CALIFORNIA BUDGET PROJECT

BUDGET WATCH

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CAN THE BUDGET BE BALANCED WITHOUT A TAX INCREASE?

The Governor's May Revision scales back the realignment of state services to counties proposed in January (and the accompanying tax increase), assumes that Vehicle License Fees (VLF) will increase, and proposes to borrow $10.7 billion that would be repaid through a temporary half-cent sales tax increase. The budget plans adopted by the Senate and Assembly Budget Committees assume the same tax increases as the Governor's May Revision, but differ on a number of spending proposals. In contrast, the Senate and Assembly Republican Caucuses have outlined spending plans that reject any tax increases, embrace a multi-year rollover of the 2002-03 deficit, accept most of the reductions proposed by the Governor, and rely on across-the-board spending reductions to close the remaining gap. (See *The 2003-04 Budget Gap: Where Are We After the May Revision?* at www.cbp.org for details on the Republican plans and the Governor's May Revision.)

At the heart of the budget debate is a disagreement over whether the state's unprecedented budget gap can or should be balanced without additional revenues, as well as disagreement over the cause of the current crisis.

Can the State "Grow Its Way Out" of the Deficit?

California faces a structural budget deficit. A structural deficit exists when, even during good economic times, the revenues produced by the state's tax system fail to provide sufficient funds to pay for current levels of public services. The Department of Finance estimates that the state would face a deficit of $7.9 billion in 2004-05 if the Governor's May Revision proposals were enacted in full. The Legislative Analyst, based on slightly more optimistic revenue forecasts, estimates that the May Revision, if enacted completely, would result in a deficit of approximately $6.7 billion in 2004-05, which increases in subsequent years.

Forecasts predict continuing deficits despite the fact that between 2005-06 and 2007-08 revenues are anticipated to increase more rapidly than expenditures. If the tax increases proposed in the May Revision are not enacted, revenue growth would have to increase at a substantially higher rate than currently projected in order for the state to outgrow the deficit. Simply put, the current gap is so large that economic growth alone is insufficient to bring the budget into balance for the foreseeable future.

Moreover, current estimates of the structural deficit leave no room for future spending increases or tax cuts and assume that all of the Governor's proposed spending reductions and revenue increases are enacted. Many of the spending cuts contained in the May Revision, such as the 15 percent cut in reimbursement rates for Medi-Cal providers, have been strongly criticized by lawmakers of both parties. Similarly, the targeted $680 million in revenues from tribal gaming activities may be difficult to achieve.

Why Can't the Rollover Be Repaid Out of Existing Resources?

Repaying bonds issued to finance the deficit out of existing resources would require deeper cuts and/or tax increases in the future. For example, the Assembly Republican Caucus plan for bridg-

ing the budget gap relies on debt that would be repaid out of existing resources. The Legislative Analyst estimates that the Assembly Republican plan would leave the state facing a deficit of $10.3 billion in 2004-05, requiring $12.6 billion in 2004-05 spending reductions to reach the plan's targeted reserve level of $2.4 billion. The required reductions translate into 15 percent of 2004-05 spending and, if applied proportionally, "would translate into a savings of $4 billion in Proposition 98, $1.8 billion in Medi-Cal, and $775 million in the Department of Corrections" on top of cuts enacted in 2003-04.

Won't a Tax Increase Hinder an Economic Recovery?

In many instances, spending reductions may be even more harmful to the economy. A recent report co-authored by Nobel Prize winning economist Joseph Stiglitz argued that, "economic analysis suggests that tax increases would *not* in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be *smaller* than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption. For example, if taxes increase by $1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is attenuated in the short run. Some types of spending reductions, however, would reduce demand in the economy on a dollar-for-dollar basis and therefore would be *more* harmful to the economy than a tax increase."

Fourteen of the state's leading economists have argued, "it is totally unrealistic to pretend that spending cuts alone can solve the problem" and that, "Because of the size of its budget gap and the lack of flexibility to run deficits, California must face up to the need for immediate and substantial budget cuts and tax increases and act now. Delay in taking these actions will make the eventual policies even more severe and, by jeopardizing the state's creditworthiness, could exacerbate their impact on the state's economy."

DID CALIFORNIA SPEND ITS WAY INTO THE CURRENT FISCAL CRISIS?

Many analysts have attributed the unprecedented budget gap – estimated by the Governor at $38.2 billion – to out-of-control spending during the late 1990s. However, a closer examination of the data indicates that spending since 1989-90 grew more slowly than in previous decades. In fact, much of the spending growth that occurred in the late 1990s represented a restoration of cuts made during the budget crisis of the early 1990s.

Recent State Spending Has Grown Slower than Historical Rates

General Fund spending per resident increased by an annual average rate of 1.0 percent between 1989-90 and 2002-03, after adjusting for inflation (Figure 1). Per capita spending was $2,211 in 2002-03, as compared to $1,950 in 1989-90 (in 2002-03 dollars). State spending peaked in 1989-90, corresponding to the last economic peak prior to 2001, before falling during the recession of the early 1990s. Per capita spending reached its next peak of $2,425 in 2000-01, before falling in both 2001-02 and 2002-03.

Spending grew much faster in prior decades. Per capita General Fund spending since 1959-60 has increased at an annual rate of 6.1 percent, six times the rate since 1989-90. Per capita spending increased at an annual rate of 8.8 percent between 1959-60 and 1969-70 and 6.8 percent between 1969-70 and 1979-80. Spending remained essentially flat between 1979-80 and 1989-90.

Where Has Spending Grown Since 1989-90?

Four areas of the budget account for the entirety of the increase in General Fund spending since 1989-90 after adjusting for inflation and population growth: K-12 education, health and human services, corrections, and tax relief (included as

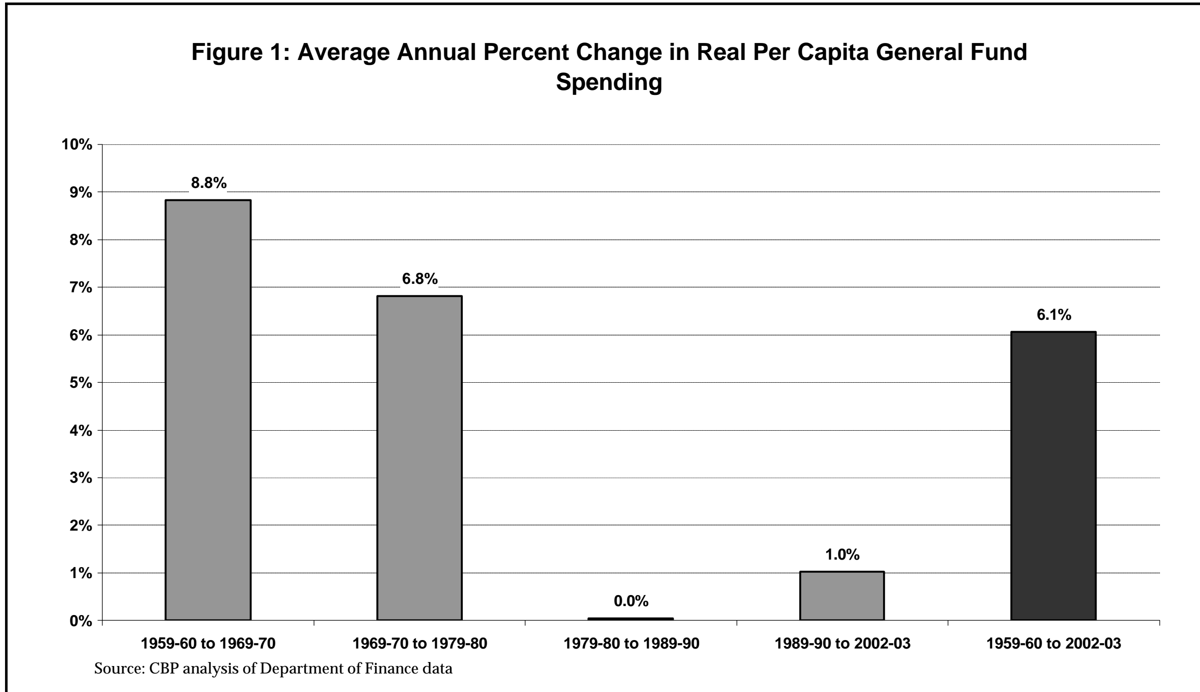

Figure 1: Average Annual Percent Change in Real Per Capita General Fund Spending

Source: CBP analysis of Department of Finance data

expenditures in General Government) (Figure 2). Spending in other major areas of the budget remained flat or declined (Figure 3).

K-12 Education accounts for the largest portion (42.7 percent) of increased spending between 1989-90 and 2002-03. K-12 spending has increased due to the student population growing faster than the population as a whole, as well as policy changes, such as class size reduction. Spending in K-12 schools and community colleges is largely driven by a constitutional guarantee enacted by Proposition 98 of 1988.

Health care expansions and the growing elderly population drove up health and human services

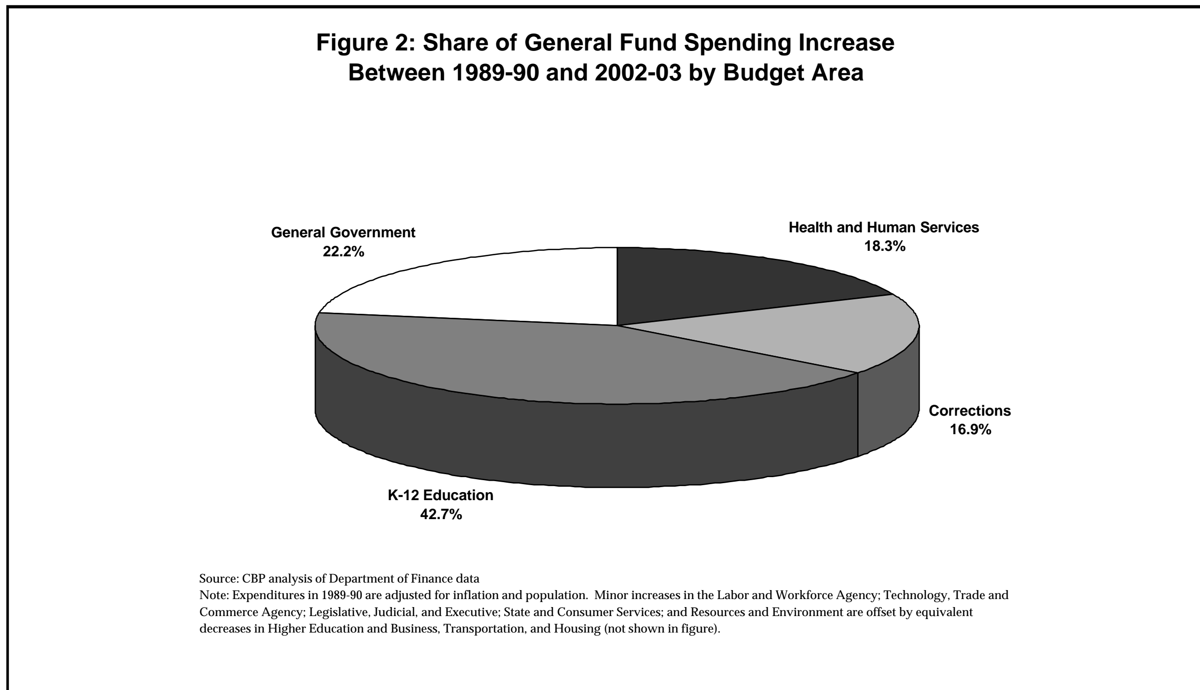

Figure 2: Share of General Fund Spending Increase Between 1989-90 and 2002-03 by Budget Area

Source: CBP analysis of Department of Finance data
Note: Expenditures in 1989-90 are adjusted for inflation and population. Minor increases in the Labor and Workforce Agency; Technology, Trade and Commerce Agency; Legislative, Judicial, and Executive; State and Consumer Services; and Resources and Environment are offset by equivalent decreases in Higher Education and Business, Transportation, and Housing (not shown in figure).

spending (18.3 percent of total spending growth). California's efforts to cover uninsured children through the Healthy Families Program and expansions in Medi-Cal eligibility, coupled with rising health care costs, increased health spending. The aging of the population also increased

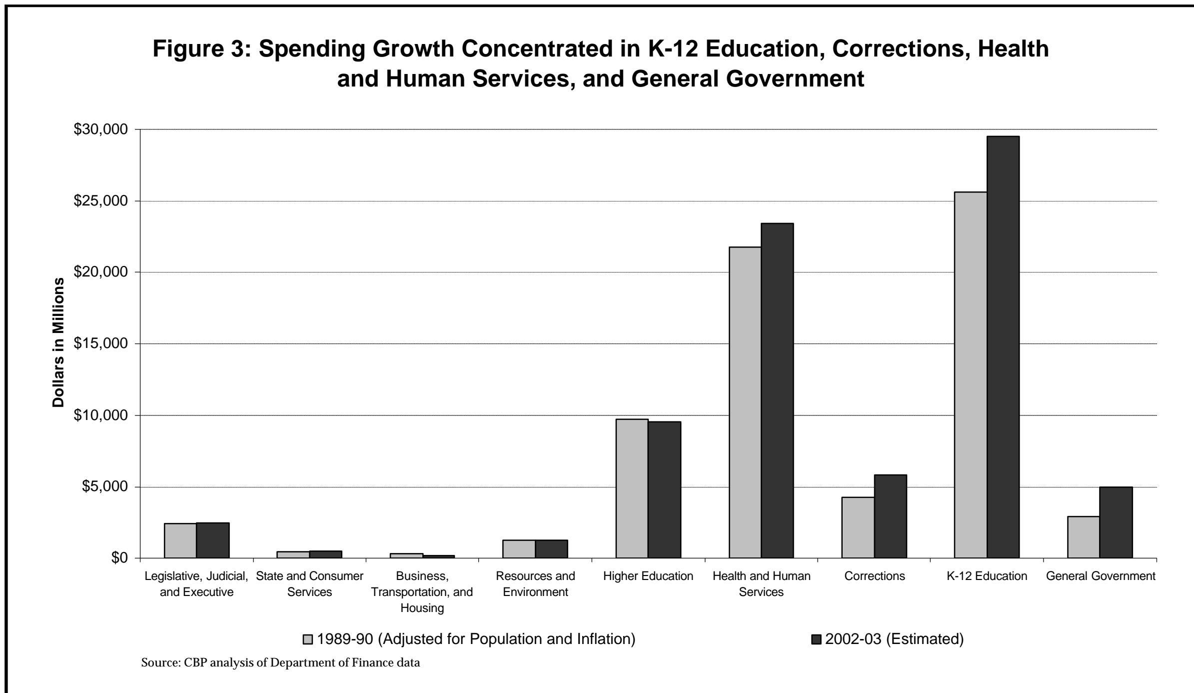

Figure 3: Spending Growth Concentrated in K-12 Education, Corrections, Health and Human Services, and General Government

Source: CBP analysis of Department of Finance data

spending for In-Home Supportive Services, which provides in-home assistance for low-income aged and disabled Californians, and Supplemental Security Income/State Supplementary Payment cash grants.

General Government spending accounts for 22.2 percent of increased expenditures. This increase is due to tax reductions in the 1990s that are included as expenditures in this category (which also includes several small departments). When the state lowered the VLF, it "backfilled" lost revenues to local governments (VLF revenues flow to local governments). The state spent $3.9 billion to reimburse local governments for VLF losses in 2002-03, but had no such costs in 1989-90, which was prior to the rate reduction. Discounting VLF backfill costs, General Government spending declined between 1989-90 and 2002-03.

Corrections accounts for 16.9 percent of increased spending, reflecting growth in California's prison population. The Youth and Adult Corrections Agency is one component of "state operations," often referred to as state bureaucracy.

FEDERAL TAX CUTS SLANTED TOWARD THE WEALTHY

On May 28th, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (HR 2) into law declaring, "that we can say loud and clear to the American people, you got more of your own money to spend so that this economy can get a good wind behind it." Upon closer review, this latest package of tax cuts – with a $350 billion 10-year price tag – does not give *all* of the American people more money to spend and is unlikely to provide an effective stimulus to the economy.

The Devil Is in the Details

While President Bush has touted the benefits that his tax package will provide to all taxpayers, an estimated 49 percent of all taxpayers nationwide and in California will receive less than $100 from

the cuts in 2003, and 55.8 percent of the tax cuts over the next four years will go to the top 5 percent of California taxpayers. In addition, the Urban Institute-Brookings Institution Tax Policy Center estimates that 8.1 million lower- and middle-income taxpayers, including 5.6 million who pay more than $250 in income tax, will receive no tax reduction under HR 2.

HR 2 accelerates many of the cuts included in the 2001 tax package, changes depreciation and expensing provisions for businesses, reduces taxes on investment income, modifies the corporate tax, and provides fiscal relief to states. Specifically, HR 2:

- Accelerates the reductions to individual income tax rates, scheduled to occur in 2004 and 2006; the expansion of the child credit from $600 to $1,000 per child; the increase in the taxable income level of the 10 percent tax bracket; and the elimination of the "marriage penalty" by increasing the standard deduction and the 15 percent tax bracket for married taxpayers filing jointly;
- Increases the standard exemption amount for the Alternative Minimum Tax (AMT) by $4,500 for single taxpayers and by $9,000 for joint filers for 2003 and 2004;
- Increases "bonus" depreciation to 50 percent through 2004;
- Reduces the tax rates on income from capital gains and dividends from 10 and 20 percent to 5 and 15 percent through 2007, and to zero and 15 percent for 2008;
- Allows 25 percent of 2003 estimated corporate tax payments to be made in 2004; and
- Provides $20 billion in fiscal relief to the states.

Several Republican and Democratic senators indicated that they would not support a tax package that had a 10-year cost over $350 billion. In order to keep the cost of the tax package within this limit, many of HR 2's provisions are scheduled to sunset within two to five years. The cuts that provide the majority of the middle- and low-income taxpayer benefits, such as marriage penalty relief and the increase in the child credit, are scheduled to revert to current law in 2005. In contrast, those cuts benefiting primarily higher-income taxpayers, such as the dividends and capital gains rate reductions, are not scheduled to sunset until December 31, 2008.

The Bait and Switch

While HR 2 provides some limited tax relief to low- and middle-income taxpayers, a last minute change in the final bill eliminated benefits for an estimated 6.5 million very low-income families. The Senate version of the tax bill accelerated the expansion of the refundability of the child credit to 2003. The 2001 tax package allowed families with little or no federal income tax liability to claim a refundable child credit equal to 10 percent of their income above $10,000 up to the maximum credit per child, which increased from $600 to $1,000 with the passage of HR 2. (The $10,000 income threshold is indexed for inflation and is $10,500 in 2003.)

Estimated Budget Effects of HR 2 (In Millions)

Provision	Cost FY 2003-2013	Percentage of Total Cost FY 2003-2013
Expand Child Credit	-$32,488	9.3%
Marriage Penalty Relief	-$35,074	10.0%
Expansion of 10% Bracket	-$11,906	3.4%
Acceleration of Rate Schedule	-$74,185	21.2%
Increase in AMT Exemption	-$17,782	5.1%
Increase in Bonus Depreciation	-$9,194	2.6%
Expand Business Investment Expensing	-$952	0.3%
Dividends and Capital Gains Reductions	-$148,086	42.4%
State Fiscal Relief	-$20,000	5.7%
Total	**-$349,667**	**100.0%**

Source: Joint Committee on Taxation

Many low-income families would receive no benefits from the increase in the child credit in HR 2 without an acceleration of the refundable child credit expansion. This is because the current refundable credit is limited to 10 percent of income that exceeds the $10,500 threshold. For many families, 10 percent of their income over the threshold is already below the per child credit. For example, a family of four with an income of $20,000 and no federal income tax liability would receive a child credit refund of $950, or $475 per child in 2003. This family's refund is already below the current law maximum credit of $600 per child, so increasing the level of the child credit to $1,000 per child provides them with no benefit.

High Income Californians Are the Big Winners from the Bush Tax Cuts			
Income Group	Average 2003 Income	Average Tax Cut Over Four Years (2003 - 2006)	Percentage of Tax Cut Received by California Taxpayers
Lowest 20%	$11,300	-$60	0.4%
Second 20%	$24,200	-$293	1.8%
Middle 20%	$39,200	-$792	4.9%
Fourth 20%	$62,900	-$1,946	12.1%
Next 15%	$112,000	-$5,393	25.1%
Next 4%	$240,000	-$11,243	13.9%
Top 1%	$1,334,000	-$130,401	41.9%
Total	**$67,000**	**-$3,196**	**100.0%**

Source: Citizens for Tax Justice

The final bill dropped the provision to accelerate the refundable child credit expansion, eliminating benefits for 11.9 million children nationwide. Citizens for Tax Justice estimates that increasing the child credit refundability percentage from 10 percent to 15 percent would help 1.7 million children in California.

In the face of intense public scrutiny, both houses of Congress have passed bills restoring the provision, albeit with considerable differences that will need to be resolved in a conference committee. Both the Senate and House bills would accelerate the increase in the child credit refundability provision for low-income families and would expand the number of high-income families eligible for the credit. However, the Senate bill would allow for refund checks to be sent to eligible low-income families in 2003, while the House bill would not require that refunds be sent until 2004. In addition, the House bill increases the income level at which the child credit begins to phase out from $110,000 to $150,000 retroactive to January 1, 2003, while the Senate increase would not occur until 2008. The Senate bill would expand eligibility for the child credit to members of the military by allowing combat pay to be included in earned income for purposes of the credit. The House bill does not include this provision. The House bill also differs from the Senate by extending the increase in the child credit beyond 2004 to 2010, excluding any capital gains on the sale of principal residences by members of the military, and excluding various benefits received by members of the military from income for tax purposes.

The Senate bill would cost $9.8 billion over 10 years and would be paid for with an extension of customs user fees. In contrast, the House bill has a 10-year cost of $82.0 billion and does not include provisions to offset the cost.

SHOULD CALIFORNIA MODIFY THE STATE APPROPRIATIONS LIMIT?

Some have suggested that a spending cap should be part of the 2003-04 budget agreement. In fact, California has had a spending limit since 1979 that does exactly what cap proponents want – limit the growth in state spending to population growth and inflation. While several spending limit measures have been introduced this year, none are currently moving through the legislative

process. The following examines the state's current cap and the implications of some commonly discussed proposals to change it.

California Already Has a Spending Cap

California has a spending cap that limits appropriations from the proceeds of taxes. The state has exceeded the State Appropriations Limit twice: in 1986-87 and 1999-00. Moreover, other features of the state constitution constrain spending and revenue growth, such as the two-thirds vote requirement for passage of a budget, the two-thirds vote requirement for spending other than for education, and the two-thirds vote requirement for measures that increase tax revenues.

The Current Limit Is Designed to Limit the Share of the Economy Paid in Taxes

The current inflation factor (per capita personal income growth) mirrors the resources from which Californians pay their taxes. This provision prevents taxes from rising as a share of income over time. The current limit's population factors reflect the growth in enrollment for the portion of the budget dedicated to programs covered by the Proposition 98 spending guarantee, and the growth in population for the remainder of the budget.

What Would Happen If the State Adopted a Limit Based on the CPI?

The Consumer Price Index (CPI) is designed to track changes in the market basket of goods purchased by households, not expenditures made by governments. Over the past year, for example, the CPI-U for the nation increased by 2.2 percent, while the health care component of the CPI increased by 4.0 percent. Consumers spend, on average, 4.6 percent of their income on health care. In contrast, 15.0 percent of estimated 2002-03 state General Fund expenditures were for health care. The state would have exceeded its spending limit consistently since 1983-84 had ACA 6, which creates a new cap based on CPI, been enacted beginning in 1979-80. If ACA 6 had been enacted in 1979, the cap would have been $12.7 billion below actual 1991-92 spending during the depth of the budget crisis of the early 1990s, and $40.1 billion below estimated 2002-03 spending.

A Limit Based on CPI Is Incompatible with the Proposition 98 Guarantee

Under normal ("Test 2") conditions, the inflation factor for the Proposition 98 guarantee is per capita personal income. Between 1979 and 2001, California per capita personal income increased at an average of 5.5 percent per year, while the California CPI increased by an average of 4.7 percent per year. Switching to a spending cap based on CPI would create a disparity between the inflation factor used for the spending and that used for Proposition 98. Over time, this disparity would steadily reduce the share of the budget available for programs outside the Proposition 98 guarantee and spending for K – 14 education would account for a steadily increasing share of the budget.

Eliminating the Current Exclusions Will Create a Disincentive to Invest in Infrastructure

The current spending cap excludes appropriations for debt service, capital outlay, costs related to federal and court-ordered mandates, and expenditures from specified voter-approved revenues from the limit. Eliminating the exclusions would create competition for scarce resources between programmatic spending and infrastructure spending. Eliminating the exclusion for court and federal mandates could require significant reductions in priorities established by the Legislature in order to accommodate mandated expenditures within the cap.

Is a New Spending Cap the Only Way to Create a Budget Reserve?

While only 16 states (including California) have a constitutional spending cap, 47 states (including California) have some sort of reserve. Many states place limits on the expenditure of funds

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from a reserve so that they are available for truly "rainy days." California could establish a mandatory reserve without modifying the current spending cap.

What Would Be the Impact of "Rebenching" the Current Spending Cap?

Some proposals would establish a new base year for a spending cap. Establishing a new base year during the middle of a budget crisis would make it impossible for the state to repay the loans, deferrals, and other obligations contained in last year's budget agreement and proposed as part of this year's budget, as well as other constitutional obligations for education and debt service without deep reductions in spending that is not protected by the state constitution, federal mandates, or other requirements. For example, the proposed shift in the accounting treatment of Medi-Cal expenditures reduces spending by $930 million in the budget year. However, while reducing the state's obligations in the budget year, this effort does not change the total amount the state spends on health services – it simply changes the year in which services are paid for. The cost of Medi-Cal will go back to "normal" levels in 2004-05. Similarly, the state must repay special funds for amounts borrowed and make payments on pension obligation debt, in addition to the normal year-to-year increases in program costs and growth in school spending mandated by Proposition 98.

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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