Stanford University • October 2009

SIEPR policy brief

Stanford Institute for Economic Policy Research

on the web: http://siepr.stanford.edu

California's Mounting Budget Mess

By Joe Nation

At the end of July, California state government ended what was likely the most difficult and tumultuous budget in the state's history. (It is however, certainly not the last budget crisis California will face. There is evidence that a budget meltdown has again started.) With plummeting revenues, and continued upward pressure on expenditures, the state was forced to close a nearly $24 billion budget shortfall.

California's 2009-2010 (FY 2010) budget dance was abnormally protracted. With the onset of the international financial crisis in September 2008, state leaders had warning that the 2009-2010 budget would be difficult. But because of the severity and speed of the financial crisis, they were forced not only to cut future spending but also to cut current (i.e., 2008-2009) spending from the budget that was enacted in the summer of 2008. Legislators and the governor initially were in agreement on a budget package in February, but that deal was torpedoed when voters rejected virtually the entire package in a May special election. Finally, in late July, with California issuing IOUs and the pain of some budget cuts becoming apparent, the governor and the legislature concluded the 2009-2010 budget.

This policy brief addresses several issues:

- How did California close this recent $24 billion budget gap?
- What is the likelihood that the state will need to enact mid-year budget reductions in the next year?
- What are the long-term pressures on the state budget?
- What prospects, if any, exist for budget and other reform measures?

The 2009–2010 Budget Bill

California's enacted 2009-2010 General Fund Budget contains $86.2 billion in total resources and $84.6 billion in expenditures and projects a fund balance of

continued on inside...

About the Author

Joe Nation directs the graduate student practicum in public policy at Stanford University, where he teaches climate change, health care policy, and public policy. He is also a Principal at Climate Action Partners, where he provides carbon advisory services, decarbonization project development and management, offset portfolio management, community renewable energy assessment and data analysis for multiple clients.

Nation was recently appointed by Governor Schwarzenegger to the Allocation Advisory Committee, which will establish the carbon allocation guidelines for the state's cap and trade carbon system. He previously served on California's Market Advisory Committee, which recommended a design for the market for greenhouse gas emissions trading.

Nation earned a B.A. in Economics, German and French at CU, and subsequently a Masters in Foreign Service from Georgetown University, where he graduated with honors. He received a Ph.D. in Public Policy Analysis from the Pardee RAND Graduate School.

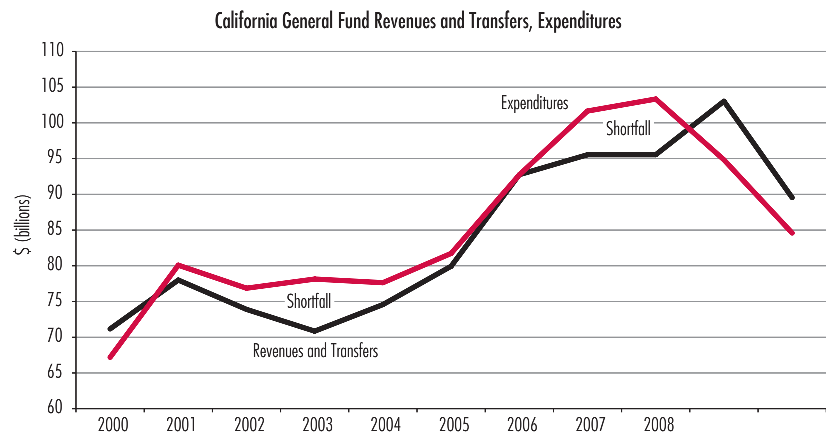
$1.6 billion. Figure 1 illustrates actual revenues and transfers and expenditures since FY 2000. As indicated, in eight of 11 years, expenditures exceeded revenues and transfers. The cumulative shortfall from FY 2000-2010 totals just under $14 billion.

More than two-thirds of the FY 2010 fund balance of $1.6 billion is designated for encumbrances, leaving a reserve of only $500 million for economic uncertainties. In fact, California has rarely maintained an unrestricted reserve of appropriate size, as illustrated in Figure 2. The average unrestricted reserve share of General Fund expenditures from 2001-2010 is 1.9 percent. Although there are no minimum required reserves for the state budget, many have suggested at least 3 percent or more. In fact, California school districts must maintain this minimum reserve level or be subject to takeover by the state.

How did the governor and the legislature close a budget gap that reached about one-fourth of recent General Fund expenditures? In short, the FY 2010 budget solutions consist of significant cuts in education and other categories, limited revenue increases, and traditional accounting gimmicks that push much of the problem into future years. Table 1 lists FY 2010 budget solutions totaling $23.7 billion by type (expenditure reduction, revenue and transfer increases, and borrowing). It includes other characteristics associated with these solutions, such as their effects on out-year budgets.

As Table 1 indicates, most of the $18.0 billion in expenditure reductions are either uncertain (e.g., unspecified reductions in state Medi-Cal spending), temporary (e.g., delaying state payroll by one day), or require repayment in subsequent years (K-14 education funding). Similarly, the $3.5 billion in increased revenues and transfers are essentially cash flow devices only. For example, about one-half of the increase is due to increased payroll withholding, which is temporary. Finally, of the $2.2 billion in borrowed "budget solutions," $1.9 billion must be repaid (with interest) within three years to local government. One accounting measure that was considered, but rejected, required an extra property tax payment in calendar year 2009 because there was not agreement on when that extra payment would be returned to property owners.

Figure 1 — Revenues and Transfers, Expenditures, FY 2000-FY 2010



Source: Dept. of Finance
Note: 2010 data are planned, not actual.

Figure 2 — Planned General Fund Reserve Share of Expenditures, FY 2001-FY 2010

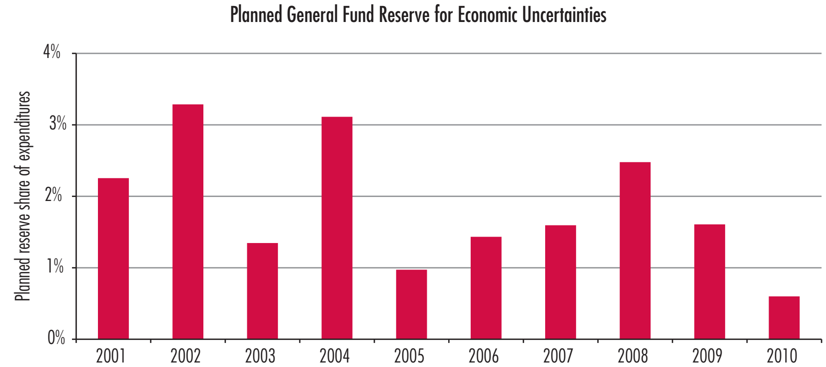


Table 1 — General Fund Budget Solutions, FY 2010

Expenditure Reductions

Budget Solution	Amount (millions)	Effect on Out-Year Budgets	Savings
Reduces K-14 education, related funding	6,500	Repaid in future years	Temporary; $3.5 billion must be repaid in FY 2011
Reduces UC, CSU funding	2,000	None	Yes
Assumes reduced federal Medi-Cal funding requirement	1,000	None	Uncertain
Reduces state Medi-Cal funding	323	None	Uncertain (savings unspecified)
Reduces developmental services funding	284	None	Yes
Reduces other health care savings	595	None	Yes
Reduces other social services	1,000	None	Yes
Shifts local redevelopment funds to General Fund	1,700	None	Yes
Suspends non-education mandates	66	None	Yes
Delays June 30, 2010 payroll for state employees one day	937	Increases FY 2011 by roughly equivalent amount	Temporary
Assumes legislature rejects labor contract	210	None	Uncertain
Reduces CalPERS retiree and health contributions	150	None	Yes
State employee furloughs	425	None	Yes
Reduces criminal justice, court funding	1,000	None	Yes
Assumes “spillover” gasoline taxes available to General Fund, shifts other funds	900	$135 plus interest must be repaid to State Highway Account within three years	Yes
Other	910		
Total	**18,000**		

Increased Revenues and Transfers

Budget Solution	Amount (millions)	Effect on Out-Year Budgets	Savings
Increases payroll withholding	1,700	None	Temporary (must be returned to taxpayers)
Assumes sale of State Compensation Insurance Fund	1,000	None	Uncertain
Other	200	None	Yes
Total	**3,500**		

Increased Borrowing

Budget Solution	Amount (millions)	Effect on Out-Year Budgets	Savings
Suspends Proposition 1A, borrows from local government	1,900	Must be repaid with interest	Temporary
Other	300	None	Uncertain
Total	**2,200**		

Source: Legislative Analyst’s Office, July 29 Budget Package, July 29, 2009 (http://www.lao.ca.gov/2009/bud/july_09_budget_package/july_2009_budget_package_072909.pdf.)

Likely 2009-2010 Mid-Year Cuts

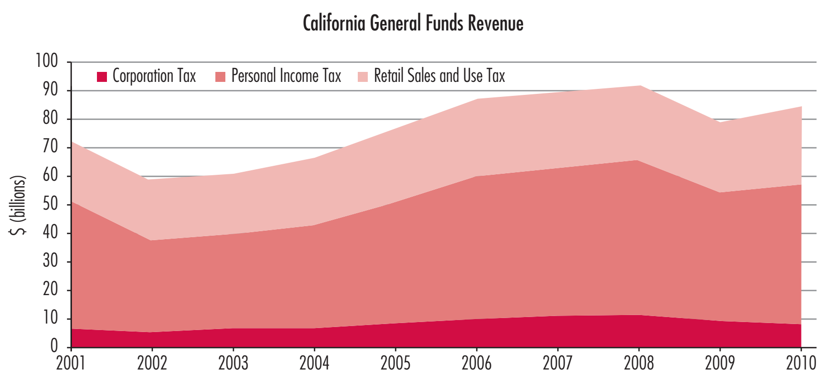
With this high number of budget solutions that are temporary or speculative, or that reflect borrowing that must soon be repaid, it seems that the FY 2010 budget solution was indeed simply "kicking the can down the road." Those "non-budget solutions" are likely to require significant mid-year cuts in the current fiscal year. In fact, the FY 2010 budget prognosis may be even worse, according to revenue data from the State Controller's Office. Even with only a modest revenue drop, mid-year cuts are likely considering the $500 million unrestricted reserves for economic uncertainties, as discussed above.

Much of the basis for California's frequent budget crises is its overdependence on Personal Income Tax (PIT) revenues. Figure 3 illustrates both the wide swings in revenue to California state government, and the importance of PIT, in particular, in providing general funds. Between 2001 and 2010, PIT revenues ranged from $32.7 billion in FY 2002 to $52.0 billion in FY 2007.

This variation in PIT revenues is even more stunning on a year-to-year basis, as illustrated in Figure 4. From 2001-2002, for example, PIT revenues fell more than 25 percent. Two years later, revenues jumped nearly 15 percent. The decline from FY 2008 to FY 2009 registered 16 percent. There is also significant volatility in the Corporate Income Tax (CIT), which ranged from -23 percent to 28 percent. But it is in absolute terms about one-fifth the PIT, and CIT revenue has been more stable over the last several years. Sales and Use Taxes (SUT) are the most stable, with year-to-year changes of -3 percent to +8 percent (except FY 2010, when a +12 percent change is projected).

In short, California remains highly dependent on very volatile revenue sources, and it is not clear that PIT revenues will recover as projected in Figure 4. Although the fiscal year has just begun, data from the State Controller's Office indicate that total revenues are down $211 million in July and August, the first two months of FY 2010. Personal income tax revenues are $276 million lower than projections, casting doubt on the 7.9 percent increase included

Figure 3 — California General Fund Revenues, FY 2001-FY 2010



Source: Office of the Legislative Analyst. Note: 2010 figures are projections.

Figure 4 — Change in Personal Income Tax Revenues to California General Fund, FY 2002-FY 2010

Source: Office of the Legislative Analyst. Note: 2010 figures are projections.

in the FY 2010 budget. Sales and use taxes are unexpectedly $128 million above projections. However, that may be due to the "Cash for Clunkers" program and its summer success. If that is the case — and if PIT revenues continue to underperform about 5 percent — that alone opens a $5.8 billion shortfall in FY 2010. Similar weakness in CIT and SUT could exacerbate that shortfall.

As California has become more dependent on volatile revenue sources, it has become far more difficult to forecast revenues accurately (Figure 5). As indicated, it is not uncommon for revenue volatility to result in forecast errors of 5 percent or more. In FY 2003, for example, actual revenues were 10 percent below those forecast. In 2009, that increased to 18 percent. In FY 2006, actual revenues exceeded forecast revenues by 10 percent. (Legislators and the governor then increased spending $2.7 billion above their initial plan, or about one-third the unexpected revenue increase.)

Finally, even in years with lower than expected revenues, the legislature seems to spend more than it planned (Figure 6). As indicated below, actual expenditures exceeded planned expenditures in seven of the nine years.

Figure 5 — Change in Revenues to California General Fund, FY 2001-FY 2010

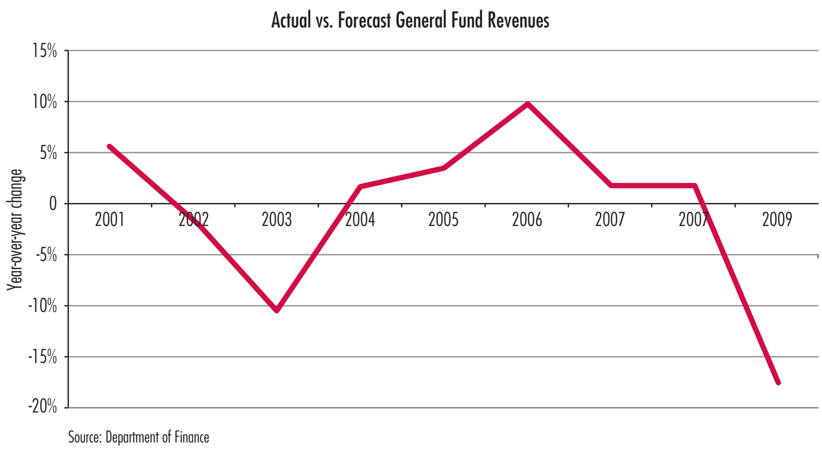
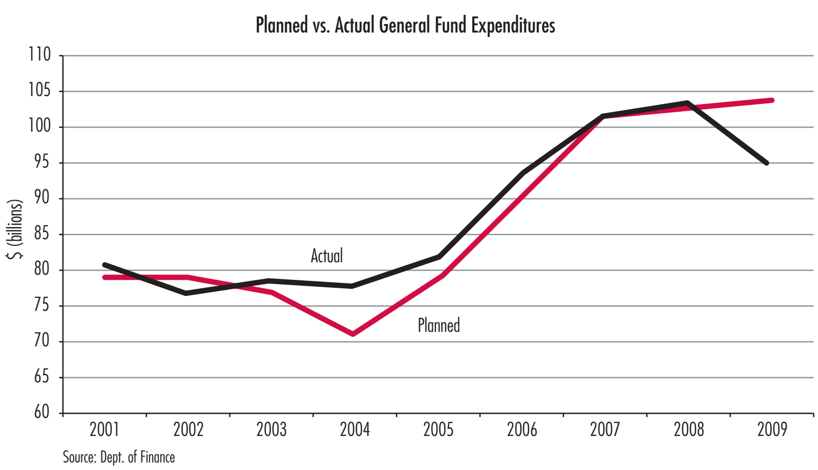


Figure 6 — Planned vs. Actual General Fund Expenditures, FY 2001-FY 2009



Long-Term Pressures on California's Budget

Consistent focus on short-term budget crises has diverted attention from far more critical long-term budget problems, particularly state liabilities, such as pension and health care liabilities, and bond and other obligations.

Budget-Related Liabilities

The discussion above briefly described several budget "solutions" from the FY 2010 year and their impacts in upcoming budget years. For example, the FY 2010 budget contained a $6.5 billion cut to K-14 education. (The total required re-payment from current or recent education budget cuts is estimated at $11.2 billion and will be repaid over a several year period.)[1] But much of that must be repaid, starting

1 Legislative Analyst's Office, July 29 Budget Package, July 29, 2009 (*http://www.lao.ca.gov/2009/bud/july_09_budget_package/july_2009_budget_package_072909.pdf.)*

with an estimated $3.5 billion in FY 2011. Similarly, because the budget solution delayed payroll for some employees by one day, that $937 million must be repaid in FY 2011 (unless, of course, the payroll date is delayed a second time). And in the next three years, the state must repay local governments — with interest — for $1.9 billion in borrowed funds in the current fiscal year. In total, the Legislative Analyst's Office has estimated the value of all budget-related liabilities at more than $35 billion[2] (Table 2).

Table 2 — Budget-Related Liabilities ($ millions)

Liability	Amount ($ billions) on June 30, 2008
Employee Pay and Benefit Deferrals	937
Proposition 98	6,300
Special Fund Budgetary Loan Repayments	2,000
Local Government Reimbursements	1,000
Education Reimbursements	1,500
Quality Education Investment Act (QEIA) Obligations	2,100
K-12 Revenue Limits and Proposition 98 Maintenance Factor [a]	11,200
Proposition 1A Repayment	2,000
Economic Recovery Bonds (ERBs), authorized by Proposition 57	8,000
Total	**35,037**

a The legislature can reduce this by reducing its maintenance factor obligation.

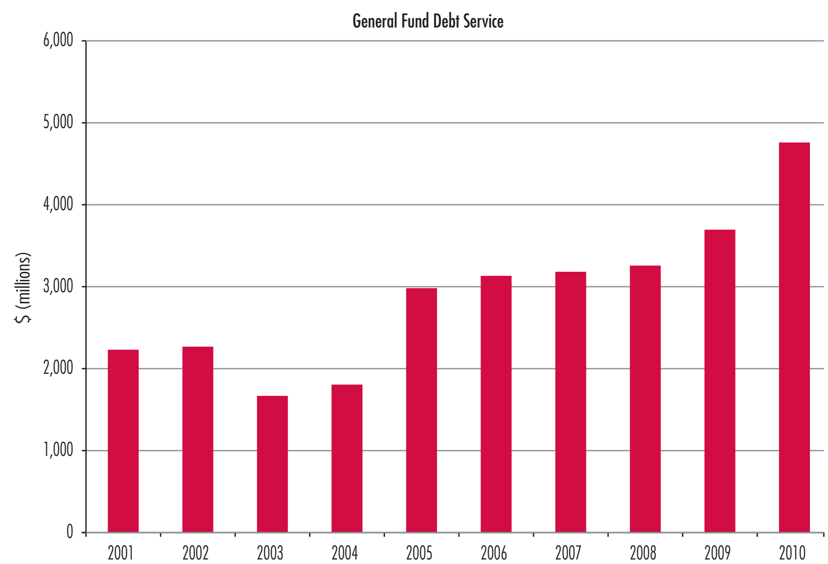
Debt Service

In addition to these budget-related liabilities, the state has liabilities in two significant areas: interest on its debt, and pension and health care obligations. Currently, debt-related liabilities, principally from bonds for infrastructure, total about $69 billion. General Fund debt service in FY 2010 is about $4.8 billion (Figure 7); total debt service for all funds is now $5.0 billion. Note that General Fund debt service has increased from just over $2 billion in FY 2001 to nearly $5 billion in FY 2010. (As a point of reference, California's expenditures on non-bond related higher education total $9.8 billion in FY 2010.) General Fund debt service share of total expenditures increased from a low of 2.1 percent in 2003 to 3.9 percent in 2009. That figure jumps to an estimated 5.6 percent in 2010, but is unlikely to increase significantly in the near future given the state's limited borrowing capacity. However, an agreement to issues bonds for water supply improvements could change that significantly.

Retiree Pension and Health Care Obligations

Retiree pension and health care obligations are significantly larger than budget- and debt-related liabilities. According to the Legislative Analyst's Office, net pension and health care obligations for retirees exceeded more than $100 billion in July 2008, as detailed in Table 3.

Figure 7 — General Fund Debt Service, FY 2001-2010



Source: Legislative Analyst's Office. Note: 2010 is a projection.

2 July 30, 2009, letter from LAO to Assemblymember Juan Arambula.

Table 3 — State Retiree Pension and Health Care Liabilities

Liability	Amount ($ billions) on June 30, 2008
California Public Employees' Retirement System (CalPERS)	21
California State Teachers' Retirement System (CalSTRS) [a]	21
State government and CSU retiree health care	48
University of California (UC) Retirement Benefits [b]	13
Total	**103**
Estimated market decline effect since 2008	30
Grand Total	**133**

a There is some local obligation, so the state share may be overstated.

b Estimated based on July 30, 2009, letter from LAO to Assemblymember Juan Arambula.

There have been suggestions that total state pension and retiree health care liabilities may be significantly greater. For example, some have suggested informally that the net total liability for CalPERS and CalSTRS could reach $300 billion[3] because PERS and STRS have discounted their liabilities at an excessively high rate.

There is, of course, tremendous political pressure to ignore the pension and health care liability issues. For example, in a recent opinion piece, the head of the California Federation of Teachers argued that "actuarial projections upon which payments are based are highly speculative" and that pre-funding made no sense.[4]

The total of California's budget-related, debt service, and state retiree and health care obligations amounts (conservatively) to $237 billion and could be, according to some pension observers, more than double that amount.

Prospects for Budget and Other Reforms

The search for budget reform predictably has resulted in partisan solutions, with Democrats arguing to lower the threshold for raising taxes/passing the budget from two-thirds to 50 percent and Republicans arguing for greater spending constraint, such as a rainy day fund or mandatory reserves. More thoughtful reform includes a focus on minimizing the revenue volatility described above. For example, the Commission on the 21st Century Economy is set to unveil its suggestions for minimizing revenue volatility and promoting economic growth. Under that plan:

- The number of tax brackets would be reduced from six to two, a tax rate of 2.75 percent for income up to $56,000 for joint filers ($28,000 single filers) and 6.50 percent for incomes above that amount.
- Credits would be eliminated (except for the other states' tax credit).
- Deductions would be curtailed; itemized deductions would be limited to mortgage interest, property taxes, and charitable contributions.

Governor Schwarzenegger has indicated that he will call a special session to address the commission's recommendations. However, it is already obvious from legislators' comments that such radical changes will require significant political momentum and courage, which is generally lacking. Similar reform, such as pay-as-you-go requirements, a two-year budget process,[5] changes in state mandates (such as Proposition 98) and other revenue and spending reforms, will face significant political opposition.

A final approach to reform, which recently has gained significant attention, is to create a citizen-led approach to budget and broader political reform. That support seems to be building for a constitutional convention. Given the legislature's poor performance on managing state finances, both short- and long-term, and the political obstacles to reform from Sacramento, this citizen-led effort may offer more potential. In the interim, however, California should prepare for more protracted budget battles and a worsening financial picture.

3 A team of Stanford students in the Graduate Public Policy Practicum will be working on this issue in the next few months. A report will be issued in March 2010.

4 Marty Hittelman, "Retired teachers' health care 'crisis' is overblown," *San Francisco Chronicle,* Aug. 9, 2007, p. B-7.

5 Based on my experience in the California Legislature, I see nothing inherently beneficial from a two-year budget. There is always pressure to increase expenditures, even with mid-course corrections. In fact, higher than expected revenues in year one would likely lead to higher expenditures in both years one and two, regardless of whether the first year revenues were likely to continue. See Legislative Analyst's Office, **Budget Flexibility and Restrictions**, Aug. 18, 2009).

SIEPR

About SIEPR

The Stanford Institute for Economic Policy Research (SIEPR) conducts research on important economic policy issues facing the United States and other countries. SIEPR's goal is to inform policymakers and to influence their decisions with long-term policy solutions.

Policy Briefs

SIEPR Policy Briefs are meant to inform and summarize important research by SIEPR faculty. Selecting a different economic topic each month, SIEPR will bring you up-to-date information and analysis on the issues involved.

SIEPR Policy Briefs reflect the views of the author. SIEPR is a non-partisan institute and does not take a stand on any issue.

For Additional Copies

Please see SIEPR website at *http://SIEPR.stanford.edu*.

SIEPR *policy brief*

A publication of the
Stanford Institute for Economic Policy Research
Stanford University
579 Serra Mall at Galvez Street
Stanford, CA 94305
MC 6015

Non-Profit Org.
U.S. Postage
PAID
Palo Alto, CA
Permit No. 28