Policy Brief

Stanford Institute for Economic Policy Research

California's Budget Crisis: What Happened?

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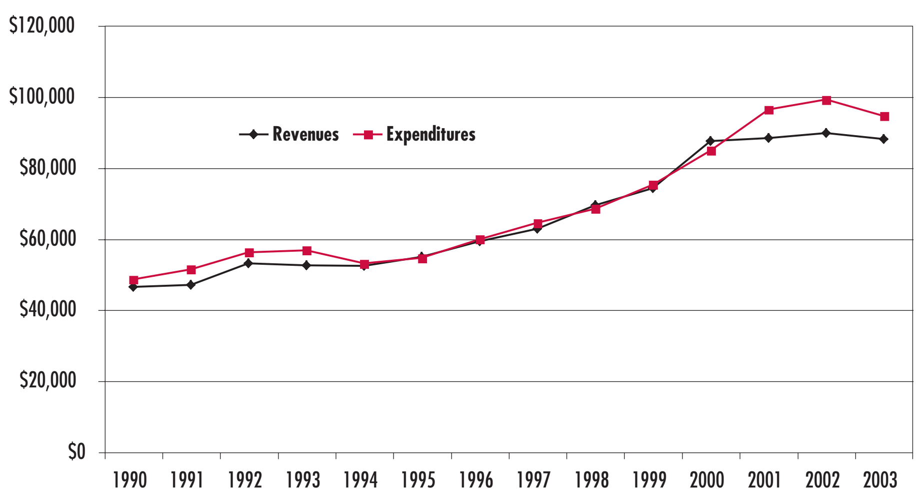
California faces a staggering budget shortfall through the summer of 2004 that will require future state budgets to impose large cutbacks in public services, hefty tax increases or some combination of these remedies. Projections of this deficit have soared from $7 billion to $8 billion estimated last summer to somewhere between $26 billion (according to the independent Legislative Analyst's Office) and $34 billion (according to the Governor) at the current time.[1] Forty other states also face budget deficits, but California alone accounts for nearly half of the total in state deficits expected next year. California went through a budget crisis a decade ago when the state suffered a deeper and longer recession than the rest of the nation. In the current business downturn, the state has so far avoided a comparable recession. How did a budget crisis happen again, especially in the absence of a seriously distressed economic environment?

Figure 1.
Total State Revenues and Expenditures from 1990 to 2003 ($ million)



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[1] The $8 billion difference comes from two sources: The Governor forecasts $3 billion less in revenue this year than the Legislative Analyst's Office; and the administration uses a baseline budget with $5 billion more in spending than implied by inflation and projected caseload increases.

A simple comparison of state tax revenues and spending since 1990 given in Figure 1 tells the essential story. California's state budget reached $95 billion in the current fiscal year (2002-03), up 38% since 1996. Tax revenues experienced a rapid rise during the mid-1990s, fueled by a booming economy and taxes raised on capital gains and stock returns. After 2000, tax revenues practically stabilized. In sharp contrast, state spending kept pace with the rapid rise in revenue in the mid-1990s and continued its increase well beyond the flattening out of tax revenues in 2000. Although spending finally dropped 5% in the current fiscal year, expenditures still outstripped revenues by more than $6 billion. It was the failure to curb spending after revenues leveled off, artificially covered by borrowing and fund transfers, that brings us to our current circumstances: a budget deficit amounting to virtually a third of the state's current spending.

Revenues have become more dependent on high-income families

Beginning in 1999, forecasters warned that a substantial segment of the state's revenue gains came from uncertain sources that could not be counted upon in the future. Just as with the predictions of stock market observers at the time, such concerns were not fully heeded as the economy and related income taxes continued to soar.

The state's revenues have become steadily more volatile as its tax base has narrowed. Personal income taxes grew from 35% of all revenues in 1981 to 47% in 1996 and 58% in 2001. The top 1% of taxpayers now account for over 40% of all personal income taxes, making a large component of state revenues quite sensitive to the economic circumstances of a tiny portion of the highest-income households. In contrast, sales taxes and the Vehicle License Fee, sources making up a larger fraction of state income in the past, constitute a more stable source of revenue. These taxes come from consumer expenditures less subject to economic fluctuations and are paid by almost everyone. Since 1998, the Vehicle License Fee was reduced by two-thirds and sales tax fell from 35% of revenues to under 29%. California's greater reliance on a highly progressive state income tax system resulted in a temporarily large and risky source of revenues in the late 1990s, when the income gap widened and the stock market boomed. This revenue source is far more difficult to forecast than other components of state income; both public and private sector forecasters have systematically underestimated these revenues in the past several years.

Per-capita expenditures have risen and spending flexibility is limited

State spending per capita rose sharply during the latter half of the 1990s. Figure 2 shows this rise, with expenditures measured in inflation-adjusted ("real") terms per resident in California over the 1978-2002 period. From 1994 to its peak in 2001, spending shot up 40%, from $2126 per person to $2991. The 2001 peak represents a hefty 23% increase in real per capita spending compared to the highest value attained in the 1978-1994 period (reached in 1992). Even if the Governor's proposed 17% decline in spending for 2003-04 should be fully enacted, real per capita expenditures would still be 5% higher than the low point in 1994 and 14% higher than the 1983 level.

Figure 2.
State Expenditures Per Capita (constant 2003 dollars)

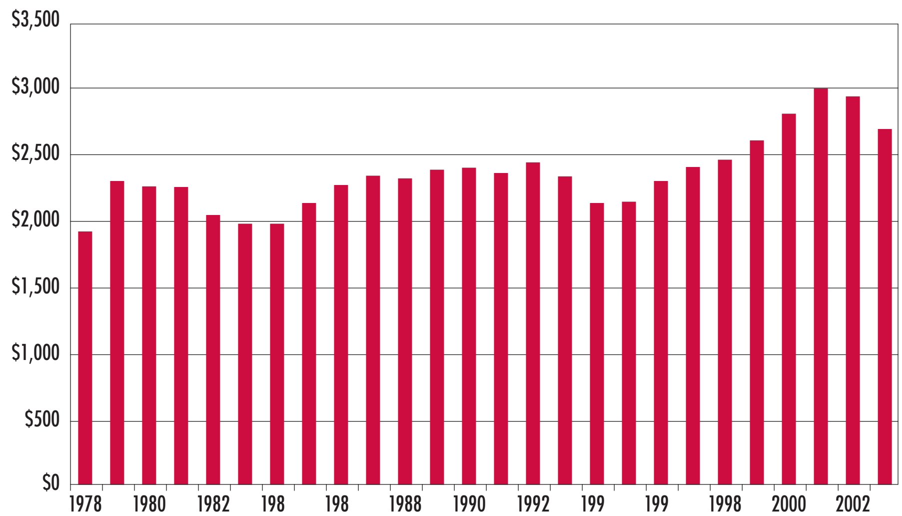
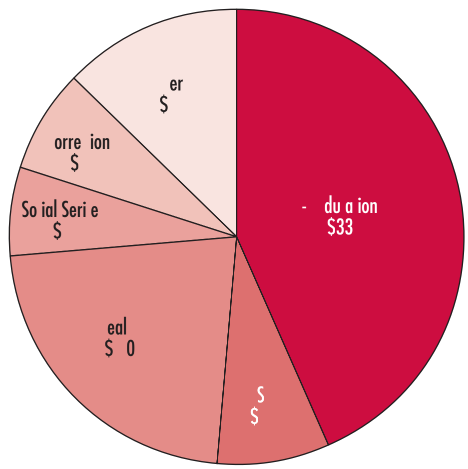


Figure 3 shows the composition of state expenditures in the current fiscal year. Serious limitations restrict the options available to the Governor and Legislature in responding to the current budget crisis. For example, Proposition 98 sets a floor of 40 percent on the share of spending that must go to K-14 education, and it further restricts how spending may change from one year to the next.[2] During the boom years, spending on K-14 rose by almost $11 billion more than the minimum levels guaranteed by Prop. 98 in response to widespread concerns about performance of the state's schools. This additional spending has become a permanent base, crowding out other spending that is less constrained. As a consequence, much of the spending declines must be taken out of social services, health programs and higher education, since little can be done to reduce expenditures on corrections without finding some way to reduce the prison population.

Figure 3.
2002-03 General Fund Spending ($ billion)



Status of current proposals

The Governor's proposed budget for 2003-04 would significantly cut spending compared to the previous two years. With the exception of community colleges (where real spending falls over 20%), real education spending would remain above 1998 levels, as does the "Other" category. Health and social service spending would fall by almost 10%, while corrections spending would remain 17% higher than its 1998 level. Unlike the federal government, California is not allowed to run a budget deficit, although it can and does move funds across budget years and uses debt financing and fund transfers to help balance its General Fund in any given year.

Promoting expectations of permanently higher spending based upon a temporary boost in tax revenues has made addressing the budget crisis particularly painful. To reduce the odds of another budget crisis in the next recession, the state needs to widen rather than narrow the tax base; give cities and counties more control over their own revenues and spending (without leaving them under-funded as it has in the past); and reserve excess revenues — revenue growth that exceeds the growth in personal income — for debt repayment and capital spending rather than for programs that are difficult to cut in lean years.

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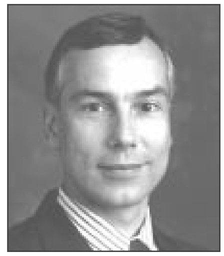
[2] Spending must increase by at least the combined percent increase in statewide average daily attendance and personal income. Funding can be cut only through emergency legislation, rather than in the budget bill.

About the Authors

Michael Dardia is Vice President & Director of Research at the SPHERE Institute. His research interests cover workforce development; redevelopment; regional economics; and public finance and taxation issues. Prior to joining SPHERE, he helped start up the Public Policy Institute of California and was a consultant to the RAND Corporation. He is a member of the California Workforce Investment Board's Economic Advisory Council, a technical advisor to the Economic Strategy Panel, and has participated in numerous other state and local government advisory groups. He edits the Growth and Employment series of the *California Policy Review* and writes the Regional Highlights for the ***Bay Area Economic Pulse.*** He earned his Ph.D. in Policy Analysis from the RAND Graduate School.



Thomas MaCurdy is a professor of economics at Stanford University and a senior fellow at the Stanford Institute for Economic Policy Research and the Hoover Institution. He is also an adjunct fellow at the Public Policy Institute of California. MaCurdy's research falls broadly in the area of human resources, with its main focus on the impacts of low-income support programs, income transfers, and tax systems on human development and economic activity. Among his current public service activities, MaCurdy serves as a member of standing committees advising the U.S. Bureau of Labor Statistics, the U.S. Census, the Congressional Budget Office, the Institute for Research on Poverty, and many state and local governmental agencies in California. Professor MaCurdy received his B.A. in 1973 from the University of Washington and his Ph.D. in 1978 from the University of Chicago.

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