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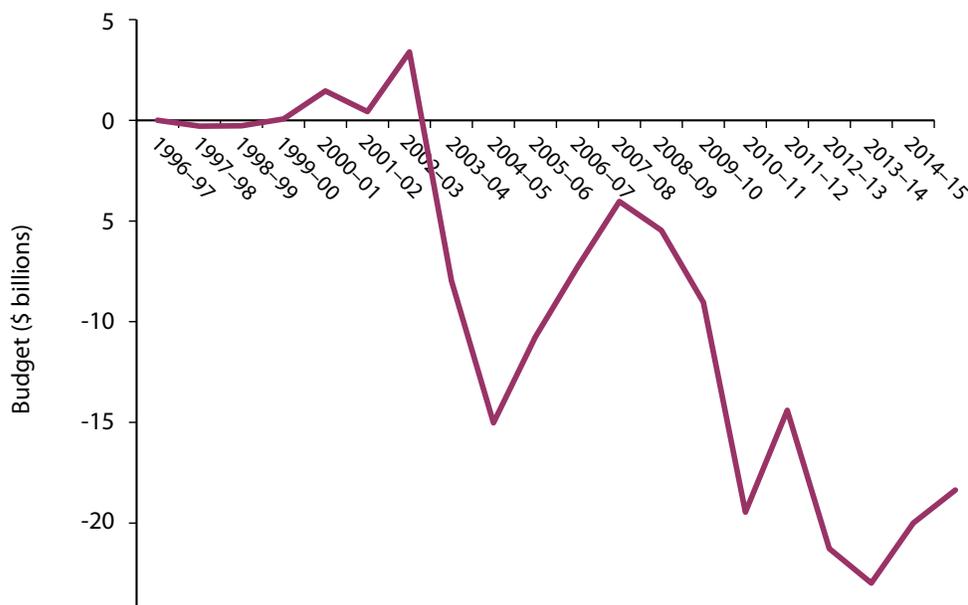
PUBLIC POLICY
INSTITUTE OF CALIFORNIA

CALIFORNIA'S BUDGET PROBLEMS ARE LONG STANDING

To many Californians, the state's current budget woes are distressingly familiar. California contended with huge budget shortfalls during the recessions of the 1980s and 1990s. And the state has struggled to live within its means since the recession of 2001–2002, when tax receipts dropped by 15 percent in a single fiscal year. Since then, California has faced multibillion-dollar gaps between projected revenues and expenditures at the start of every budget cycle.

Despite signs of early recovery in the state and national economies, California will continue to face hard budget choices in the near term. Nevertheless, the current crisis may also offer opportunities. In particular, Californians are unusually attuned to the state's finances—since the fall of 2008 the PPIC Statewide Survey has consistently shown that more than three-quarters of residents characterize the state's budget imbalance as a "big problem." This public attention may help policymakers address California's perennial budget woes and confront longer-term fiscal challenges, such as costly retiree health benefits and rising debt.

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 2015.

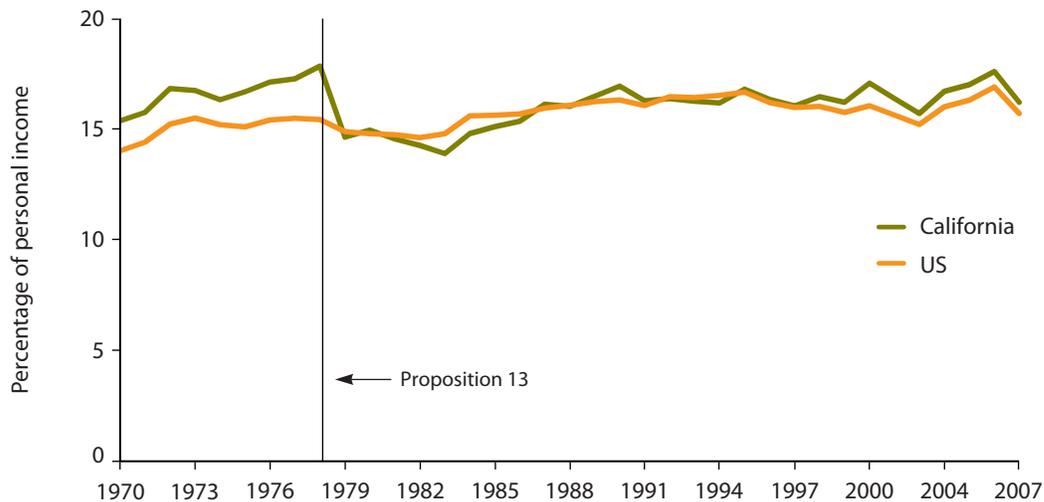
CALIFORNIA HAS A NARROW AND VOLATILE REVENUE BASE

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 flattening and simplifying California's revenue system by broadening tax bases, lowering tax rates, and eliminating certain tax preferences.

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

In fiscal year 2006–2007, the latest year for which comprehensive data are available, California’s state and local governments collected \$255 billion, or \$7,029 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 20th 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, corporate taxes, and sales and use taxes. The income tax is a volatile revenue source because it relies on a narrow slice of taxpayers (in 2007, the top 1% of filers paid 48% of the tax) whose earnings tend to fluctuate with the economy. Sales and use taxes are also subject to economic fluctuations—they have been hard hit in the current 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.

WHY DO WE KEEP GETTING INTO THIS MESS? HIGH AND RISING SERVICE DEMANDS

As the largest state in the nation and one of the largest economies in the world, it is perhaps not surprising that California spends more than the average state. Less well known are the reasons for California’s higher expenditures.

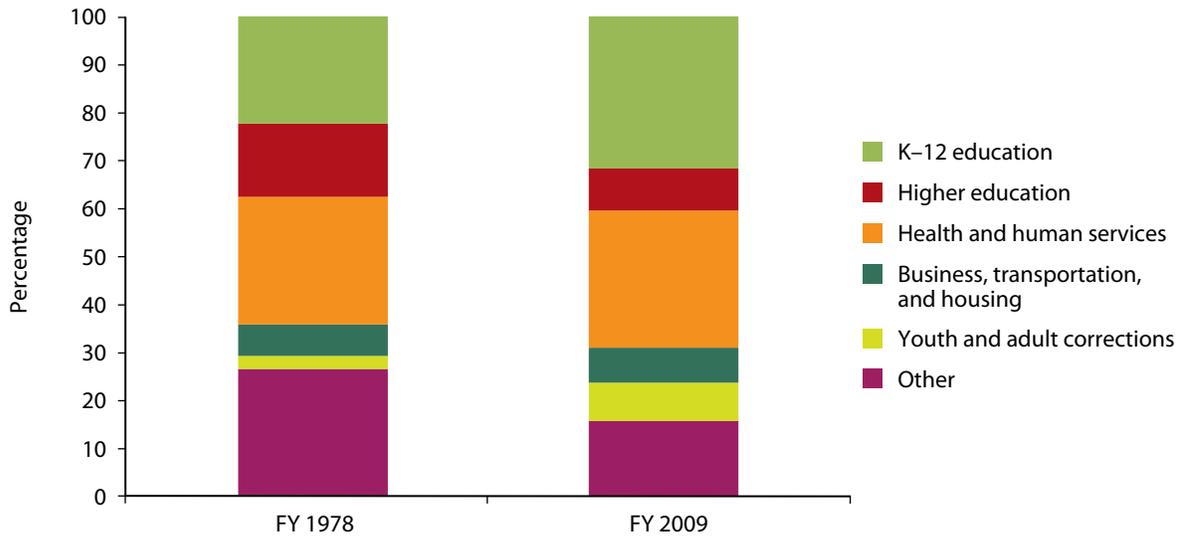
- **California state government is a nearly \$200 billion enterprise.**

In the fiscal year ending June 30, 2009, the state spent \$196 billion, of which \$91 billion came from the state’s main discretionary fund, the General Fund. Another \$73 billion came from federal funds (including stimulus funds), \$24 billion from special funds, and \$8 billion from bond funds..

- **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 . . .**

Many of California's public programs have larger caseloads, or workloads, because of demographics—in particular, more school-age children and low-income families. Also, the state has also made policy decisions to expand program eligibility and use in some areas—health and social services and higher education, for example. In addition, California pays some public employees—such as those in K-12 education, public safety, and administration—more generously than other states do.

- **. . . 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

California's current budget problems significantly distract from long-term planning. But the state will face many fiscal challenges in the years ahead. Some key areas to consider:

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. A recent report commissioned by the State Controller's Office estimated California's state liabilities at \$51.8 billion. The state's Public Employee Post-Employment Benefits Commission estimated combined state and local OPEB liabilities at \$118 billion. Recent stock market declines may leave public pensions in need of additional contributions.

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 reach 10 percent of projected revenues.

The two-thirds requirement. California is one of three states to demand a two-thirds vote for passing a budget. Research suggests that political or fiscal institutions such as supermajority voting requirements have limited effects on overall spending. However, in California, the two-thirds rule is a roadblock to timely budgets and, perhaps, to taking on difficult issues.

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, for example, to services and Internet or catalogue 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 Debt: What Does It Pay For?

Public Bond Financing in California

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This publication is part of PPIC's [Planning for a Better Future](#) project.



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