

CALIFORNIA

BUDGET



CALIFORNIA'S BUDGET PICTURE BRIGHTENS, ALTHOUGH CHALLENGES REMAIN

After a decade of budget deficits, California's fiscal situation improved significantly in 2012. The passage of Proposition 30 in the November 2012 election temporarily increased sales and income taxes, providing \$6 billion a year to the state budget for several years. Voter approval of Proposition 39 raised corporation taxes primarily for out-of-state businesses, adding another \$1 billion annually in revenues. These new revenues and the state's budget actions improve the immediate budget outlook, and the improving economy allows for a rosier long-term budget forecast.

But California still faces fiscal challenges. The state's budget problems were exacerbated by the Great Recession, which hit the state hard. In 2009, state tax revenues plummeted 14 percent from the previous year, compared to 9 percent nationally. This dramatic drop widened the gaps between revenues and expenditures—gaps the state had been wrestling since 2000. The legislature responded with an array of actions including temporary tax increases, fee increases, funding shifts, and budget cuts—all at a time of increased demand for Medi-Cal and other public assistance programs. This has left the state with significant liabilities that will need to be addressed in the future, including budgetary debt, debt service obligations, and unfunded retirement costs. Recent PPIC Statewide Surveys show voters closely divided about whether to raise taxes and increase government services or cut spending and reduce service levels.

BUDGET SURPLUS PROJECTED TO BEGIN IN 2014–15



SOURCE: Legislative Analyst Office's Fiscal Outlook projections at the start of each budget cycle and estimates through FY 2017–18.
NOTES: Figure does not show budget solutions to close the gap in past years. For example, in November 2011 the LAO estimated a \$12.8 billion budget gap for fiscal year 2012–13. The 2012–13 Budget Act and Proposition 30 mostly closed this. The LAO now estimates that unless corrective action is taken, the state will close 2012–13 with a \$943 million deficit because spending is higher and tax receipts are lower than projected in the enacted budget.

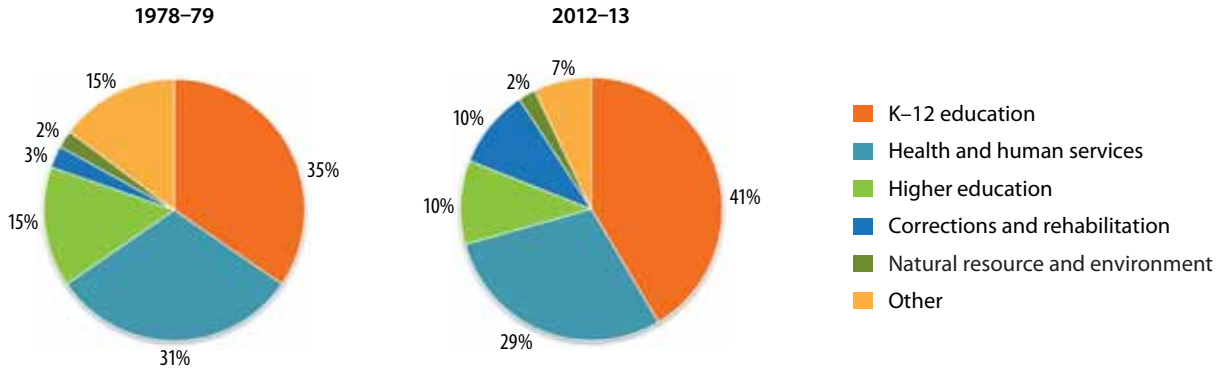
HOW DOES THE STATE MANAGE ITS MONEY?

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.

- **California's state government is a more than \$200 billion enterprise.**

In the fiscal year ending June 30, 2012, the state spent \$213 billion, of which \$87 billion came from the state's main discretionary fund, the General Fund. Another \$78 billion came from federal funds. Special funds supplied \$35 billion, and \$13 billion came from bond funds. The vast majority of General Fund spending is in three areas: K-12 and higher education (more than 50 percent), health and social services (about 30 percent), and corrections (10 percent).

EDUCATION HAS LONG DOMINATED GENERAL FUND SPENDING



SOURCE: California Department of Finance, Chart C and 2012-13 enacted budget summary chart 4.
 NOTES: Figure includes only General Fund expenditures. "Other" includes business, transportation, and housing; tax relief; state consumer services; and other expenditures.

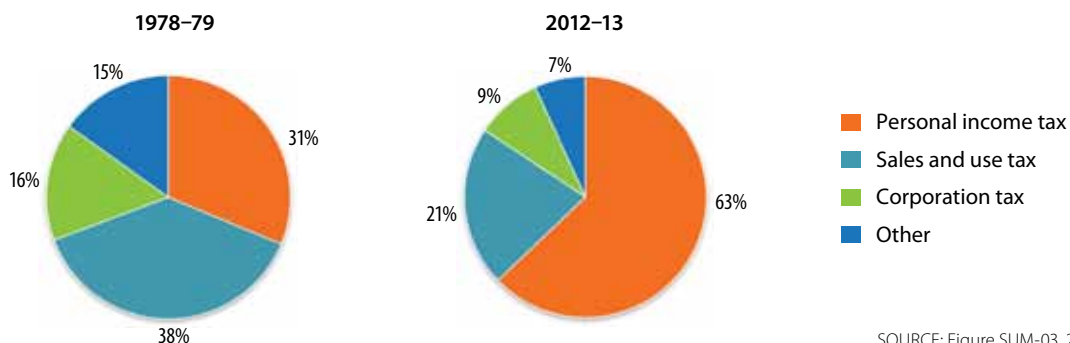
- **California's tax burden is above average.**

Even before voters passed Proposition 30, California had the highest state sales tax of any state and the third-highest marginal personal income tax rate, according to the Tax Policy Center (only Oregon and Hawaii tax income at a higher rate). Thanks to Proposition 13, California's statewide property tax rate is low, though home prices are higher in California than in other states. In fiscal year 2009-10, the latest year for which comprehensive data are available, California's state and local governments collected \$252 billion, or \$6,752 per capita, from taxes, fees, charges, and other miscellaneous sources. By this measure, California had the 11th-highest tax burden in the nation. However, as a high-income state, California has a large tax base. When state and local general revenues are expressed as share of economic activity or personal income, California's ranking edges down to 15th nationally.

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

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'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 volatile because it relies heavily on a narrow slice of taxpayers whose earnings tend to fluctuate with the economy (in 2009, 15 percent of tax filers—those with incomes above \$100,000—paid 80 percent of this tax). Sales and use taxes are also tied to economic fluctuations—these revenues plunged during the recession. Moreover, the passage of Proposition 13 left California less reliant on a relatively stable revenue source, the property tax.

CALIFORNIA'S REVENUE SOURCES HAVE CHANGED OVER TIME



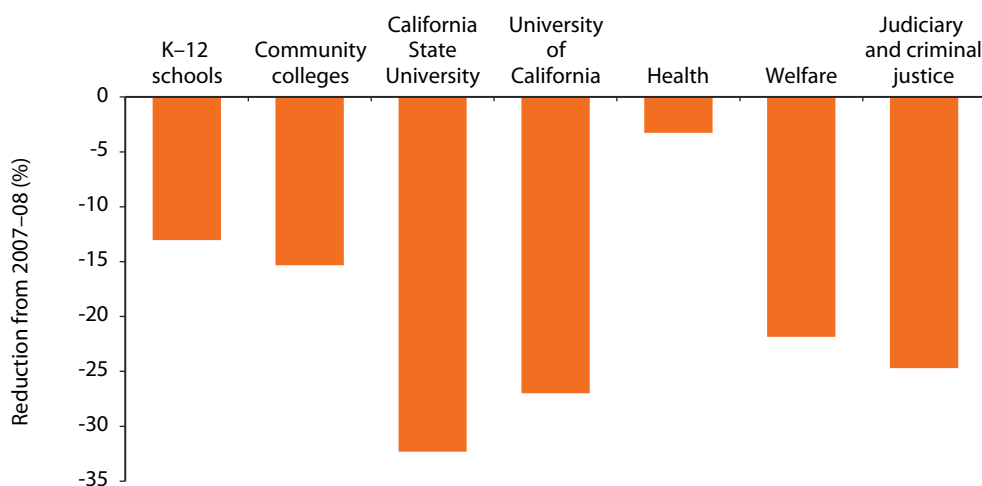
SOURCE: Figure SUM-03, 2012-13 Enacted Budget.
 NOTE: Figure includes only General Fund revenues.

LOOKING AHEAD

Although the budget picture is brightening, balancing the budget remains a significant short-run challenge. According to the Legislative Analyst's Office, the state will have a \$1.9 billion gap between expenditures and revenues for the budget year that begins in July 2013. This gap is much smaller than in the past, but the immediate focus is likely to remain on spending reductions, not budget increases. Over the longer run, if projected surpluses materialize, the state can restore some of the cuts made during the recession and address the long-term liabilities that have accumulated over the past decade.

Restoring past budget cuts. As the economy improves, the pressure to restore funding to programs that have seen years of budget reductions will likely be intense. Overall, General Fund spending fell 7 percent from 2007–08 to 2012–13. Some funding cuts have been replaced by revenue from other sources—for instance, a portion of the cuts to the state's colleges and universities was offset by higher tuition charges. But most programs are smaller now than they were before the recession, and the pent up desire to address unmet needs is significant.

MOST PROGRAMS HAVE EXPERIENCED MAJOR GENERAL FUND CUTS SINCE 2007–08



SOURCE: The 2012–13 Budget: California Spending Plan, Legislative Analyst's Office, September 2012. California Spending Plan 2009–10, November 2009.
NOTE: Change is calculated as the difference between the 2012–13 Budget Act and actual 2007–08 spending levels.

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 OPEBs and pensions a ballooning cost for state and local governments throughout the nation. California has an estimated \$62 billion unfunded OPEB liability. In addition, the state's unfunded pension liabilities have been estimated at \$181 billion; they may be higher, depending on the modeling assumptions (including the choice of a discount rate). Governor Brown signed a pension reform package in 2012 that reduces the state's liabilities by about \$10 billion.

Outstanding debt. Over the past decade the state closed most of its budget gaps through temporary measures such as payment deferrals, bonds, and loans from special funds. This has created an outstanding budgetary debt of \$35 billion. In addition, the state borrowed \$10 billion from the federal government to cover unemployment benefits and must restore \$10 billion to K–12 education after making cuts during the recession. Finally, the state is responsible for about \$5 billion in annual capital and interest costs on \$81 billion in general obligation and lease revenue bonds for infrastructure and long-term investments.

Tax reform. Tax reform has been on the policy agenda in Sacramento for several years. Voter approval of Proposition 39, which fixed a loophole in the corporate income tax law, suggests voters are willing to consider some revisions to the system. One proposal is to extend the sales tax to areas such as services. PPIC Statewide Surveys indicate that a majority of Californians oppose taxing services. Our surveys also show that while most Californians support Proposition 13’s restraints on the residential property tax, they would support a “split roll” tax, which would raise commercial property taxes.

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. The PPIC Statewide Survey finds that most Californians favor using some of the future budget surplus to build a “rainy day” fund that would protect the state from revenue volatility. 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 voter priorities.

We invite you to dig deeper at ppic.org. Related PPIC resources include:

California’s State Budget

PPIC Statewide Survey: Californians and Their Government

California’s Debt: What Does It Pay For?

Consumption Tax Options for California

Contact a PPIC expert:

Paul Warren

Margaret Weston

This publication is part of PPIC’s Planning for a Better Future project.



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Public Policy Institute of California
500 Washington Street, Suite 600
San Francisco, CA 94111
T 415 291 4400 F 415 291 4401

PPIC Sacramento Center
Senator Office Building
1121 L Street, Suite 801
Sacramento, CA 95814
T 916 440 1120 F 916 440 1121

www.ppic.org

CA2025

The series is funded by PPIC’s Donor Circle and the S. D. Bechtel, Jr. Foundation
v0113