

What's the Problem? What's the Solution? Understanding California's Budget Problems and Proposals for Change

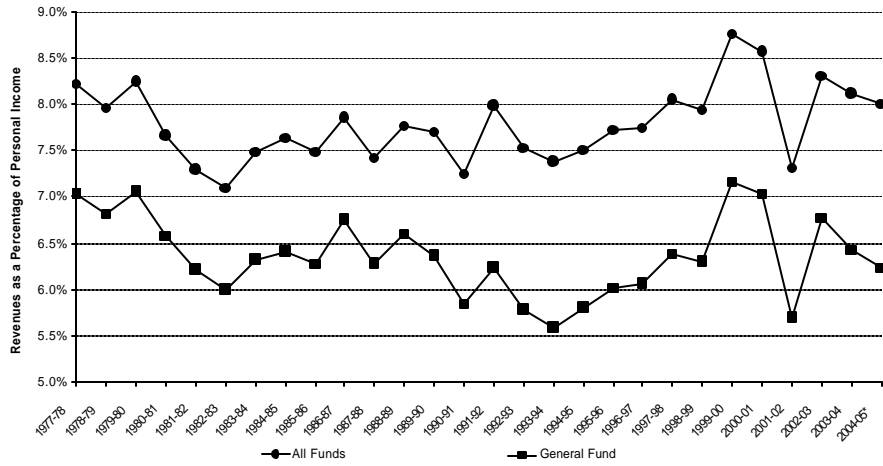
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Does California Have a Spending Problem?

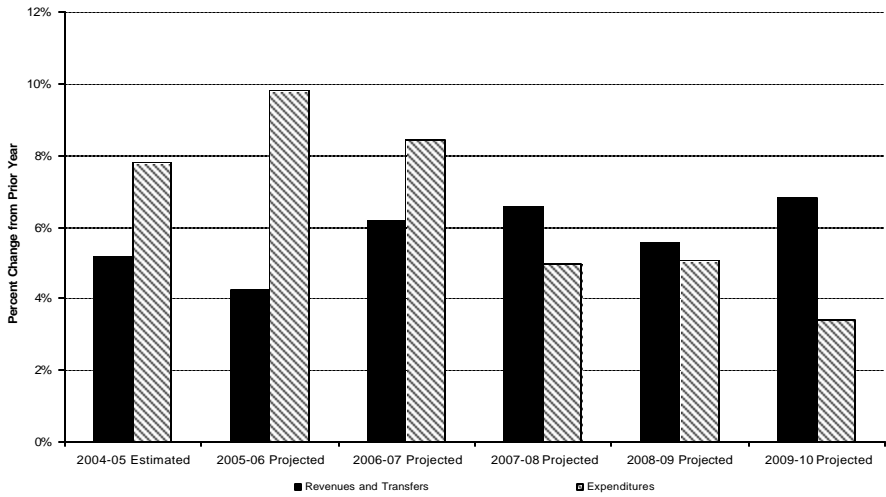
- ▶ In his State-of-the-State address, the Governor argued that, "We don't have a revenue problem. We have a spending problem."
- ▶ In fact, state spending has not kept pace with the growth in personal income, a measure that takes into account population growth as well as taxpayers' ability to pay. If General Fund spending equaled the same share of personal income in 2005-06 as it did in 1978-79, spending would be \$12.6 billion higher than the level proposed in the Governor's Proposed Budget. If total spending equaled the same percentage of personal income in 2005-06 as it did in 1978-79, total spending would be \$1.7 billion higher than the level proposed in the Governor's Budget.
- ▶ California falls in the middle of the states, ranking 24th in 2001-02, in total spending as a percentage of personal income. While California ranks relatively high with respect to health care spending, the state spends the least per Medicaid recipient and ranked 23rd with respect to the share of non-elderly persons with incomes below the poverty line who received their health coverage from Medicaid in 2003.
- ▶ State revenues have been relatively constant as a share of the economy.

State Revenues Are Relatively Stable as a Percentage of Personal Income



*2004-05 estimated.
Source: Legislative Analyst's Office and Department of Finance

Beginning in 2006-07, Revenues Are Projected to Increase By A Greater Percentage Than Spending



Source: Legislative Analyst's Office

How Does California's Spending Compare to That of Other States?
State Expenditures as a Percentage of Personal Income, 2001-02

	<u>California Rank*</u>	<u>California</u>	<u>US</u>
Total Expenditures	24	16.2%	14.6%
General Expenditures	26	13.9%	12.6%
Education	29	4.7%	4.4%
Hospitals	24	0.4%	0.4%
Health	6	0.9%	0.6%
Highways	46	0.7%	1.0%
Police Protection	24	0.1%	0.1%
Corrections	16	0.5%	0.4%
Natural Resources	23	0.3%	0.2%
Parks and Recreation	20	0.1%	0.1%

*All rankings exclude the District of Columbia.

Source: US Census Bureau and US Bureau of Economic Analysis

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Another Way to Look at the Problem

- ▶ The cost of recent tax cuts exceeds the size of the structural deficit.
- ▶ Structural changes in the state's tax system have reduced revenue collections.
- ▶ Federal tax cuts cost the state over \$1 billion per year.

The Cost of Recent Tax Cuts Exceeds the State's Structural Budget Deficit

- ▶ While the Governor argues that California has a spending, not a revenue problem, the facts show that state lawmakers have enacted tax cuts that will cost the state an estimated \$9.3 billion in 2004-05 – an amount that exceeds the \$8.6 billion shortfall in the 2005-06 budget.
- ▶ The largest reductions include the Vehicle License Fee cut (\$4.5 billion), dependent tax credit increase (\$897 million), corporate tax rate reduction (\$467 million), and increased net operating loss deductions (\$478 million).
- ▶ Lawmakers have continued to cut taxes, despite the state's budget crisis. Bills passed in 2004 alone will reduce 2004-05 revenues by an estimated \$233 million.
- ▶ The phase-out of the federal estate tax will cost the state over \$1.1 billion in 2005-06. The 2001 federal tax package phased out the federal estate tax in 2010 and eliminated states' share of the tax beginning in 2005. Under current law, the estate tax would be reinstated in 2011. However, the President has proposed making the repeal permanent.

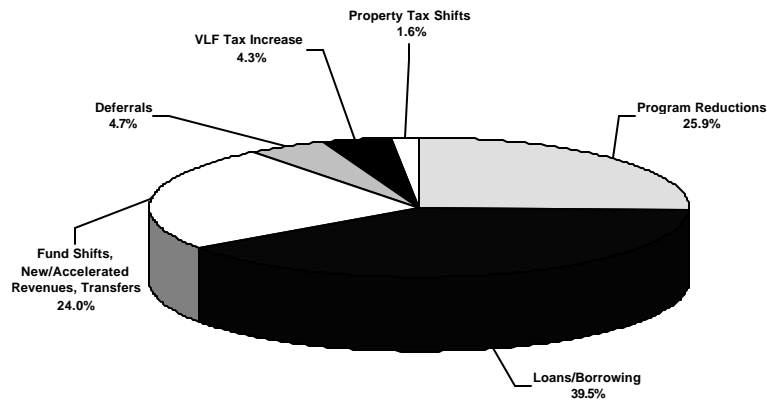
The Structure of the State's Tax System Contributes to the Budget Gap

- ▶ The drop in tax collections attributable to stock options and capital gains exceeds the size of the state's structural budget gap. The state collected \$17.6 billion in income taxes paid on stock options and capital gains in 2000. The Department of Finance estimates that these sources of income will generate \$8.2 billion in tax revenues in 2005.
- ▶ Corporate income taxes have declined over time when measured as a share of total General Fund revenues and as a share of corporate profits.
- ▶ The yield of the state's sales tax has declined over time, reflecting broader economic trends, such as the shift in economic activity from goods to services and the rise of Internet and electronic sales that escape taxation.
- ▶ Alcohol and tobacco tax revenues have been stagnant over time, reflecting societal consumption trends.
- ▶ While the state's personal income tax has posted the most robust growth of all of the state's major taxes over time, the drop in collections related to stock options and capital gains is largely responsible for the structural budget gap.

The Cost of Avoiding the Problem

- ▶ The current and recent years' budgets have largely relied on borrowing and other temporary solutions. The Legislative Analyst estimates that by 2004-05, the state had accumulated \$26 billion in budget-related debt, including \$18 billion in bonds, \$4 billion in loans from local governments, and approximately \$4 billion in loans from transportation and other special funds.
- ▶ Debt service on **existing** budget-related debt will cost the state nearly \$4 billion per year between 2006-07 and 2008-09. The annual cost of budget-related debt service exceeds combined General Fund spending for the California State University (\$2.6 billion), Environmental Protection Agency (\$68.9 million), Child Protective Services Program (\$645.1 million), and Foster Care Program (\$412.7 million).
- ▶ The Legislative Analyst estimates that repayment of the \$26 billion of accumulated debt will account for over 40 percent of the operating deficits in the next several years' budgets.
- ▶ The Governor's Proposed Budget would add over \$4.2 billion to the state's outstanding budget-related debt, and includes new borrowing to pay off the settlement of a lawsuit related to flood damages and additional use of the deficit bonds authorized by Proposition 58.

How Have Past Budgets Been Balanced? Budget Solutions by Category, 2002-03 to 2004-05



Source: Legislative Analyst's Office

Note: The Vehicle License Fee (VLF) tax increase of 2003-04 was subsequently reversed.

The Governor Would Make Major Constitutional Changes Affecting the Budget

The Governor has proposed a constitutional amendment (ACAX1 4 as amended February 24) that would:

- ▶ Require automatic across-the-board spending reductions if the Governor determines that expenditures plus the transfer to the Budget Stabilization Account will exceed revenues by \$250 million or more during the fiscal year.
- ▶ Implement the across-the-board reductions by reducing checks issued by the state from the General Fund and checks issued by a local government in proportion to the General Fund support for a particular program or service. The only exclusions would be for debt service or payments required by the US Constitution.
- ▶ Eliminate the state's obligation to restore school funding levels in future years to make up for lower funding levels during the current budget crisis. This provision would reduce long-term education funding by approximately \$3.9 billion per year.
- ▶ Eliminate a provision of the Proposition 98 school funding guarantee that allows a temporary reduction in school spending in "bad budget" years ("Test 3").
- ▶ Eliminate the Legislature's ability to suspend the Proposition 98 guarantee.
- ▶ Eliminate the Legislature's ability to suspend the transportation funding authorized by Proposition 42.
- ▶ Eliminate the state's ability to loan monies from special funds to help close a General Fund budget gap.

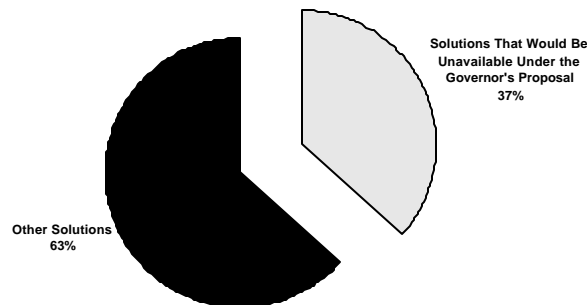
The Governor's Proposals Will Increase, Not Decrease, Autopilot Spending

- ▶ The Governor claims that "autopilot," formula-driven spending is the source of the state's budget problems. However, the Governor's proposed constitutional amendment would put a much greater share of the budget on "autopilot" and eliminate the "safety valves" in several key programs that have been used to help close recent budget gaps.
- ▶ Proposition 1A, which ratified the Governor's agreement with local governments, also results in "autopilot" spending by locking in state spending to make up for the 1998 Vehicle License Fee reduction and will significantly limit the state's ability to reallocate local property tax dollars to generate state budget savings.
- ▶ The Governor-sponsored Proposition 49 of 2002 created a new spending obligation for after-school programs that cannot be reduced in the event of a budget shortfall.
- ▶ Had the Governor's proposal and Proposition 1A been in effect in 2004, over a third of the "solutions" used to bridge this year's \$16.1 billion budget gap would not have been available, forcing deep cuts in other areas of the budget.
- ▶ The across-the-board reductions required by the Governor's proposal could:
 - Cause the state to lose federal matching funds.
 - Reduce the wages for state and local government workers below the state's minimum wage.
 - Result in disparities between state workers, based on whether they are paid by the General or special funds, and between school districts and community colleges based on their "mix" of state and local funds.

Policy Issues Raised by the Governor's Proposal

- ▶ Power over the budget would shift from the Legislature to the Governor.
- ▶ ACAX1 4 would reduce "benefits and services, including any entitlement created by state law," by an amount consistent with the required across-the-board reductions. It is unclear how this would apply to regulatory activities (i.e., social worker visits to foster children), authorized hours of In-Home Supportive Services, Medi-Cal services, or many other activities.
- ▶ The scope of exclusions covered by the federal constitution is uncertain.
- ▶ Across-the-board reductions would create wage inequities among state workers based on the source of funds used to pay their wages.
- ▶ It is unclear how across-the-board reductions might interact with the maintenance of effort requirements of the 1991 program realignment that transferred responsibility for a number of social service, mental health, and health programs from the state to counties.
- ▶ The Governor's proposal breaks deals made with education and local governments as part of last year's budget agreement.

If the Governor's Proposed Constitutional Changes Had Been in Effect in 2004-05, More Than One-Third of the Solutions Used to Balance the Budget Would Not Have Been Available, Forcing Deep Cuts in Areas of the Budget Without Constitutional Protection



Total 2004-05 Solutions = \$16.1 Billion

Source: CBP analysis of Legislative Analyst's Office data

Note: Solutions that would not have been available include \$1.3 billion in property tax revenues shifted from local governments to schools.

California Live Within Our Means Act (RF0067)

- ▶ Caps total spending at prior year times average annual General Fund revenue growth in three prior years. Excess to Budget Stabilization Account, maintenance factor repayment, Prop 42 loan repayment, and school and road improvements.
- ▶ Capped spending would include revenues from fees.
- ▶ Gives the Governor broad authority to cut spending in the event the budget goes out of balance mid-way through a fiscal year or if the Legislature does not pass a budget on a timely basis.
- ▶ Eliminates Prop 98 "Test 3" and excludes outstanding maintenance factor from future years' base.
- ▶ Eliminates Prop 42 suspension option.
- ▶ Prohibits loans from special funds to the General Fund.
- ▶ The sponsors have also submitted a measure ("The Two-Thirds Vote Preservation Act of 2005) that would overturn the Sinclair Paint decision and require most fees to be enacted by a two-thirds vote of the Legislature (state) or the voters (local governments).

"California Deficit Prevention Act"

- ▶ Multiple versions of a measure sponsored by Senator John Campbell, Jon Coupal (Howard Jarvis Taxpayers Association), and Larry McCarthy (California Taxpayers Association, Cal-Tax) would modify the state's spending cap.
- ▶ These proposals would, in general, use the Consumer Price Index (CPI), rather than per capita personal income growth as an inflation factor; cap all spending, not just spending from the proceeds of taxes; establish a new base year for the state's spending cap; cap state debt service expenditures; require most fees to be enacted by a two-thirds vote of the Legislature; and allocate revenues in excess of the cap to a reserve fund; repayment of Prop 98 maintenance factor or transportation loans, to school or road improvements, and a sales tax rebate.
- ▶ They would also require local governments to enact a balanced budget and submit new and increased fees to the voters for approval.
- ▶ Some versions change the Prop 98 inflation factor to the lesser of CPI or per capita personal income growth.