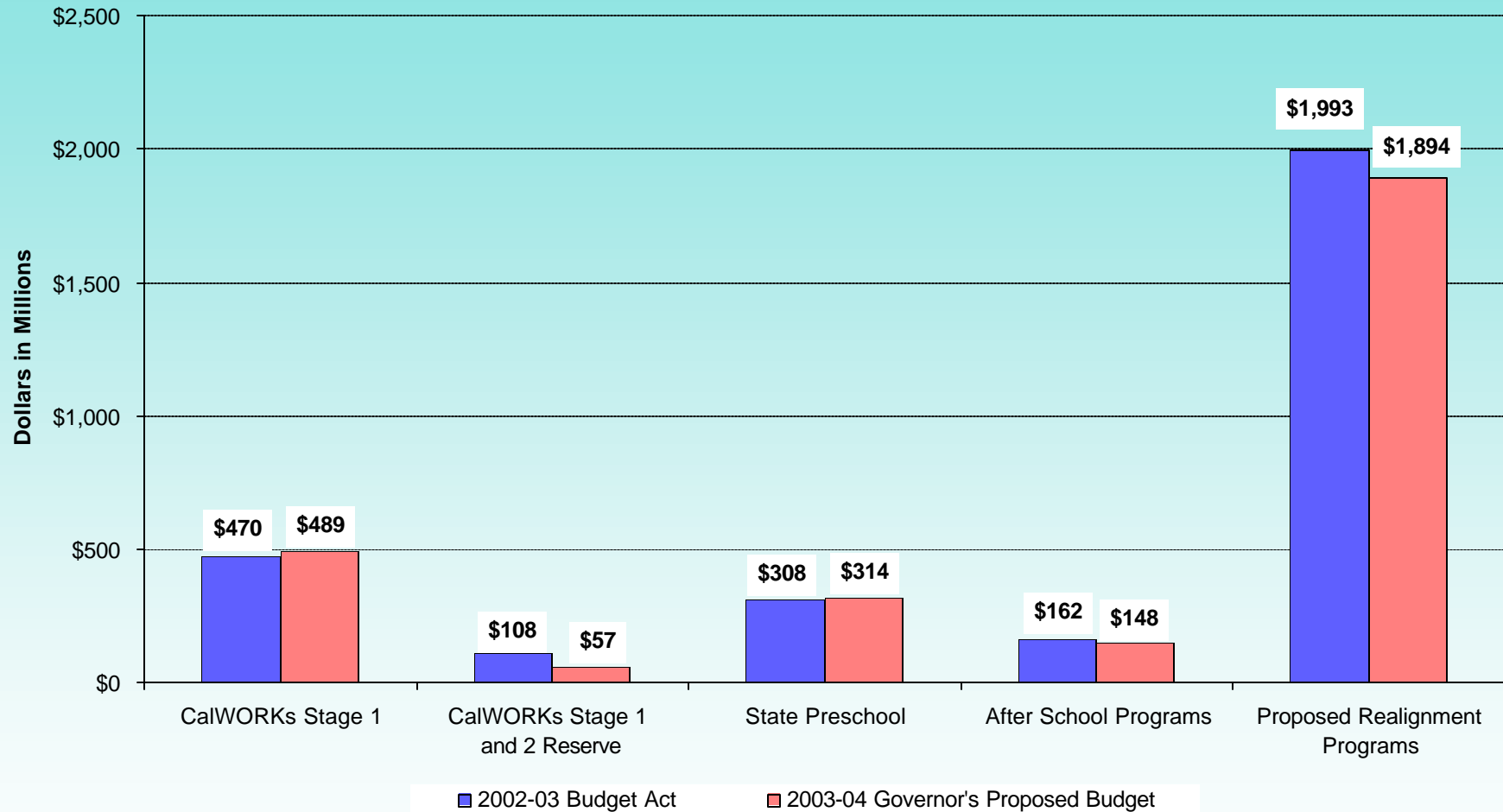
- ▶ The Governor proposes to transfer responsibility for \$8.2 billion in mental health, substance abuse, court, social service, child care, health, and long-term care services from the state to counties.
- ▶ The transfer would be funded with the proceeds of a one cent increase in the state's sales tax rate, reinstatement of the top personal income tax brackets on the wealthy, and a \$1.10 per pack increase in the cigarette tax rate.
- ▶ Proposed realignment revenues appear sufficient to fund the realigned programs in 2003-04.
- ▶ The proposal lacks many substantive details, including how much flexibility counties would have to alter service levels and eligibility standards, as well as how the state would ensure that program standards are met when responsibility is devolved to 58 individual counties.

Proposed Budget Shifts \$8.3 Billion in Health and Social Service Programs to Counties



Total Realignment Cost to Counties: \$8.273 Billion

Governor Proposes to Shift Majority of Child Care Programs to Counties



note: Includes General Fund, realignment, and federal funds. CalWORKs Stage 1 includes \$15 million for California Community Colleges CalWORKs child care. Programs within the proposed realignment include General Child Care, Alternative Payment Programs, CalWORKs Stage 2 and 3, Resource and Referral, Migrant Day Care, Extended Day Care, Campus Centers, Quality Plan, Handicap programs, Local Planning Councils, and a Cost-of-Living Adjustment.

Does the Proposed Realignment Make Sense?

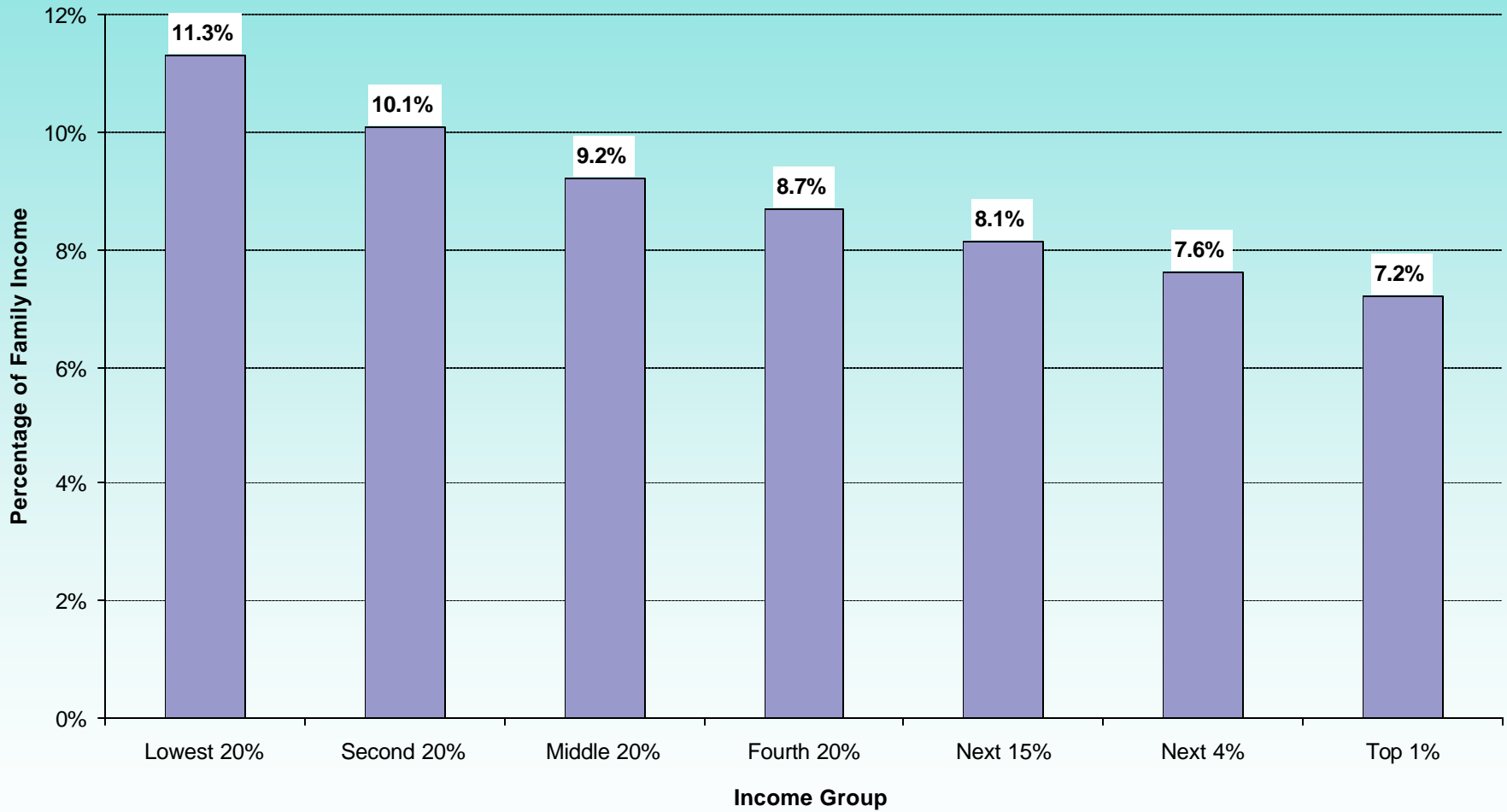
The Governor's state-local realignment proposal raises several questions:

- ▶ Will program costs grow faster than revenues? Medi-Cal and In-Home Supportive Services, major components of the proposed realignment, are two of the fastest growing areas of the budget, reflecting the increasing number of elderly and rising prescription drug costs.
- ▶ Will the proposed revenue source provide a sufficient stream of funding to support current and future program costs? Revenues from the increased personal income tax (PIT) are forecast to decline in 2004-05. Revenues from the PIT increase will be higher on a one-time basis in 2003-04 since they will include actual tax owed for 2003, in addition to withholding for 2004 liabilities.
- ▶ Will the proposal provide incentives for providing services efficiently, or will counties simply have an incentive to discourage enrollment and reduce service provision in important safety net programs?
- ▶ Does the proposal include the "right" mix of programs? Are the programs proposed for transfer the most appropriate candidates for flexibility at the local level, or is it more important to ensure that service levels are consistent across the state?

Who Pays Taxes in California?

- ▶ While high-income Californians pay the majority of the state's personal income tax, the poorest fifth of California non-elderly taxpayers pay the largest share of their incomes in state and local taxes.
- ▶ Sales and excise taxes account for the majority of taxes paid by the bottom 60 percent of non-elderly taxpayers, while income taxes account for the majority of taxes paid by the wealthiest 5 percent.
- ▶ High-income families benefit significantly from the fact that state income and property taxes are deductible for federal income tax purposes.
- ▶ Low- and middle-income families benefit from the state's high tax threshold – the point at which families become subject to the state's income tax. The 1997 increase in the dependent tax credit substantially increased the threshold for families with children.

Distribution of State and Local Tax Burden by Income Group 2002, Non-Elderly Taxpayers

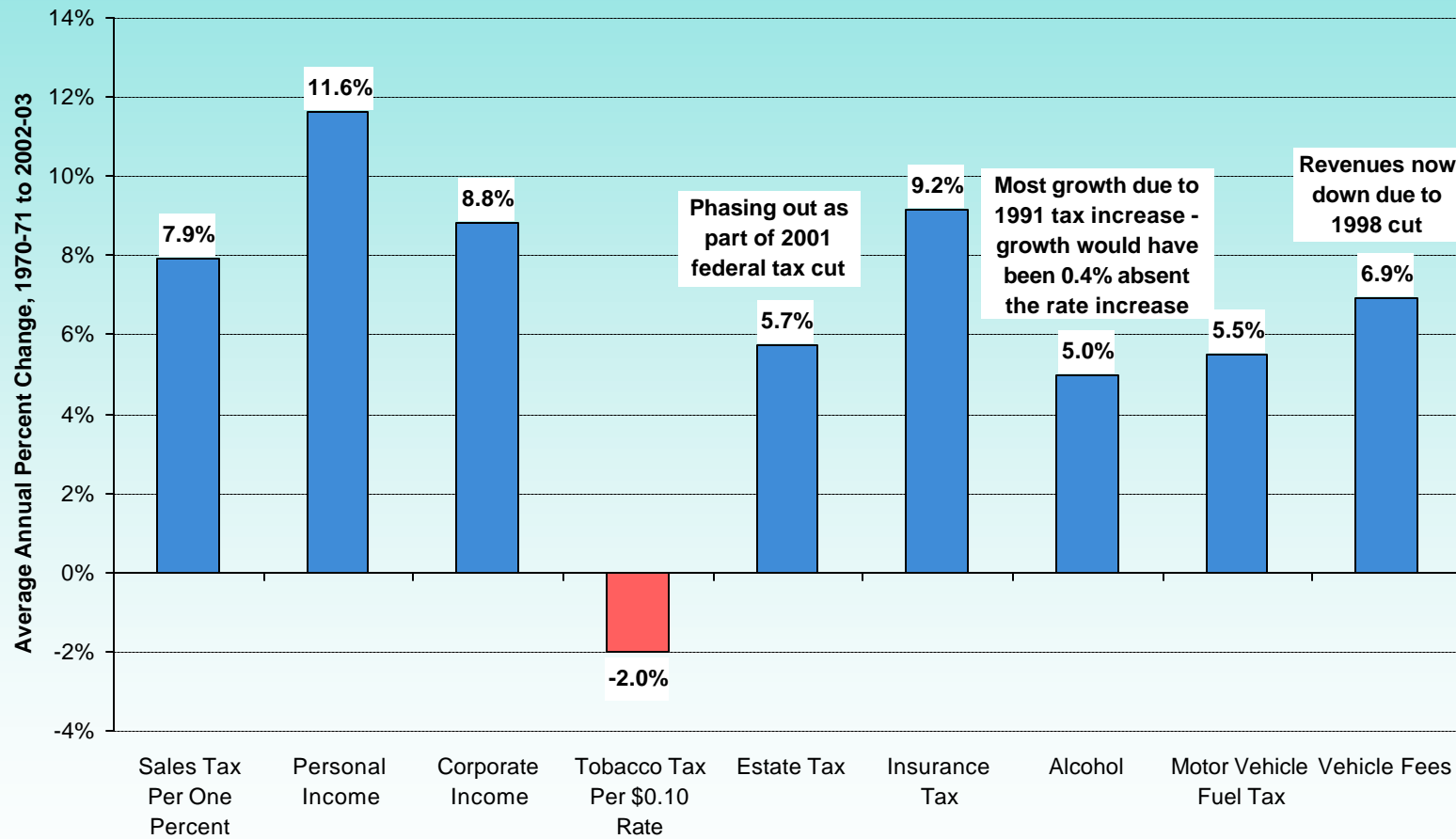


Note: Reflects offset for federal deductibility.

Is the Volatility of the Income Tax the Problem?

- ▶ While the sharp drop in tax collections attributable to stock options and capital gains is one of the primary causes of the decrease in the state's income taxes, over the long term personal income tax collections are near forecast levels.
- ▶ Most economists believe that the “bubble” of the late 1990s was unique and will not be repeated in the near future.
- ▶ Over the long-term, the income of the wealthiest 5 percent of personal income taxpayers has increased substantially more than that of the bottom 95 percent of taxpayers. The disparity in growth rates remains even when only incomes from wages and salaries are compared.
- ▶ Over the long term, the personal income tax continues to post the strongest growth of any of the state's major taxes.

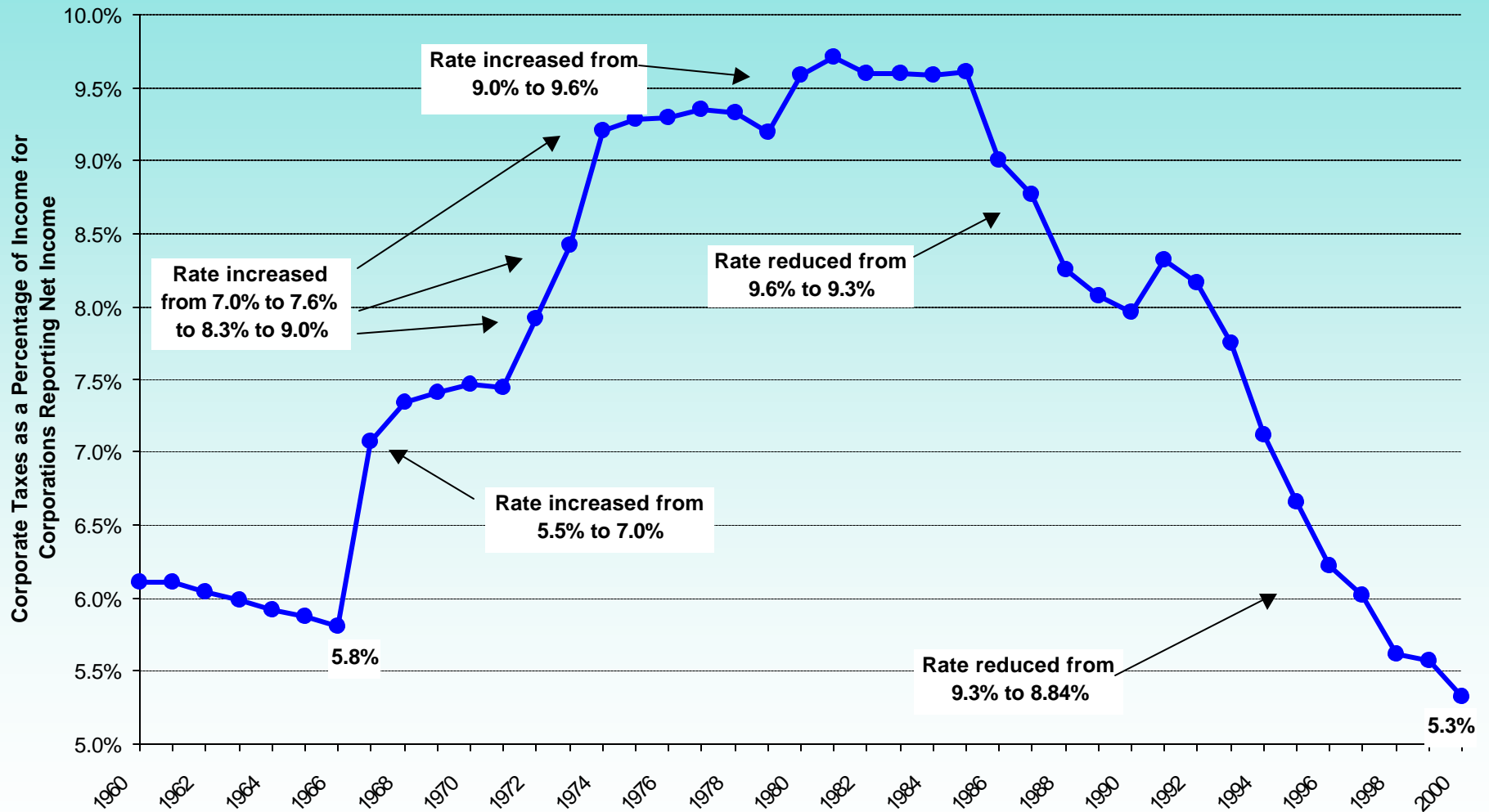
Over the Long Term, Personal Income Tax Posts the Strongest Growth



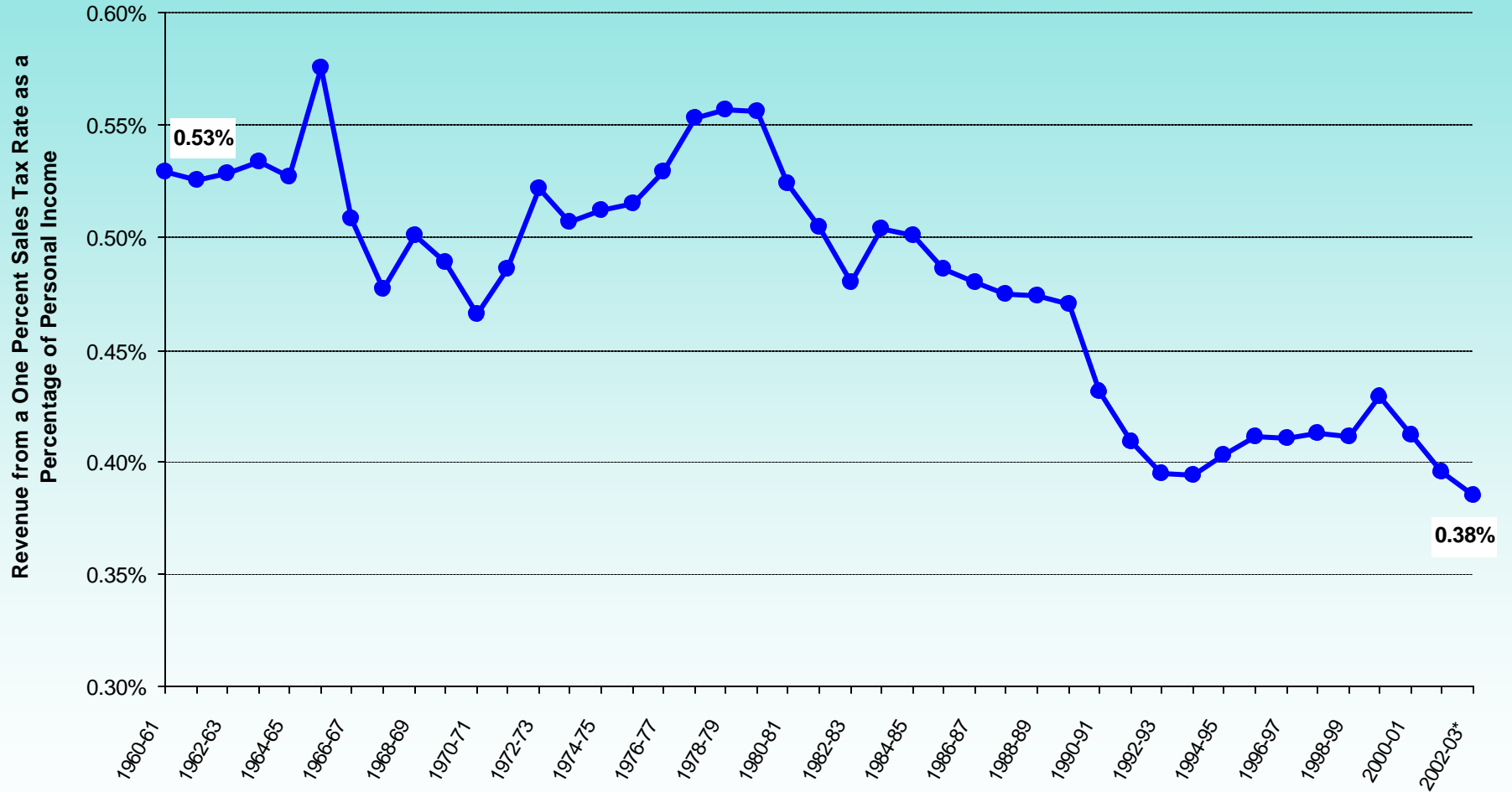
What About the State's Other Taxes?

- ▶ Corporate income taxes have fallen as a share of General Fund revenues in recent decades. Moreover, the share of net income of the state's profitable corporations paid in taxes fell by 45.2 percent between 1981 and 2000. This drop reflects growth in the number of corporate tax expenditures, the 1996 reduction in the corporate tax rate, and increasing sheltering of corporate income from taxation.
- ▶ State revenues from the estate tax have fallen from \$934.7 million in 2000-01 to a projected \$404.2 million in 2003-04. This drop reflects the phase out of the federal estate tax as part of the 2001 federal tax package. Historically, states have received a share of the federal tax. State proceeds will drop to zero in 2005.
- ▶ The sales tax performed strongly in 1999 and 2000, before declining modestly in 2001 and 2002. Alcohol and tobacco tax revenues remain stagnant due to declines in per capita consumption.

Share of Corporate Income Paid in Taxes Continues to Fall



Sales Tax Collections Have Declined as a Share of Personal Income



*2002-03 estimated.

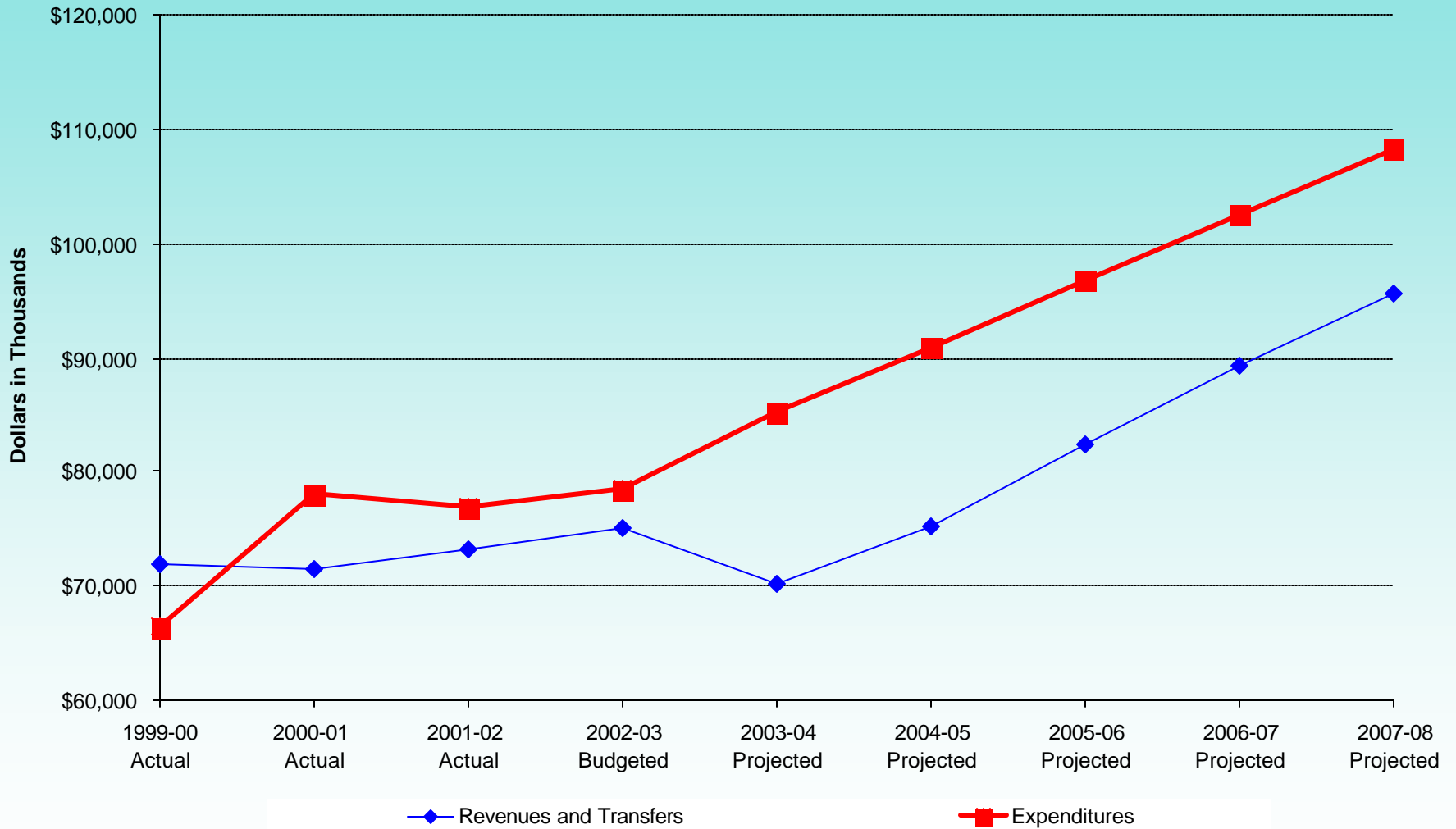
Note: Revenues are adjusted for differences in the sales tax rate.

How Does California Compare?			
(Revenues as a Percentage of Personal Income)			
	CA Rank^a	CA	US
Total State & Local Own Source (1999-00) ^b	18	16.27%	15.15%
Total State & Local Taxes (1999-00)	11	11.50%	10.58%
State Taxes (2000-01)	13	7.44%	6.24%
Local Taxes (1999-00)	32	3.47%	4.04%
State & Local General Sales Taxes (1999-00)	18	2.92%	2.61%
State & Local Property Tax (1999-00)	36	2.51%	3.02%
State General Sales Tax (2000-01)	27	2.08%	2.02%
State Motor Fuels Taxes (2000-01)	43	0.27%	0.35%
State Tobacco Tax (2000-01)	19	0.11%	0.10%
State Alcoholic Beverage Taxes (2000-01)	40	0.03%	0.05%
State Individual Income Tax (2000-01)	4	3.51%	2.25%
State Corporate Income Tax (2000-01)	5	0.59%	0.37%
^a All rankings exclude the District of Columbia.			
^b Total Own Source revenues, which exclude federal government transfers, is the broadest measure of state and local government revenues.			

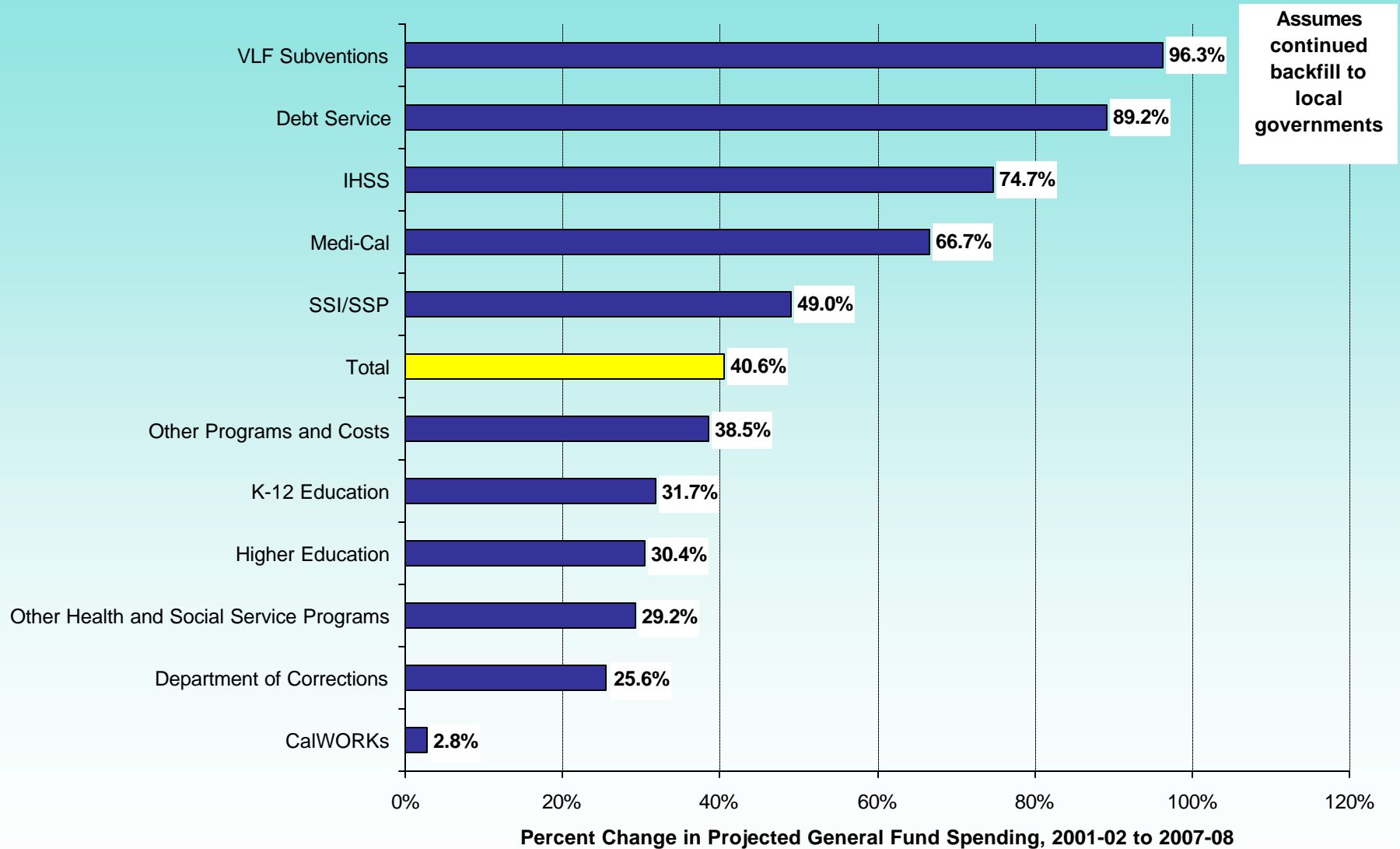
Deficits Projected for the Foreseeable Future

- ▶ In November, the LAO projected that the state would face operating deficits ranging from \$12.5 billion to \$15.8 billion between 2003-04 and 2007-08.
- ▶ Deficits would occur despite the fact that revenue growth is expected to outpace spending beginning in 2004-05.
- ▶ Revenue growth is unlikely to return to pre-recession levels due to changes in the accounting of stock options and the drop in the stock market, which will depress capital gains.
- ▶ Spending for IHSS, debt service, and the VLF backfill for local governments is expected to increase more rapidly than total spending between 2001-02 and 2007-08, while CalWORKs, K-12 Education, and Higher Education is expected to lag total spending.

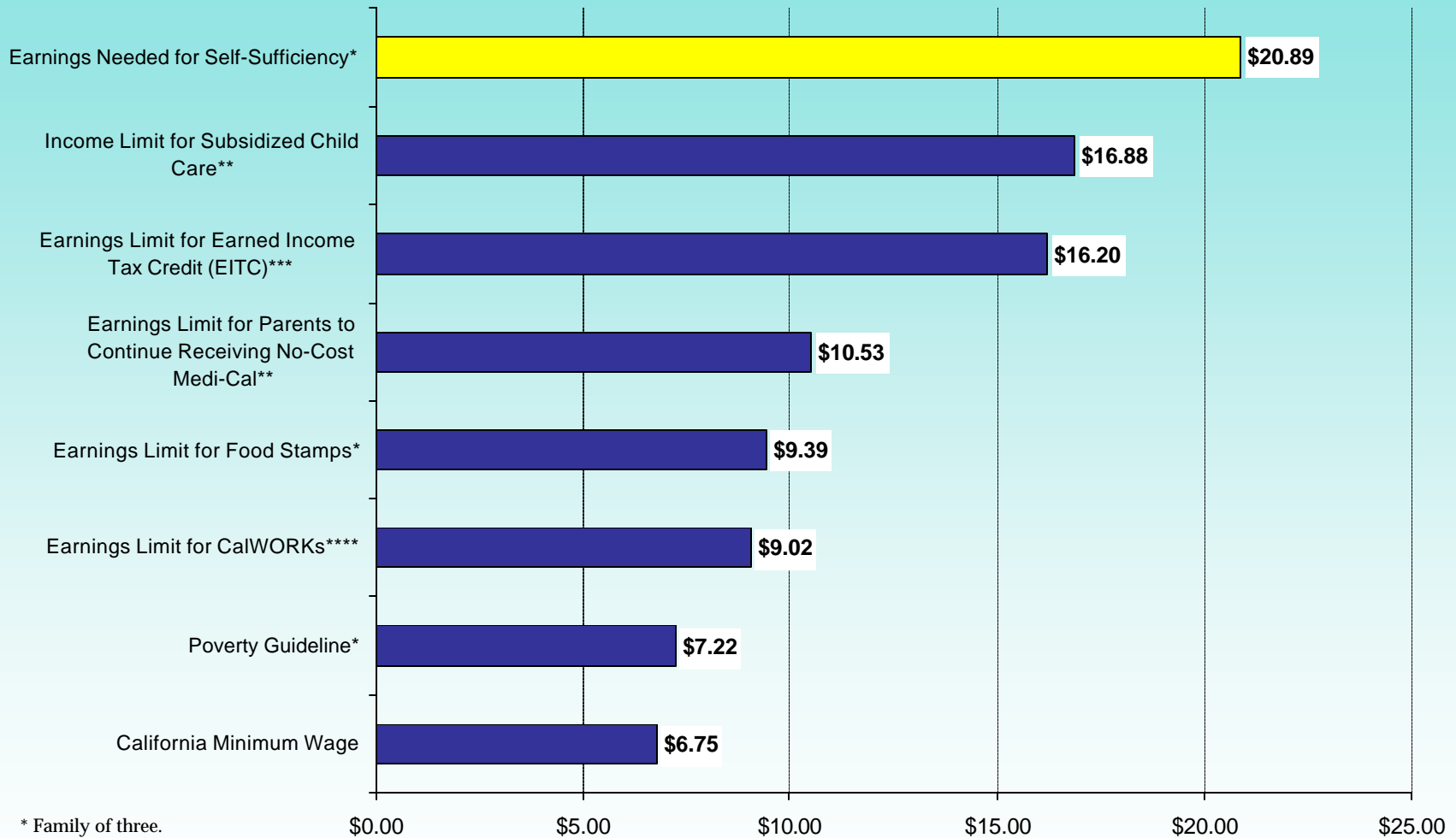
The State Faces Operating Deficits for the Foreseeable Future



Projected General Fund Spending Growth, 2001-02 to 2007-08



Supports for Working Families End Before Families Reach Self-Sufficiency



* Family of three.

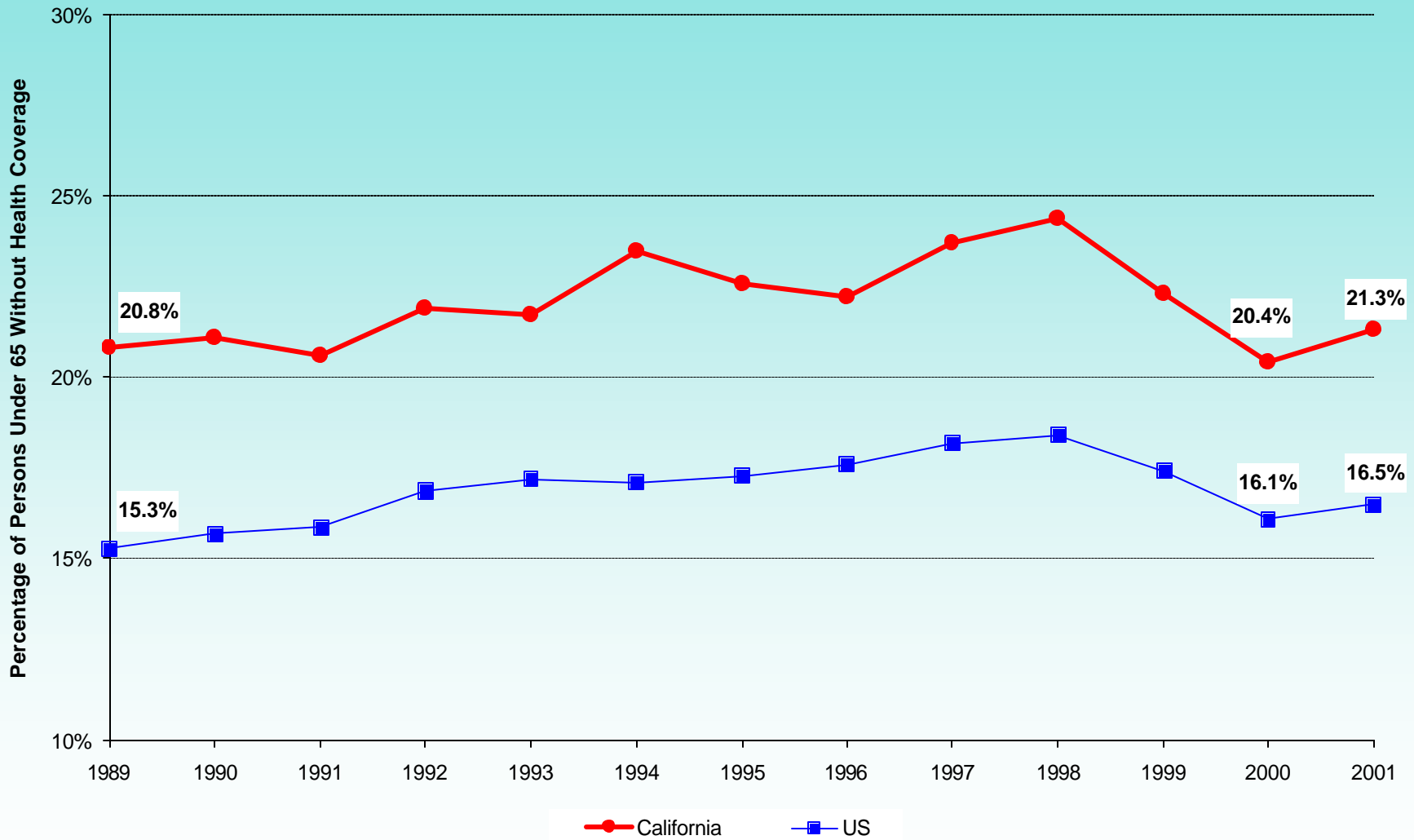
** Family of three, current law.

*** One-parent family with two or more children.

**** CalWORKs grant level until June 2003 for a family of three in Region 1.

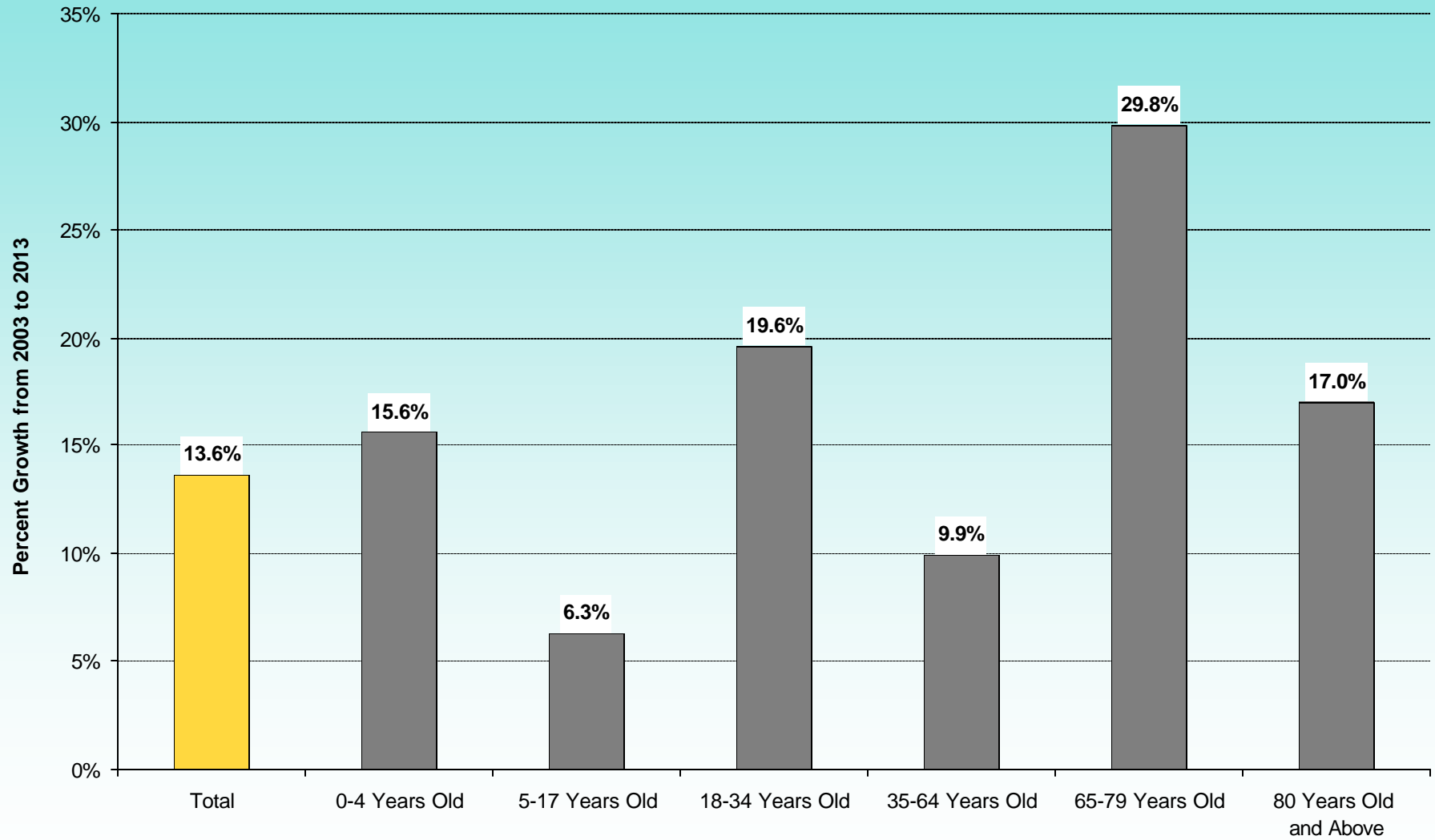
Hourly Wage or Equivalent
(Assumes 40 hours of work per week, 52 weeks per year)

More Non-Elderly Californians Continue to Lack Health Coverage Than in the US Overall



Note: Changes in survey methodology led to lower estimates of the number of uninsured persons beginning in 2000.

California's Aging Population Will Create New Demands on the Budget



Is the Budget Process Broken?

- ▶ Governor Davis has said, “Reforms to California’s current fiscal structure must be an integral part of resolving the 2003-04 Budget.”
- ▶ Among potential reforms identified by the Governor are:
 - Creating a budget reserve;
 - Requiring sunset review of all “automatic” spending laws;
 - Giving the Governor unilateral power to make mid-year reductions;
 - Requiring sunset review of all tax breaks;
 - “Rebalancing” state and local revenues to provide greater stability and to encourage “rational growth” at the local level; and
 - Restoring local control of programs and revenue raising.
- ▶ More fundamental reform would address the two-thirds vote requirement for approval of a budget and tax increases. California is one of just three states to require a two-thirds vote for approval of the budget and one of eleven (and the only large state) to require a two-thirds vote for any tax increase.