CALIFORNIA BUDGET PROJECT

BUDGET WATCH

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GOVERNOR PROPOSES DEEP CUTS, BORROWING IN 2004-05 BUDGET

California faces a budget gap of $17 billion. The Legislative Analyst estimates that approximately $15 billion of this amount is structural – an ongoing gap between current service levels and revenues – with the remaining $2 billion attributable to a shortfall in the 2003-04 Budget. The Governor's Proposed 2004-05 Budget, released in January, outlines a plan for bridging a gap of approximately $16 billion. The Governor's plan, if enacted in full, would leave the state facing a deficit of approximately $7 billion in 2005-06 according to the Legislative Analyst. (The disparity between the Legislative Analyst's estimate of the shortfall and that of the Governor stems from differences in assumptions regarding anticipated revenues and expenditures needed to implement the Administration's budget plan, as well as the loss of 2003-04 savings proposed by the Governor, but not approved by the Legislature.)

The Governor's Proposed Budget assumes the passage of Propositions 57 and 58, which would authorize the state to issue up to $15 billion in "Economic Recovery" bonds to finance the accumulated deficit, on the March 2 ballot. If either of these measures fails (both must pass for either to take effect) the gap would widen by $5 billion assuming the sale of the original $10.7 billion in bonds authorized by the 2003-04 budget agreement. However, these bonds are subject to legal challenge. If either Proposition 57 or 58 fails and the original bonds are ruled unconstitutional, the budget gap would widen by approximately $11 billion.

How Does the Governor Propose to Bridge the Gap?

The Governor proposes to bridge the gap using a combination of spending reductions, borrowing, and cost shifts. Components of the Proposed 2004-05 Budget include:

- $7.3 billion in program reductions and savings, including deep cuts to K – 12 Education ($2.0 billion), Medi-Cal ($1.1 billion), Higher Education ($886 million), and Transportation ($950 million). Other programs slated for significant reductions include CalWORKs, In-Home Supportive Services (IHSS), and child care programs.
- $1.6 billion in proceeds from the economic recovery bonds, representing the difference between the $10.7 billion in bonds assumed in the 2003-04 Budget and the $12.3 billion in net economic recovery bond proceeds assumed by the Governor's Proposed Budget.
- $1.3 billion in reduced debt service on the economic recovery bonds. The savings come from the fact that the state would make smaller annual debt service payments, but pay over a longer period of time. A one-half cent sales tax rate would repay the $10.7 billion bond included in the 2003-04 budget agreement over five years. A one-quarter cent sales tax rate would repay the bonds authorized by Proposition 57 over nine to 15 years.
- $2.6 billion in other loans and borrowing, including $930 million in pension obligation bonds, $947 million from deferring Proposition 98 "settle up" payments, a $475 million increase in the amount of the 2003-04 Vehicle License Fee (VLF) backfill payment loan, and loans from transportation funds.
- $1.8 billion in cost shifts to local governments, the largest of which is a $1.3 billion property tax shift from cities, counties, and special districts to schools, which reduces the state's

school funding obligation. Other components include eliminating the CalWORKs allocation to juvenile probation programs, reducing transportation funds, eliminating reimbursements for booking fees, and other cost shifts.
- $1.6 billion in transfers and other revenues, including $350 million in assumed new federal funds.

Proposed spending reductions would affect nearly every area of the budget. An analysis by program area shows that the largest share of the "solutions" to the budget gap would come from Health and Human Service Programs ($3.1 billion); K – 14 Education ($3.0 billion); savings related to the economic recovery bonds ($2.8 billion); Business, Transportation, and Housing ($1.9 billion); and the shift of property taxes from local governments ($1.3 billion). The budget proposes the largest cuts in percentage terms in the CalWORKs program, K – 12 Education, IHSS, and Environmental Protection (Table 1).

In many programs, the magnitude of the proposed cuts would be substantial. Proposed reductions in K – 12 Education spending, for example, translate into a $175 reduction in per pupil Proposition 98 spending between 2003-04 and 2004-05, after adjusting for inflation. Implementation of this reduction would require suspension of the Proposition 98 guarantee, which requires a two-thirds vote of the Legislature in a bill that makes no other changes. In Higher Education, the budget would reduce 2004-05 enrollment in the University of California and California State University systems by a total of 7,000 students relative to 2003-04 levels, would boost student fees, and would not increase financial aid awards to make up for higher fees.

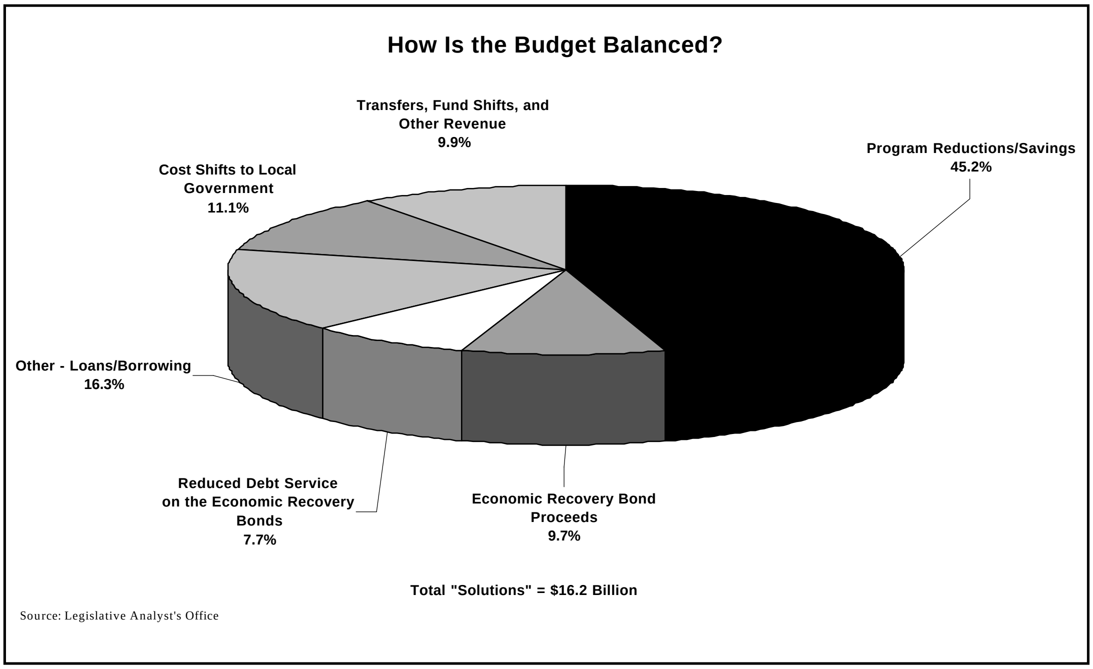
The $697 million in budgeted 2004-05 savings from reducing Medi-Cal provider reimbursement rates by 15 percent equals 7.1 percent of 2003-04 state spending for the program. Proposed changes to the IHSS Program would result in over 164,000 elderly, blind, or disabled persons losing access to some or all of their in-home care once fully implemented, affecting more than half of the program's current caseload.

Table 1: How Are the Governor's Proposed "Solutions" Allocated?

	Proposed 2004-05 General Fund Spending	2002-03 Proposed "Solutions"	2003-04 Proposed "Solutions"	2004-05 Proposed "Solutions"	Total "Solutions"	"Solutions" as a Percentage of 2004-05 Spending	Percentage of Total "Solutions"
Legislative, Judicial and Executive	$2,616,312	$0	$0	$113,961	$113,961	4.4%	0.7%
State and Consumer Services	$478,316	$0	$18,550	$14,941	$33,491	7.0%	0.2%
Business, Transportation and Housing	$374,949	$0	$886,800	$999,250	$1,886,050	503.0%	11.6%
Trade and Commerce Agency	$0	$0	$6,600	$0	$6,600	0.0%	0.0%
Resource Agency	$938,971	$132,200	$8,700	$47,269	$188,169	20.0%	1.2%
California Environmental Protection Agency	$69,760	$0	$0	$9,338	$9,338	13.4%	0.1%
Health and Human Services	$24,599,472	$29,584	$413,890	$2,700,044	$3,143,518	12.8%	19.4%
Medi-Cal	$11,569,091	$8,184	$229,994	$880,521	$1,118,699	9.7%	6.9%
Public Health	$388,610	$0	$4,444	$9,749	$14,193	3.7%	0.1%
MRMIB	$313,592	$2,290	$0	$32,109	$34,399	11.0%	0.2%
CalWORKs	$1,995,329	$0	$0	$787,360	$787,360	39.5%	4.9%
SSI/SSP	$3,345,805	$0	$0	$134,675	$134,675	4.0%	0.8%
IHSS	$896,681	$0	$129,163	$126,539	$255,702	28.5%	1.6%
Developmental Services	$2,169,085	$2,709	$0	$155,368	$158,077	7.3%	1.0%
Mental Health	$911,087	$1,408	$361	$37,562	$39,331	4.3%	0.2%
Other Health and Human Services	$3,010,192	$14,993	$49,928	$536,161	$601,082	20.0%	3.7%
Youth and Adult Corrections	$5,732,155	$0	$0	$438,017	$438,017	7.6%	2.7%
K-12 Education*	$30,317,052	$517,836	$449,028	$3,339,996	$4,306,860	14.2%	26.5%
Higher Education	$8,693,760	$0	$157,709	$728,782	$886,491	10.2%	5.5%
Labor and Workforce Development Agency	$85,783	$0	$808	$808	$1,616	1.9%	0.0%
General Government	$2,155,339	$0	$680,931	$1,704,297	$2,385,228	110.7%	14.7%
TOTAL	**$76,061,869**	**$709,204**	**$2,623,016**	**$10,096,703**	**$13,399,339**	**17.6%**	**82.5%**
Other Solutions							
Economic Recovery Bonds		-$1,433,400	$0	$3,012,000	$1,578,600		9.7%
Property Tax Shift		$0	$0	$1,256,000	$1,256,000		7.7%
TOTAL		**-$724,196**	**$2,623,016**	**$14,364,703**	**$16,233,939**		**100.0%**

*Includes K - 14 "re-basing" of the Proposition 98 spending guarantee.

Source: Legislative Analyst's Office and Department of Finance



What Does It Mean to Have a Structural Budget Gap?

A structural budget gap exists when revenues raised by the state's taxes, fees, and other revenue sources are insufficient to fund service levels under existing law adjusted for population growth and inflation. The Legislative Analyst's long-term budget forecast, released in November 2003, shows the state with an ongoing gap of approximately $14 billion, narrowing slightly in future years. This gap persists despite the fact that over the forecast period revenues are anticipated to increase slightly more than expenditures.

Only ongoing spending reductions, ongoing revenue increases, or a combination of the two can close a structural budget gap. The Legislative Analyst estimates that slightly less than two-thirds (63 percent) of the Governor's 2004-05 proposed solutions to the budget gap are ongoing, with the remaining 37 percent one-time in nature. The state would face a gap of approximately $7 billion in 2005-06 due to the expiration of one-time savings, combined with outstanding loan obligations and the resumption of deferred spending to reimburse local governments for mandated expenditures.

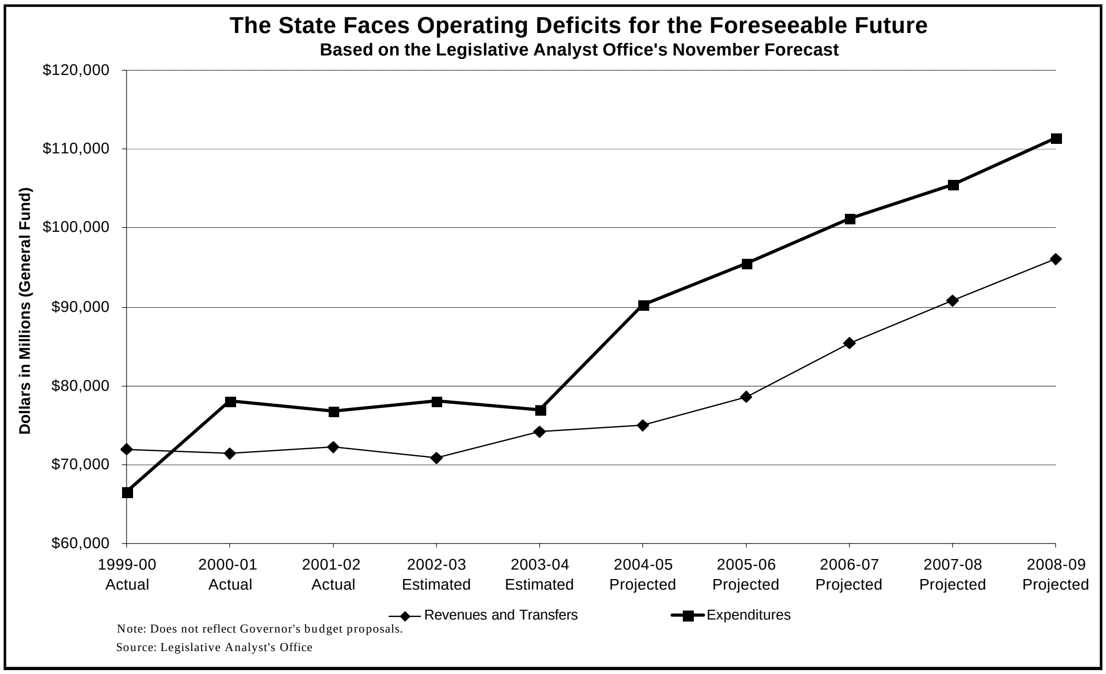
What Led to the Structural Budget Deficit?

The Governor attributes the state's fiscal problems to overspending during the boom of the late 1990s, stating, "If government had simply spent at the same rate that California's economy has grown, the State's budget would be balanced today."

In fact, state spending has not kept pace with the growth in personal income – a measure that takes into account population, as well as taxpayers' ability to pay. If it had, 2004-05 spending would be $2.5 billion higher than the Governor proposes. If spending had kept pace with the growth in personal income and the rising cost of reimbursing counties and cities for lost VLF revenues, the state would be spending $6.6 billion more in 2004-05. Moreover, proposed 2004-05 spending is $2.0 billion less than the state actually spent in 2000-01, despite the fact that population has increased by 2.4 million and the cost of living has increased by 10.2 percent.

Factors affecting state revenue collections can also explain the budget gap, including:

- The sharp drop in state personal income tax collections attributable to stock options and



capital gains. In 2000-01, the state collected $17.6 billion in taxes attributable to stock options and capital gains; in 2003-04, the state is projected to collect an estimated $6.2 billion in taxes from the same sources – an $11.4 billion drop.

- Substantial tax cuts enacted during the late 1990s. Since 1998-99, the state has enacted tax cuts that reduce state revenues by approximately $5.6 billion per year.
- Federal law changes that will reduce California's estate tax revenues by $1 billion in 2004-05.

Two additional factors compound the problems outlined above. First, corporate tax collections have declined as a share of net income (profits) reported by corporations operating in California. If corporations paid the same share of their profits in corporate income taxes in 2004-05 as they did in the early 1980s, revenues would be $6.3 billion higher. This erosion tracks a national pattern. Studies attribute the decline in corporate tax collections to more aggressive tax strategies, sheltering, and tax expenditures. Second, sales tax collections have declined as a share of the personal income of Californians due to a shift in consumption patterns from goods to services and the rise of mail order and Internet sales, which escape taxation in California. If the same share of Californians' personal income went to taxable goods in 2004-05 as in the late 1970s, revenues would be $10.2 billion higher.

Bonds and the Budget

The Budget assumes that the state will issue economic recovery bonds yielding $12.3 billion in net proceeds. In January, the Governor's Proposed Budget assumed that $9.2 billion of the bond proceeds would be used to pay off the budget deficit accumulated as of June 30, 2003. However, changes made subsequent to the release of the budget have reduced the 2002-03 deficit to $8.6 billion. The difference could be used to either reduce the level of borrowing or provide one-time revenues to address the budget gap. The remaining $3.0 billion would be used to pay the state's share of employee retirement costs in 2003-04 ($1.9 billion), repay $188 million in loans from special funds to the General Fund, cover the $325 million 2004-05 cost of the expansion in Net Operating Loss deductions, make $100 million in state debt service payments, pay $209 million in state employee compensation costs, and add $300 million to the state's reserve.

Proposals Would Limit Enrollment in Health, Social Services Programs

In a departure from current practice, the Governor has proposed to limit enrollment in a number of Health and Human Services programs (Table 2). Affected programs would include the:

- Healthy Families Program, which provides health coverage for uninsured children in low-income families.
- California Children's Services Program, which treats children with certain physical limitations and chronic health conditions or diseases. Enrollment would be capped in the state-funded portion of the program.
- Genetically Handicapped Persons Program, which serves individuals with specific genetic diseases. Enrollment would be capped in the state-only portion of the program.
- AIDS Drug Assistance Program, which provides access to drug treatments for persons living with HIV to increase the duration and quality of life.
- State Mental Hospitals, where the enrollment cap would apply to the "Not Guilty by Reason of Insanity" and "Incompetent to Stand Trial" populations.
- CalWORKs for legal immigrants, which provides cash aid and services to certain families with children.
- California Food Assistance Program (CFAP), which provides food stamps to legal immigrants excluded from the federal Food Stamp Program by the 1996 federal welfare law changes.
- Cash Assistance Program for Immigrants (CAPI), which provides cash aid to elderly, blind, or disabled legal immigrants who lost eligibility for the federal SSI program due to the 1996 federal welfare law changes.

The Legislative Analyst called "most enrollment cap proposals flawed" and noted that "In some cases, the savings achieved in the short term directly due to the imposition of a caseload cap risks a result of greater state costs in the long run."

In addition, the Governor would "block grant" several programs serving legal immigrants to county governments. Counties would receive a block grant for four programs that serve documented immigrants. The Administration assumes savings of 5 percent ($6.6 million) from administrative efficiencies, but does not explain how these savings would be achieved. Block granted programs would include CalWORKs for legal immigrants, the CFAP, the CAPI, and the Healthy Families Program for documented immigrants. Counties would use block grant funds to provide "basic safety net services."

Shifting Costs to Local Governments

Of the $16 billion of "solutions" outlined in the Governor's Proposed Budget, $1.8 billion would come from shifting costs from the state to local governments. In December, the Governor acted unilaterally to restore local governments'

Table 2: Governor's Proposed Spending Caps Would Result in Significant Enrollment Reductions

	Anticipated Enrollment Cap	2003-04 General Fund Savings (in Thousands)	2004-05 General Fund Savings (in Thousands)	2004-05 Impact on Enrollment
Healthy Families Program*	732,344	$0	$31,523	159,374
California Children's Services Program**	37,594	$121	$1,895	1,256
Genetically Handicapped Persons Program**	842	$245	$194	3
AIDS Drug Assistance Program*	23,891	$275	$550	1,392
State Mental Hospitals***	2,045	$361	$3,745	42
Breast and Cervical Cancer Treatment Program**	1,658	$0	$1,781	525
California Food Assistance Program (CFAP)***	10,230	$0	$100	273
Cash Assistance Program for Immigrants (CAPI)***	8,645	$153	$4,175	984
Medi-Cal Services for Legal Immigrants**	113,139	$0	$5,631	11,439
Non-Emergency Medi-Cal Services for Undocumented Immigrants**	794,700	$0	$9,770	65,900

*Waiting list as of June 30, 2005.

**Average number of persons on the waiting list each month.

***Reduced caseload as of June 30, 2005.

Source: Legislative Analyst's Office

reimbursement for revenues lost when he reduced the VLF rate on the first day of the new administration. The Governor proposes to provide local governments with $2.7 billion in backfill payments in 2003-04 and $4.1 billion in 2004-05. The remaining $1.3 billion in 2003-04 backfill payments would be treated as a loan that would be repaid in 2006-07.

While providing VLF backfill payments, the Governor's Proposed Budget would shift $1.3 billion in property tax revenues from counties, cities, and special districts to schools in order to reduce state spending for K – 14 Education. County governments will bear the brunt of the shift with just over three-quarters (76 percent) of the lost revenues coming out of county coffers. Other reductions affecting local governments include an elimination of funding for county services to at-risk youth and juvenile offenders as of October 1, 2004, for savings of $134.3 million in 2004-05 and $201.4 million annually thereafter; a requirement that counties continue paying 25 percent of the federal penalties associated with the delay in implementing a single, statewide automated child support collection system in 2004-05 and future years; elimination of counties' share of child support collections, for additional General Fund revenues of $39.4 million; and an elimination of state subventions for "booking fees," fees paid to counties for booking inmates into county jails.

Risks to the Proposed Budget

The 2004-05 Proposed Budget faces considerable downside risks. The first and most significant risk is voter or court rejection of the bonds proposed to finance the state's deficit. If the state is blocked from issuing this debt, the gap would significantly widen. The State Treasurer has proposed an alternative plan based on short-term borrowing that would rely on a new, designated revenue source. This proposal would require rapid implementation by the Legislature. Other risk factors include whether:

- Anticipated revenues will materialize. Revenues were $877 million (2.0 percent) below forecast levels for 2003-04 as of the end of January.
- Congress will approve anticipated federal aid. The Governor's Proposed Budget assumes $350 million in new federal aid.
- Courts will approve the Governor's proposed issuance of $930 million in pension obligation bonds. Courts blocked a similar proposal in the fall of 2003.

In late February, the US Supreme Court turned down the state's appeal in a lawsuit challenging the treatment of corporate dividends for tax purposes. As a result, the state must refund between $0.5 billion and $1.5 billion to certain corporate income taxpayers affected by the Farmers Bros. decision. The state's loss in this case could also reduce ongoing corporate tax collections by as much as $180 million per year.

What Happens Next?

In February, the Assembly passed measures that would implement some of the loans and fund shifts proposed as part of the Governor's mid-year spending reductions. The Legislature will begin to hold hearings on the 2004-05 Budget in early March, once the outcome of the vote on Propositions 57 and 58 is known. Governor Schwarzenegger has announced plans to release the "May Revise" in April and has asked the Legislature to complete work on the budget by May. This goal may prove difficult to achieve since personal income tax receipts – a critical factor for determining the resources available for the budget – won't be known until after tax payments are made on April 15 and processed by the state's Franchise Tax Board.

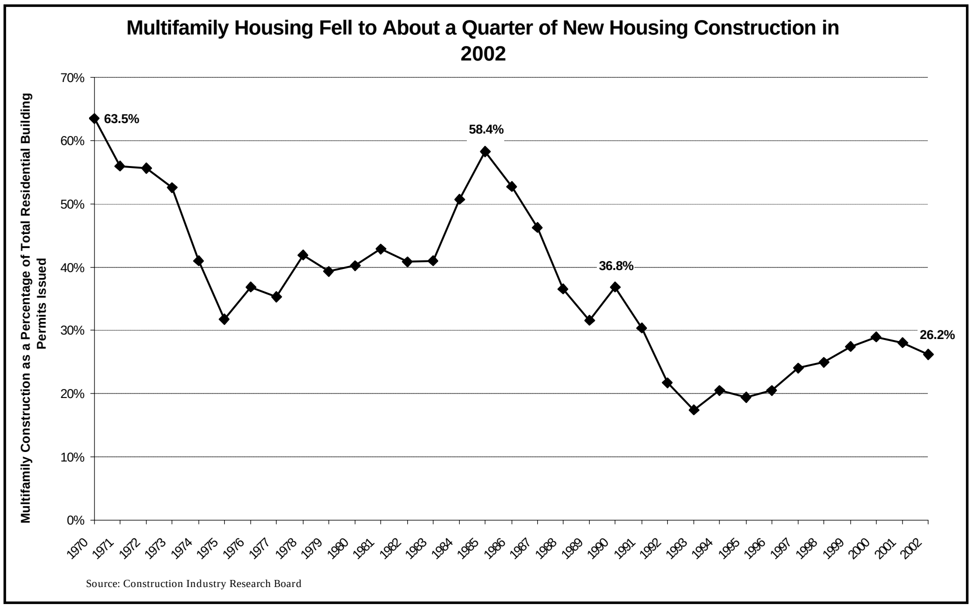
Locked Out 2004: California's Affordable Housing Crisis

A new California Budget Project (CBP) report, *Locked Out 2004: California's Affordable Housing Crisis,* finds little change in the severity of California's affordable housing crisis, as individuals and families continue to struggle to afford rental housing or a home of their own. The new report finds that:

Renters Bear the Brunt of the State's Affordable Housing Crisis

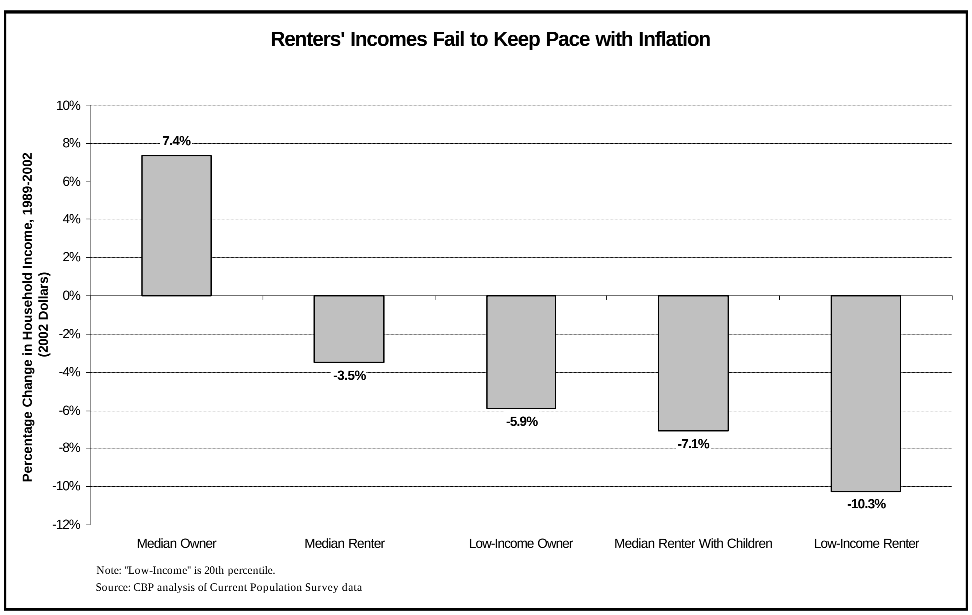
- In 2002, more than four out of 10 renter

households in Orange County, the Inland Empire (Riverside and San Bernardino counties), and San Diego County spent more than the recommended 30 percent of their income on shelter.
- More than two-thirds of low-income renters in Orange County spent more than half of their incomes on housing in 2002. Almost half of Inland Empire low-income renters and six out of 10 low-income renters in San Diego County spent more than half of their income on rent.
- The number of Californians in need of affordable housing far outstrips the supply of low-cost units. In 2002, the number of low-income renter households exceeded low-cost rental units by nearly 2-to-1 in San Diego County and nearly 3-to-1 in Orange County



Homeownership Is Out of Reach for a Growing Number of California Families

- California's homeownership rate is the fourth lowest in the nation. Only 58 percent of California households owned their homes in 2002, compared to 68 percent for the nation as a whole.
- The share of owner households headed by individuals in their twenties dropped by 14 percent between 1979 and 2002, while the share of owner households headed by individuals in their thirties dropped by 22 percent. Ownership rates declined for all age groups except seniors between 1979 and 2002.
- While 67 percent of the state's white-headed households and 60 percent of Asian and other-headed households were homeowners in 2002, just 44 percent of Latino-headed households and 43 percent of African-American-headed households owned their own homes.



Housing Production Is Still Below Forecast Need

- According to the state Department of Housing and Community Development, California needs to build more than 220,000 housing units

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per year, through 2020, in order to keep up with population growth and still be "reasonably affordable."

- Between 1990 and 2002, however, building permits were issued for an average of 120,833 units per year.
- Multifamily construction, in particular, has not kept up with projected need. Between 1990 and 2002, building permits were issued for an average of 31,502 multifamily housing units per year, just 26 percent of total permits issued and a 66 percent drop from the average level for the 1980s.

State Support for Affordable Housing Has Failed to Keep Pace with Need

- State housing spending dropped substantially during the 1990s and beyond, from 0.5 percent of General Fund spending in 1989-90 to 0.08 percent in 2003-04. In November 2002, voters approved a $2.1 billion bond act for state housing programs.
- Federal support for housing has dropped dramatically since the 1970s. Many federally-assisted units are being converted from affordable housing to more lucrative market-rate housing. In the past eight years, California lost more than 26,000 affordable housing units as landlords converted subsidized units to market rents. This represents nearly 18 percent of the state's inventory of federally-assisted units.

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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