

CALIFORNIA

BUDGET

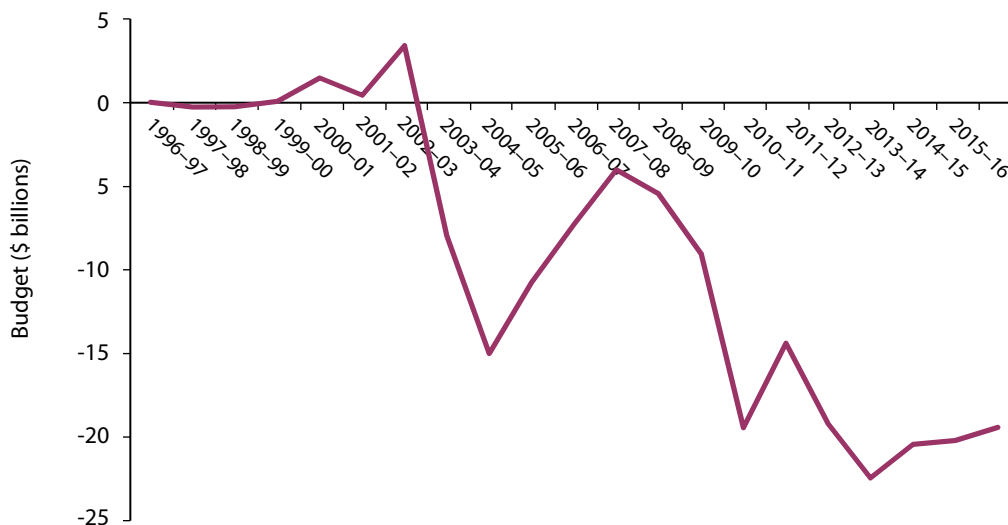


CALIFORNIA FACES SERIOUS LONG-TERM BUDGET CHALLENGES

California was hit hard by the Great Recession. In 2009, state tax revenues plummeted 14 percent from the previous year, compared to a 9 percent drop nationally. At the same time, demands escalated for Medi-Cal and other public assistance programs. As a result, the state faced record budget shortfalls of around \$100 billion, or roughly a third of General Fund expenditures, from 2008 through 2010.

Nevertheless, many of California's budget woes are long standing. The state has faced gaps between revenues and expenditures in nearly every budget cycle since the start of the decade. It contended with huge shortfalls during the recessions of the 1980s, 1990s, and early 2000s. State budgets are often passed after the start of the new fiscal year. A series of budget-related ballot measures and legislative actions has complicated the state-local fiscal relationship. Voters often express mistrust of their state government and alienation from the budget process. In addition, the state faces many long-term challenges, including large unfunded liabilities for public employee pensions and rising health care costs and debt service obligations. On a more positive note, PPIC's Statewide Survey suggests that Californians are concerned about the state's fiscal problems and ready for "major reforms."

BUDGET SHORTFALLS WILL CONTINUE TO BE LARGE



SOURCE: Based on Legislative Analyst Office projections at the start of each budget cycle and estimates through FY 2016.

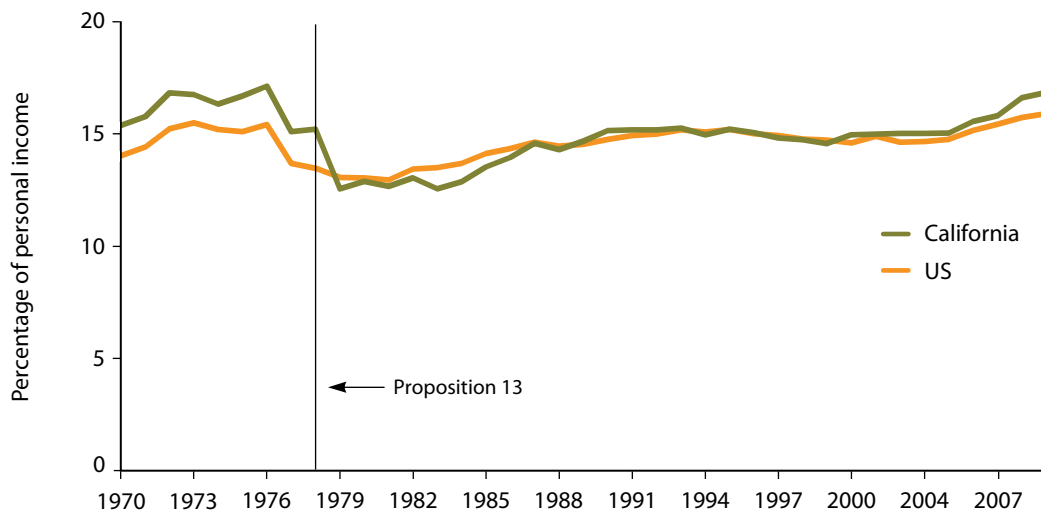
WHY DO WE KEEP GETTING INTO THIS MESS?

California spends more than the average state, and it collects more in revenues. It is also distinct in the way it raises revenues, relying more on income and sales taxes and less on property taxes. Tax experts have repeatedly urged California to flatten and simplify its revenue system by broadening tax bases, lowering tax rates, and eliminating certain tax preferences.

- **California is a moderate tax burden state.**

In fiscal year 2007–2008, the latest year for which comprehensive data are available, California’s state and local governments collected \$270 billion, or \$7,384 per capita, from taxes, fees, charges, and other miscellaneous sources. By this measure, California had the ninth-highest revenue burden in the nation. However, as a high-income state, California also has a large tax base. When state and local general revenues are expressed as share of economic activity or personal income, California’s ranking drops to 13th nationally.

CALIFORNIA’S REVENUE BURDEN HAS CHANGED OVER TIME



SOURCE: Brookings-Urban Tax Policy Center.

- **Revenue volatility is an issue in California.**

California’s revenue system is highly dependent on personal income taxes (including taxes on capital gains), corporate taxes, and sales and use taxes. The income tax is a volatile revenue source because it relies on a narrow slice of taxpayers whose earnings tend to fluctuate with the economy (in 2008, 16 percent of tax filers—those with incomes above \$100,000—paid 84 percent of the tax). Sales and use taxes are also tied to economic fluctuations—they were hard hit in the recession. Moreover, compared to the rest of the nation, California relies less on a relatively stable revenue source, the property tax, because of Proposition 13.

HIGH AND RISING SERVICE DEMANDS

As the largest state in the nation and one of the largest economies in the world, California spends more than the average state.

- **California state government is a nearly \$200 billion enterprise.**

In the fiscal year ending June 30, 2010, the state spent \$218 billion, of which \$86 billion came from the state’s main discretionary fund, the General Fund. Another \$95 billion came from federal funds (thanks in part to a considerable infusion of short-term stimulus funds), \$24 billion from special funds, and \$13 billion from bond funds. Spending is concentrated in education (about 40 percent) and health care (about 30 percent). Some of the fastest-growing expenditure areas are in-home supportive services, developmental services, mental health, corrections, and debt service.

- **The bulk of state spending funds local government activities.**

About three-quarters of state spending goes to local governments for K–12 education, health and social services, public safety, and other programs. The remaining 25 percent finances state operations, including the University of California and California State University systems, correctional facilities, and administration.

EDUCATION DOMINATES STATE SPENDING



SOURCE: California Department of Finance. NOTE: "Other" includes tax relief, resources, environmental protection, state consumer services, and other expenditures.

- **California spends more in certain areas . . .**

Historically, many of California's public programs have had larger caseloads, or workloads, because of demographics—in particular, more school-age children and low-income families. Also, the state has made policy decisions to expand program eligibility and use in some areas—health and social services and higher education, for example. In addition, California has paid some public employees—such as those in K-12 education, public safety, and administration—more generously than other states, although the 2010 budget deal included significant public compensation reforms.

- **. . . but saves in others.**

In some programs, California's higher participation rates are offset by expenditures per case that are lower than in other states. Examples include K-12 and higher education, Medi-Cal, and CalWORKs. In some cases, such as K-12 education, higher salaries are offset by larger class sizes and lower staffing in general.

LOOKING AHEAD

Faced with enormous budget gaps during the recession, California relied heavily on short-term solutions (temporary state tax increases and federal stimulus funds). Unfortunately, the tax increases and stimulus funds will soon expire, and the state Legislative Analyst's Office projects ongoing annual budget gaps of \$20 billion or more. Policymakers will face many significant long-term challenges:

Pension funds and OPEBs. The state and many local governments pay monthly pensions to their retirees. In addition, retired public employees often receive health, dental, and other benefits collectively known as "other post-employment benefits" or OPEBs. Longer life expectancies and rising health care costs have made pensions and OPEBs a ballooning cost for state and local governments throughout the nation. The state's unfunded pension liabilities have been estimated at \$136 billion; they may be higher, depending on the modeling assumptions (including the choice of a discount rate). In addition, recent stock market declines may leave public pensions in need of additional contributions. The 2010 budget deal included major pension reforms, including higher employee contributions, but these reforms will affect only new hires.

Debt service. Given the pressures of an aging infrastructure, increasing population, and service demands, the state treasurer has estimated that voters will need to approve \$226 billion in general obligation bonds over the next 20 years. As a result, debt service costs may come close to 10 percent of projected revenues.

Tax reform. Californians may be loathe to reconsider certain aspects of their tax code, such as the progressivity of the income tax or restraints on the property tax. However, the economy is also shifting to areas such as services and Internet or catalog sales. Sensible modifications to the tax code (such as extending the sales tax to services) may improve efficiency, equity, and reliability.

Budgeting for volatility. Californians may also want to consider ways to budget for peaks and troughs in revenues, which appear to be a fact of life in the state. Improvements to budget forecasting could also help to orient voters and lawmakers to future needs. In particular, the state could expand the forecasting period from four or five years to ten years and make projections more transparent, highlighting the tough choices needed to maintain voters' priorities.

We invite you to dig deeper at ppic.org.

Related PPIC resources include:

Statewide Survey: Californians and Their Government

California's State Budget

California's Tax Burden

California's Debt: What Does It Pay For?

Public Bond Financing in California

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