CALIFORNIA'S BUDGET CRISIS

Prepared for the

Blue Shield of California Foundation

by

Blue Sky Consulting Group

October 2009

Overview

The unprecedented size and nature of the state budget deficit has prompted budget actions by the Legislature and the Governor that have far-reaching impacts. Every Californian is paying more in taxes and many are seeing reductions in services.

Yet, in spite of the Legislature's and Governor's efforts to close the budget gap, the state faces ongoing deficits of probably between $10 billion and $20 billion per year for at least the next several years as the economy slowly recovers from the worst recession since the Great Depression.

The global economic downturn has forced the state into a nearly continuous budget process. California's recently revised budget addressed a roughly $24 billion shortfall that developed following the Legislature's enactment in February of a budget for 2009-10. That agreement attempted to address a nearly $42 billion problem. Due to the continuing drop in revenues and voter rejection of nearly $6 billion in proposed solutions on the May special election ballot, the February agreement had fallen out of balance even before the beginning of the fiscal year that started on July 1.

The immediate budget problem results from a combination of an unprecedented drop in state revenues due to the recession and the Legislature's and Governor's failure to address the state's structural deficit, build a rainy-day reserve, and reduce reliance on debt in the period prior to the recession.

From a longer-term perspective, the state's budget problems are the result of a constellation of forces including a long-term shift of decision making from the local level to the state in part as a result of Proposition 13, the lack of an effective mechanism to prevent over reliance on nonrecurring revenues, numerous voter-approved limitations on the budget process, and significant tax reductions and spending commitments over the last 15 years with little attention to the long-term impact of these reductions and commitments on the state's ability to continue to fund basic services.

At least as significant, however, is the political process, which has become increasingly partisan, making a candid, but civil, discussion with the public of priorities and the cost of funding those priorities difficult if not impossible. The balance of this paper explores why the state finds itself where it does, what was done during the most recent budget to address the shortfall and some of the challenges the state faces looking forward.

Historical Context of the Current Crisis

Looking at the state's current fiscal crisis, it is worth exploring the historical context in which the crisis has taken place to understand the extent to which various factors have contributed to the current crisis.

Proposition 13

The current state-local government fiscal arrangement is largely a product of changes brought about by Proposition 13 and subsequent initiatives. That proposition, which was approved by the voters in 1978, made several significant changes to the property tax, including imposing a one percent tax rate limit and limiting annual increases in property assessments. Aside from these provisions, the measure made several other significant changes. Proposition 13:

- Imposed a two-thirds vote requirement for tax increases,
- Effectively shifted a substantial portion of the responsibility for school funding to the state, and
- Imposed (along with subsequent initiative measures) significant limitations on local revenue-raising ability by establishing popular vote requirements for tax increases.

All of these changes have had the effect of shifting decision-making power away from local governments and school districts to state government in Sacramento.

Revenue Changes

Other structural changes in policy and the economy over time have affected state revenues and the condition of the budget. For example, the share of state General Fund revenues coming from the sales tax has declined from 59 percent in 1950-51 to 31 percent in 2009-10 as a result of the shift of California's economy away from consumption of tangible goods to services and intangible goods. This, in turn, has led to a greater dependence on the part of the General Fund on the personal income tax – a significantly more volatile revenue source. Similarly, the reduction of the corporate income tax rate and the adoption of several significant tax expenditures over the last 12 years has reduced the share of General Fund revenues coming from taxes on corporations.

More generally, according to the California Budget Project, tax cuts of all sorts adopted since 1993 now cost the General Fund about $12 billion annually. This includes reductions in corporate and personal income taxes as well as the more recently adopted reduction in the vehicle license fee. Nevertheless, General Fund revenue growth averaged almost 7 percent per year through 2007-08 (prior to the recession) before taking inflation or population growth into account. Since then, of course, revenues have plummeted due to the recession.

Expenditure Pressures

At the same time the changes in the state's revenue structure have been taking place, pressures have mounted on the spending side of the budget. Some areas of the budget, such as corrections, with a growth rate over 10 percent per year from the mid 1990s through 2007-08, have grown dramatically. Other programs, such as Medi-Cal and In-Home Supportive Services, experienced less dramatic, but still fairly robust, growth between 2002-03 and 2007-08, at 7.2 and 8.2 percent per year, respectively.

Some of these spending pressures result from requirements imposed by the courts, such as the recent increase in health care spending in California's prisons. Others result from requirements imposed by the voters through the initiative process. The premier example of a complex, initiative-driven spending requirement is Proposition 98, which establishes a minimum guaranteed funding level for K-12 schools and community college districts. In actuality, though, spending growth for schools has generally been fairly moderate. This may change somewhat in the future as a result of the requirement for the General Fund to repay to schools the $11.2 billion so-called “maintenance factor” as revenues grow.

Failure to Manage Volatile Revenues

Proposition 4, passed by the voters in 1979, mandates the creation of a “prudent” reserve. Notwithstanding that requirement, the state has had difficulty resisting the over-commitment of one-time revenue spikes, a circumstance exacerbated by the volatility of the state’s tax structure. Coming out of the dot-com bust earlier this decade, state General Fund revenues grew rapidly, rising from $76.8 billion in 2003-04 to $102.5 billion in 2007-08. The Legislature and the Governor did not take advantage of this brisk revenue growth to address the budget’s structural imbalance of roughly $6 to $8 billion between ongoing spending and revenues that was the legacy of an over-commitment of nonrecurring revenues during the dot-com boom.

With this backdrop, the nation’s worst recession since the Great Depression hit, dropping state General Fund revenues by approximately $60 billion combined over two fiscal years, 2008-09 and 2009-10, from the level expected based on the trend prior to the recession.

As a result of this precipitous decline in revenues, even if the Legislature and Governor had earlier aligned spending and revenues and funded a reserve, the state still would have faced a massive problem. Nevertheless, pressure on programs from the recession would be substantial but less severe if the structural deficit had been addressed, a rainy day fund established, and the substantial debt created during the dot-com bust not been incurred.

Similarly, eliminating the tax breaks of the last 16 years might have reduced or eliminated the structural deficit that existed prior to the most recent recession, but likely also would have been used to raise the budget’s spending base. Thus, if the state had not make those tax cuts, the budget would still have been exposed to the loss in revenues due to the recession.

California Suffers from Fundamental Governance Problems

Aside from the impact of the recession and the limitations of the state’s revenue structure, a number of fundamental governance problems have made it difficult to develop a consensus over state revenue and spending issues.

Many observers and participants in the process argue that the legislative process has become dominated by a more partisan atmosphere where it is difficult to work “across the aisle” to address the state’s challenges. Some think this results from so few legislative races being competitive due to the Legislature’s role in ensuring as many “safe” districts as possible – something the Legislature has been able to do by virtue of its control of the redistricting process. Implicit in this view are two assumptions. First, that increasing the number of members of the Legislature whose views are more moderate than the respective right or left wings of their parties would facilitate bipartisan compromise. Second, these observers assume that increasing the number of competitive districts will increase the number of moderate legislators. California is poised to test the latter assumption for the next redistricting after the 2010 census as a result of the voters' approval of Proposition 11 on the November 2008 ballot. This measure takes control of the redistricting process out of the Legislature's hands.

There are at least two other factors that likely have contributed to California's current budget woes. The state's supermajority vote requirement for approval of the state budget and tax increases means that a minority of legislators can hold the budget hostage to whatever particular goals they wish to pursue. In addition, a significant decline in public confidence in government means that it is difficult to engage voters in a conversation about the tradeoffs involved in addressing the state's needs even in good economic times, let alone during the current recession.

Recent Budget Reform Efforts

Propositions 57 & 58 in 2004

The voters approved two budget-related measures in 2004. Proposition 57 authorized the state to sell up to $15 billion in Economic Recovery Bonds (deficit bonds) to finance the deficit incurred as a result of the dot-com bust earlier this decade. Under the state constitution, the state could not borrow to cover the deficit without a vote of the people. Proposition 58 required the establishment of a rainy-day reserve and mandated the transfer of specified amounts of General Fund revenues until the balance in the reserve reaches $8 billion or 5 percent of General Fund revenues, whichever is greater. However, because this transfer can relatively easily be suspended, this requirement was of little help in protecting the state from the current economic downturn.

Governor's Effort in 2005 – Proposition 76

Proposition 76 would have made several changes to the state budget, but was rejected by the voters. It would have imposed a new spending limit on top of the existing spending limit imposed by Proposition 4 in 1979. The new limit would have been based on revenue growth over the prior three years. The measure would also have expanded the Governor's ability to make mid-year reductions in the event of a fiscal emergency and would have made significant changes to the school funding formulas under Proposition 98 that would have provided the state greater flexibility in terms of amount of funding required to be provided to schools.

May 2009 Special Election Measures

This Spring, the Legislature placed several measures on a May 19th special election ballot as part of the February budget agreement. Three of the measures were intended to generate about $6 billion in additional revenues for the General Fund, the bulk of which would have come from authority to borrow from future lottery revenues (Proposition 1C). The balance of the funds would have come from transfers of Proposition 10 First 5 program funds (1D) and Proposition 63 mental health income tax revenues (1E). Another measure would have revised Proposition 58's reserve requirements and established a new spending limit (1A). This measure would also have extended the duration of the tax increases approved as part of the February budget package. Lastly, a fifth measure would have established a constitutional guarantee of repayment of school funding under Proposition 98 (1B). All of these measures were rejected by the voters; however, the Legislature did establish a statutory guarantee for repayment of the school funding.

How Does California Compare to Other States?

Comparison of California's Tax Burden

At 12.1 percent of percent of personal income, California's state and local tax burden is modestly above the national average of 11.6 percent, based on 2006 tax collections. Based on this measure, California ranks 14th in the country. This average ranking, however, masks wide variation in California's ranking on individual taxes. State and local sales taxes, for example, get roughly the same national ranking as the state as a whole. Property taxes and motor vehicle fuel taxes, on the other hand, rank much lower as a percent of personal income, with fuel taxes being near the bottom of the national ranking. Individual and corporate income taxes, in contrast, are near the top of the ranking, at 4th and 6th in the country, respectively.

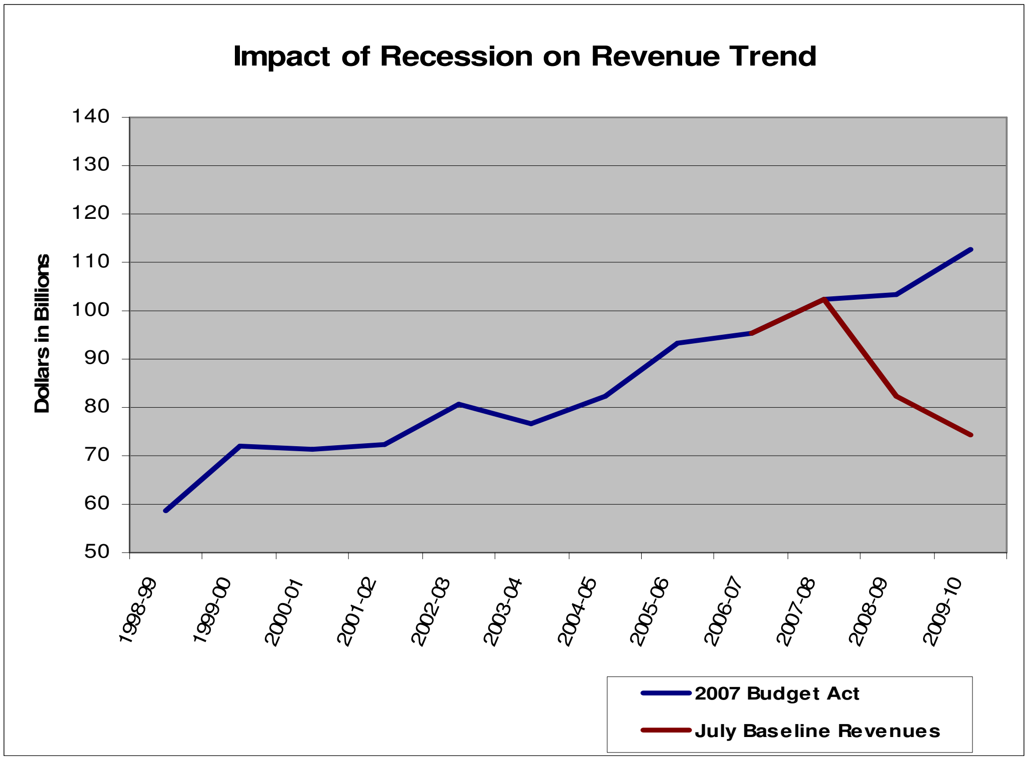
Comparison of Selected Program Expenditures

According to a California Budget Project analysis of state expenditure data reported to the U.S. Census, California again ranked in the middle of the states in terms of total spending in 2007-08 at 22nd out of the 50 states. Again, however, this aggregate measure masks wide variation in terms of spending levels for different program areas. For example, California ranked 4th on corrections spending and 8th on health spending, but 29th on spending for education and 46th on spending for highways.

Perhaps more interesting, however, is where California ranks in terms of outcomes as opposed to spending levels. For example, the Kaiser Family Foundation reports that California ranked 44th in the country in the percentage of nonelderly who had health insurance coverage in 2007-08. Similarly, the Annie E. Casey Foundation reports in its Kids Count survey that California ranked 6th in the country in 2006 in terms of the percent of low-birthweight babies, but 38th in terms of the percent of children living in families where no parent has full-time, year-round employment.

Recession Caused Revenues to Collapse

As a result of the nation's worst recession since the Great Depression, state General Fund revenues fell by approximately $60 billion over two fiscal years combined, 2008-09 and 2009-10, from the level expected prior to the recession. As shown in the chart below, baseline state General Fund revenues for 2009-10 alone have fallen from the nearly $113 billion level projected in Spring 2007 to below $75 billion. Unlike recession of the early 2000s, where income tax revenues were primarily affected, all of the state's major revenue sources have experienced significant declines.



Source: Department of Finance; Legislative Analyst's Office

Budget Agreements Address Deficit

On July 28, 2009, the Governor signed a package of amendments to the 2009-10 budget bill passed in February. As shown in the table below, the July budget changes consisted of nearly $24 billion in budget solutions. Of the total, $18 billion came from spending-related changes and nearly $6 billion from revenue accelerations or borrowing.

Solving the $60 Billion Budget Gap
($ in billions)

	February	July	Total
Spending Changes	14.5	18.0	32.5
Taxes	12.5	-	12.5
Federal Stimulus	8.5	-	8.5
Other	0.3	5.7	6.0
Totals	35.9	23.7	59.5

Source: Legislative Analyst

These budget actions came on the heels of the budget agreement passed in February that sought to close a nearly $42 billion budget gap with $12.5 billion in new revenues, $14.5 billion in spending-related changes, $8.5 billion in funds from the federal stimulus legislation, and $6 billion in solutions rejected by the voters on the May 19 special election ballot. The rejection of the special election measures (chiefly a proposal to borrow from lottery revenues) reduced the total of the February budget solutions to the $35.9 billion shown in the table. Taken together, the February and July budget actions attempted to address a $60 billion deficit.[1]

Program Reductions

In an effort to address the budget shortfall, the Legislature and Governor made significant reductions to numerous programs. As displayed in the table below, cuts to K-12 schools and higher education will affect students at all levels. Reductions in service and funding levels for safety net health and human service programs will affect many of the state's most vulnerable residents. Reductions in corrections spending will likely result in fewer rehabilitation services and fewer inmates in prison. Local government services will also be reduced as cities and counties adjust to a shift to the state of redevelopment agency property taxes and a mandated loan to the state of $1.9 billion in local general purpose property tax revenues. And, more specifically regarding counties, the current fiscal and economic situation has placed a severe strain on their ability to deliver safety net services, compounding the effects of the state social and health services cuts.

Spending Changes in the Budget Packages
($ in billions)

	February	July	Total
Reduce Proposition 98 spending to minimum	8.4	6.1	14.5
Reduce health and social services spending	1.7	3.4	5.0
Furlough state workers & reduce other employee costs	1.2	1.8	3.0
Reduce higher education spending (except CCC Prop 98)	0.9	2.0	2.9
Redirect local redevelopment funds	—	1.7	1.7
Redirect transportation funds	0.7	0.9	1.6
Reduce corrections and rehabilitation spending	0.6	0.8	1.4
Reduce other spending	1.1	1.4	2.6
Total	14.5	18.0	32.5

Source: Legislative Analyst

The total of actual spending *reductions* is somewhat less than the total of spending changes displayed above because some of the spending changes are achieved by deferring costs. For example, the budget packages shift $1.8 billion in K-12 and community college spending into 2010-11. Similarly, $938 million in savings in state employee costs comes from a deferral of payroll by one day into the 2010-11 fiscal year.

Reductions to Domestic Violence Programs and Community Clinics

Domestic Violence Programs

As part of the negotiations on the 2009-10 budget, the Legislature agreed to reduce Domestic Violence Program funding by $4.1 million, or 20 percent. When signing the budget, however, the Governor eliminated the remaining $16.4 million as part of a more than $400 million

[1] Note that the $60 billion deficit figure is different from the $60 billion drop in revenues for 2008-09 and 2009-10 shown in the chart on the previous page. The two-year revenue loss from the trend was estimated by the Department of Finance using the revenue forecast from the 2007 Budget Act. The $60 billion two-year deficit figure reflects the total of solutions from the February and July budget packages.

package of line-item vetoes. On October 14th the Legislature sent the Governor a bill to provide a loan of $16.3 million of special fund monies to the California Emergency Management Agency to restore funding for domestic violence shelters. In addition, the Governor's authority to make the budget vetoes is being challenged in an expedited review by the Court of Appeals.

The Domestic Violence Program provided funding to 94 agencies statewide, some of which operate multiple shelters. Most also assist victims with restraining orders, legal aid, child services, money management and other life skills. Funding through this program represents about 30 percent of shelter programs' budgets on average. As a result of this reduction, programs are cutting staff, reducing beds, putting staff on furloughs, and turning away clients. Prior to these reductions, shelters were unable to meet all of the demand for services. The economic downturn has increased the level of domestic violence and, consequently, the need for services. To date, six shelters in the state remain closed as a result of the reduction, while dozens more have closed satellite offices, are preparing to close additional shelters, and are significantly scaling back services.

Community Clinics

As with the Domestic Violence Program, the Governor's veto eliminated the $25 million remaining in the budget for community clinics following the Legislature's initial $10.1 million reduction. These funds support care for uninsured Californians and were allocated to the following programs: Indian Health; Seasonal Agricultural, and Migratory Workers; Rural Health Services Development; and Expanded Access to Primary Care.

The mission of these programs is to improve the quality of health care and to expand access to primary and preventive health care to medically underserved areas and populations, including rural areas and for Native Americans, American Indians, and seasonal agricultural workers.

Clinics that do not also receive federal funding will likely be most severely affected. In addition, many clinics will lose revenue as a result of the elimination of certain Medi-Cal "optional" benefits and reductions in funding for HIV/AIDS programs. As of early last month, four clinics had closed statewide.

Tax Increases

The February budget agreement increased taxes by $12.5 billion in 2009-10. The major changes included in the package were:

- a 0.25 percent increase in personal income taxes
- a one percent increase in the state sales tax
- a 0.5 percent increase in vehicle license fees
- a reduction in the dependent credit from $306 to $98

These tax increases expire in at various points in 2011, depending on the tax. The voters rejected Proposition 1A on the May 19 special election ballot that would have, among other provisions, extended the duration of the tax increases through mid 2013.

Accelerations and Deferrals

As noted above, some of the spending reductions made by the budget packages were achieved by deferring costs. In addition, the July budget package includes several revenue accelerations where future tax liabilities are required to be remitted to the state sooner. The budget agreement also includes a number of one-time savings actions, such as the proposal to sell a portion of the assets and liabilities of the State Compensation Insurance Fund. The table below details those deferrals and accelerations.

One-Time Savings and Deferrals ($ in billions)	
Defer K-12 & Community College spending into 2010-11	1.8
Increase taxpayer withholding	1.7
Accelerate estimated tax payments	0.6
Sell portion of SCIF assets & liabilities	1.0
Delay state employee payroll by one day into 2010-11	0.9
Assume additional federal Medi-Cal funding	1.0
Defer Quality Education Investment Act program by one year	0.5
Total One-Time Savings and Deferrals	7.5

Short-term Risks to the Budget Package

Although the package of budget actions taken in February and July accomplished the immediate goal of balancing the state's budget for the current fiscal year, at least temporarily, significant risks to the budget outlook remain. To the extent that revenues do not keep pace with projections, legal challenges derail anticipated cuts or revenue shifts, or other savings fail to materialize as planned, the state will end the 2009-10 fiscal year in the red.

Specifically, the most recent budget agreement includes a number of provisions about which there are concerns as to whether they will yield the level of savings anticipated, particularly as a result of legal challenges, including:

- $1.7 billion of redevelopment tax increment revenues shifted to support schools, thereby lowering the state's cost;
- $1 billion from the sale of a portion of the State Compensation Insurance Fund's assets and liabilities; and
- Challenges to the Governor's line item vetoes.

In addition, the State Controller recently reported that General Fund revenues for the current fiscal year through September fell short of the budget's projection by more than $1 billion.

And the state recently lost a lawsuit challenging the use of $1 billion in public transit funds to transport the developmentally disabled and to pay debt service on transportation bonds.

California's Future - Ongoing Deficits

Beyond the current fiscal year, the state is likely to confront continuing deficits for at least the next several years, even if none of the risks identified above is realized and revenues come at the level of the budget's revised forecast. According to the Administration, the state will face a gap of at least $7.4 billion in the 2010-11 fiscal year before taking into account any additional shortfall in revenues or failure of solutions to materialize. Given those risks, the shortfall could be significantly larger. Thereafter, it is likely that the state will face annual operating shortfalls of more than $15 billion for several years into the future absent further action to correct the imbalance.

Longer Term, the Budget Agreement Compounds the Out-Year Deficits

In addition to the short-term risks noted above, the budget agreement exacerbates the out-year deficit problem in several ways. As noted above, in addition to reductions to programs, the budget relies significantly on one-time savings and borrowing.

The budget achieves savings in part by relying on federal stimulus funding to support K-12 and higher education and health care spending levels. When these funds are exhausted, the state will be faced with either replacing the lost federal funds or making further reductions.

And, as noted, the budget also relies on numerous one-time solutions to achieve balance in 2009-10. In addition to accelerating withholding (and estimated payments), the budget shifts state employee payroll and school funding payments across fiscal years. At best, these maneuvers generate one-time savings. However, because the state almost never "unwinds" these sorts of accounting or revenue acceleration maneuvers, it has less and less flexibility in dealing with future budget problems.

The budget also creates higher funding obligations in future years by borrowing. The most prominent example of this is the transfer of $1.9 billion in local property tax funds to support schools (thereby reducing the state's obligation). Under the provisions of Proposition 1A (2004), the state must repay this borrowing within three years with interest.

The budget gap will also grow larger beyond 2010-11 in part because the February budget agreement's tax increases expire, reducing revenues by more than $8 billion on an annual basis. In addition, the out-year budgets will face pressure as a result of the loss of corporate tax revenues stemming from a tax law change adopted as part of the February budget package; the so called "single sales factor," among other corporate tax law changes, will result in ongoing reductions in corporate tax revenues of more than $1.5 billion per year by 2011-12.[2]

These actions occur in the context of a budget already burdened by significant debt repayment obligations, such as the Economic Recovery (deficit) bonds first authorized by the voters in 2004, as well as borrowing from numerous special funds. According to the Department of Finance, as of June 30, 2009 the state had an outstanding balance in excess of $1.5 billion of loans to the General Fund from various special funds. In addition, the state owes local governments more than $900 million in reimbursements for state mandates and almost $600 million to repay suspended General Fund transfers to transportation programs pursuant to Proposition 42.[3]

Thus, the fiscal outlook for California remains bleak. Indeed, the state's recovery may be slower than that in other states or the nation as a whole. Economists point in particular to two factors that may make the recession more prolonged in California: the depth of the real estate decline and the drop in exports. As a result, it may be some time before the state sees a return to robust economic growth and the increases in state tax revenues that accompany such growth.

In addition to the impact of a slow recovery, the state faces a number of major challenges, in part driven by demographic changes, that will add to the fiscal pressure that Californian's must confront. These include, among others, providing sufficient investment in higher education to ensure the educated workforce on which the state's future economic growth depends, dealing with the cost pressures that will result from the "graying" of the state's population, and funding the cost of employee pensions and retiree health care.

[2] See California Budget Project, "Uncharted Waters: Navigating the Social and Economic Context of California's Budget" and Department of Finance presentation on the 2009-10 budget deficit available here: http://www.cotce.ca.gov/meetings/testimony/documents/Genest_March-9_Presentation-G.pdf

[3] http://www.dof.ca.gov/reports_and_periodicals/documents/GF_Loans_Obl_Rept_200908.pdf