

CALIFORNIA

BUDGET



PPIC

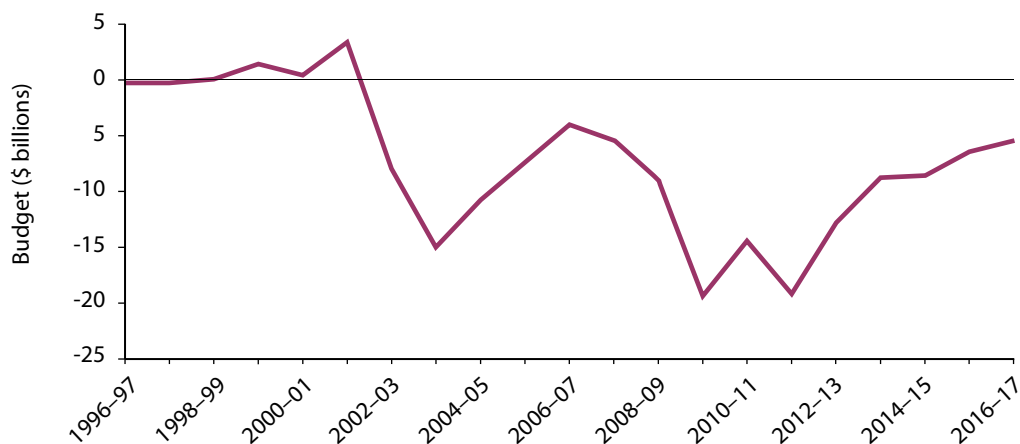
PUBLIC POLICY
INSTITUTE OF CALIFORNIA

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 national drop. Slow economic recovery and the expiration of temporary tax increases widened the state's budget gap: from fiscal years 2008 through 2011 the state faced record budget shortfalls of around \$131 billion, roughly a third of General Fund expenditures. The legislature responded with deep budget cuts at a time of increased demand for Medi-Cal and other public assistance programs. Revenue projections turned out to be overly optimistic, resulting in even deeper mid-year cuts to social services and K-12 and higher education.

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 2000. It contended with huge shortfalls during the recessions of the 1980s, 1990s, and early 2000s. 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. Recent PPIC Statewide Surveys suggest that Californians are aware of the state's fiscal problems and the impact of state budget cuts on local government services.

BUDGET SHORTFALLS WILL CONTINUE TO BE LARGE



SOURCE: Legislative Analyst Office's Fiscal Outlook projections at the start of each budget cycle and estimates through FY 2016.

NOTES: Figure does not show budget solutions to close the gap in past years. For example, in November 2010 the LAO estimated a \$19.2 billion budget gap for fiscal year 2011-12. The 2011-12 Budget Act closed this gap (which had increased to \$26.6 billion). However, the LAO now estimates that there is an outstanding budget gap of \$3 billion for 2011-12 because tax receipts are lower than projected. The Department of Finance estimates a closing 2011-12 deficit of \$4.1 billion.

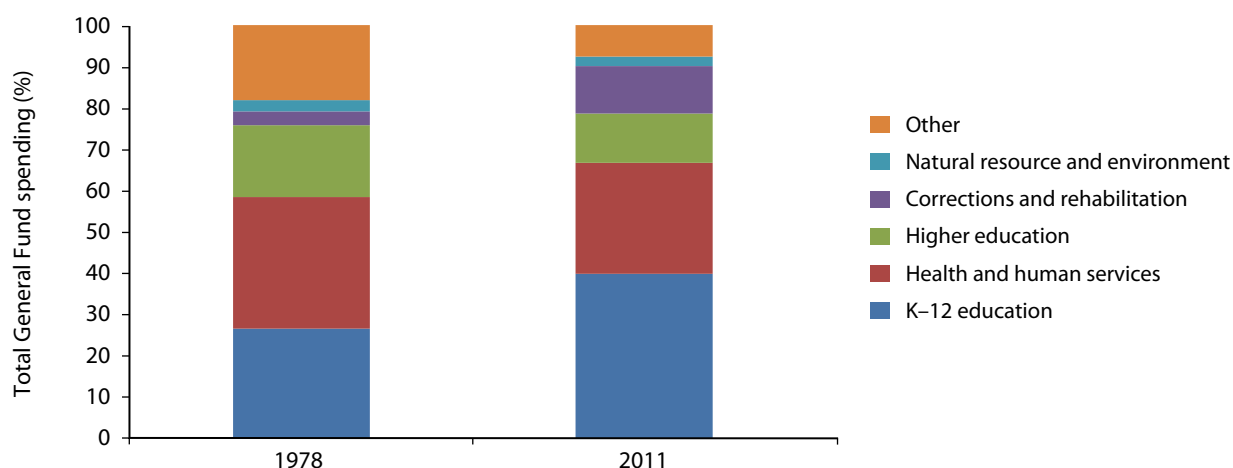
HOW DOES THE STATE MANAGE ITS MONEY?

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, 2011, the state spent \$227 billion, of which \$91.5 billion came from the state's main discretionary fund, the General Fund. Another \$91.5 billion came from federal funds (thanks in part to a large infusion of short-term stimulus funds). Special funds supplied \$31 billion, and \$13 billion came from bond funds. The vast majority of General Fund spending is for K-12 and higher education (more than 50 percent), health and social services (about 30 percent), and corrections (11 percent).

EDUCATION DOMINATES GENERAL FUND SPENDING



NOTES: Figure includes only General Fund expenditures. "Other" includes business, transportation, and housing; tax relief; state consumer services; and other expenditures. SOURCE: California Department of Finance, Chart C-1.

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

In fiscal year 2008–09, the latest year for which comprehensive data are available, California's state and local governments collected \$251 billion, or \$6,788 per capita, from taxes, fees, charges, and other miscellaneous sources. By this measure, California had the 11th-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 21st 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 on a narrow slice of tax-payers 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 the tax). Sales and use taxes are also tied to economic fluctuations—they were hard hit in the recession. Moreover, since the passage of Proposition 13, California has been less reliant than the rest of the nation on a relatively stable revenue source, the property tax.

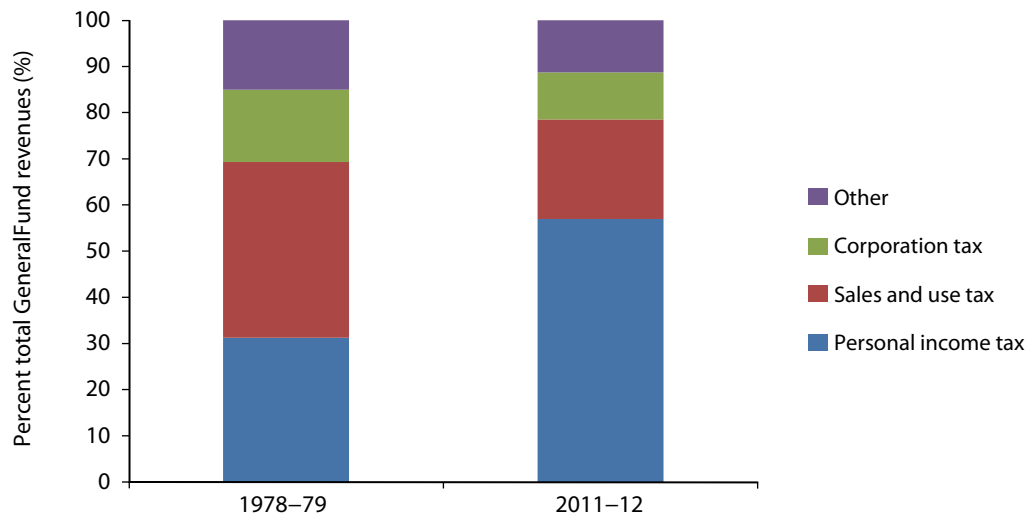
THE STATE-LOCAL FISCAL RELATIONSHIP IS CHANGING

In a process known as realignment, responsibility for key services and programs is shifting from the state to local governments. Funding these responsibilities over the long term may pose challenges.

- **The bulk of state spending goes to local government activities.**

About 70 percent of general state revenues are transferred to local governments and school districts for K-12 education, health and social services, public safety, and other programs. The remaining 30 percent finances state operations, including the University of California and California State University systems, correctional facilities, and administration.

CALIFORNIA'S REVENUE SOURCES HAVE CHANGED OVER TIME



SOURCE: State of California Revenues Historical Data, Legislative Analyst's Office (www.lao.ca.gov/laoapp/LAOMenus/lao_menu_economics.aspx).
NOTE: Figure includes only General Fund revenues.

- **But local governments' responsibilities are increasing.**

California recently began implementing a major shift of responsibility from the state to the counties for nonviolent, nonserious, nonsexual felony offenders. Other realigned programs include court security, substance abuse treatment, and mental health and child welfare services.

- **Funding realigned programs remains a challenge.**

In 2011-12, the state directed a portion of the existing state sales tax (\$5.1 billion) and vehicle license fee (\$453 million) to local governments to pay for their new responsibilities. Many believe that these funds will be insufficient or that the state may reduce funding if its budget problems worsen; these concerns are bolstered by the fact that the shift decreases K-12 funding. Some propose giving local governments more power to raise local revenues, and Governor Brown wants voters to consider a permanent funding source for corrections in November 2012.

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 much of the stimulus funding expired June 30, 2011, and the Legislative Analyst's Office projects ongoing annual budget gaps of \$5 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 \$181 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. Governor Brown has proposed pension reform that includes raising the age of retirement and switching to a hybrid pension and 401(k) model for new employees.

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 \$81 billion in general obligation and lease revenue bonds for infrastructure and long-term investments.

Tax reform. Californians may be unwilling 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 voter priorities.

Putting fiscal reform on the ballot. Multiple efforts are under way to collect enough signatures to place tax increases and fiscal reform measures on the November 2012 ballot. California voters will likely be asked to decide on the level of governmental services they desire and how much they are willing to pay for those services.

We invite you to dig deeper at ppic.org.

Related PPIC resources include:

Untangling the State-Local Relationship (a PPIC initiative)
PPIC Statewide Survey: Californians and Their Government
California's State Budget
California's Debt: What Does It Pay For?

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