

INSTITUTE OF REGIONAL AND URBAN STUDIES

610 UNIVERSITY AVENUE • PALO ALTO • CALIFORNIA • 94301

TELEPHONE: (650) 326-5770

FAX: (650) 321-5451

www.ccsce.com

DATE: December 1, 2003
TO: Budget Project Friends
FROM: Stephen Levy
SUBJECT: State Budget Data and Issues

1. This is the fifth in an ongoing series of memos on state budget issues and their relationship to the California economy. Our work is supported by a grant from The James Irvine Foundation. Previous memos are posted at www.ccsce.com.

2. **The Recall is Over and the Budget Challenges Remain**

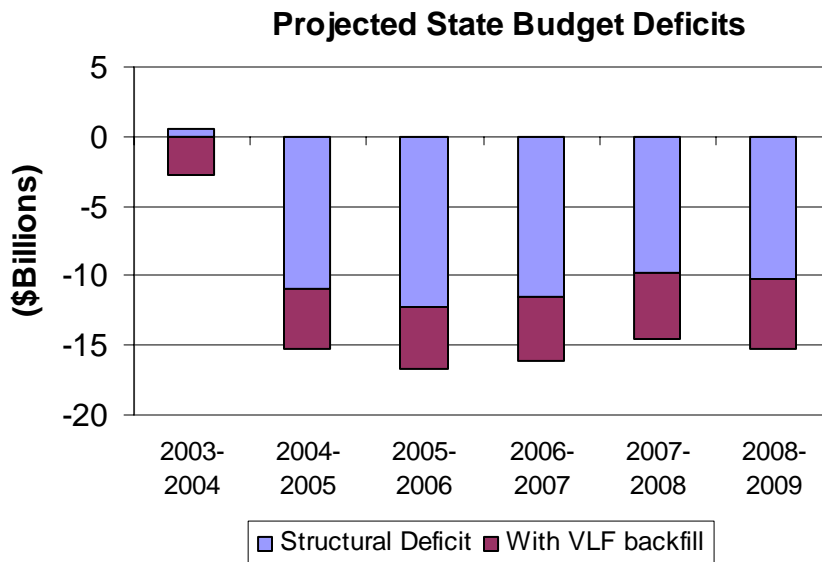
The recall is over and the debate over the 2004-2005 state budget is beginning. Residents and legislators face broad policy choices—should spending be cut and where; should taxes be raised temporarily and which taxes; should a long-term bond be used to pay off part of the deficit; and should the state have a new spending limit.

This is the first in a series of memos on the 2004-2005 budget policy choices. The purpose of this memo is to begin building an information base about the state budget that is relevant to current policy choices. The memo covers questions such as what does state spending go for; what contributed to the recent deficit; what is the anticipated deficit in 2004-2005 and beyond; how many state and local government employees does California have compared to other states and what share of personal income goes to the state budget.

3. **Good News—Basic Agreement Emerges on Size of Deficit Challenge**

The Legislative Analyst's Office (www.lao.ca.gov) and the new Director of Finance have just released estimates of future budget conditions and there is significant agreement between the two analyses.

California faces **an ongoing annual budget deficit of \$15 billion starting in July 2004 (the 2004-2005 budget year) and lasting until corrective actions are taken.** This ongoing or "structural" deficit includes approximately \$11 billion in spending that was covered this year **with one-time measures adopted in the 2003-2004 budget** and \$4 billion to "backfill" or reimburse local governments for the loss of vehicle license fee money now that the Governor has lowered the license fee. The LAO deficit estimates are shown below.



There is also agreement that substantial borrowing will be needed as part of balancing the current year (2003-2004) budget **and that this borrowing will do nothing toward reducing the future ongoing deficits discussed above.** There is \$12.6 billion in borrowing built into the recently adopted budget (\$10.7 for deficit bonds and \$1.9 billion for bonds to pay two years of pension obligations). Governor Schwarzenegger has proposed issuing \$15 billion in bonds, voted on by the public, to replace the borrowing already in the budget.

So, there is now broad agreement that California faces both a short-term borrowing challenge and a long-term budget deficit challenge.

4. One Difference Between Government and Business

Nearly 300,000 Californians have lost jobs since the peak job levels in late 2000. **For most workers, job losses came because there was “not enough business”.**

But the number of “customers” for government **rose during the past four years. The number of government customers usually rises steadily** (population and the number of school and college attendees usually rise each year) **and rises more rapidly in recessions** as the number of people eligible for “safety net” programs increases during recessions.

Thus, when government revenues fall, there is often an increase, not decrease, in the number of customers.

5. What Does the State Budget Pay For?

The budget tables and charts below refer to the state **General Fund** budget. In the just-completed budget year (2002-2003), General Fund spending was approximately \$78 billion and the LAO estimates that General fund spending in 2003-2004 will be \$77 billion including funds to reimburse local governments for the loss of vehicle license fee revenues.

The state also spends money from bond funds, from revenues designated for specific purposes like the gasoline tax (special funds), and from federal revenues given to the state for specific purposes such as special education and payments to residents who are unemployed, on welfare or eligible for medical assistance to poor families.

It is the General Fund budget that the legislature debates and passes and it is the General Fund budget over which the state has the most policy choices.

General Fund Spending in 2002-2003		
(\$Billions)		
Education		\$38.3
K-12	29.3	
Higher Ed	9.0	
Health		14.3
Medi-Cal	10.9	
Other	3.4	
Social Services		8.9
State Prisons		4.9
Tax Relief		3.8
Other		7.8
Total		\$78.0

Source: California Department of Finance, Legislative Analyst's Office

Half of the General Fund budget goes to education. In 2002-2003, \$29.3 billion went for K-12 education and \$9.0 billion went for higher education including community colleges. UC, CSU and the community colleges each raised fees by between 30% and 60% to offset budget cuts.

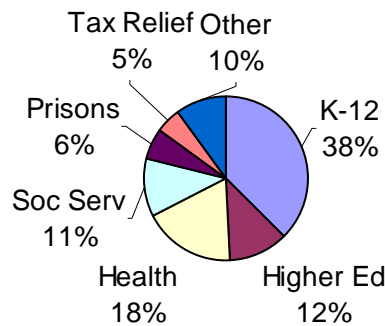
Health services accounted for \$14.3 billion including \$10.9 billion for health care serving poor families (Medi-Cal). Social service spending was \$8.9 billion and included approximately \$2 billion for welfare (CalWorks), \$3 billion in income payments to poor and disabled residents, and other funds directed toward providing services for poor and disabled residents.

The state prison system accounted for \$4.9 billion, tax relief (payments to local governments to replace revenue lost when vehicle license fees were lowered)

was \$3.8 billion and all other expenses including the expenses of running state government agencies and debt service were \$7.8 billion.

Approximately half of the state General Fund went to education and approximately 30% to health and social services. All of the remaining categories of spending accounted for just over 20% of General Fund spending.

Percent of General Fund Spending in 2002-2003



5. A Relatively Small Share of the State Budget Goes to State Agencies

The vast majority (75%) of General fund spending goes to local governments and school boards and directly to providers of health care and social services.

	Local and Providers	State Level	Total
Education	\$31.9	\$6.4	\$38.3
Health	13.5	0.8	14.3
Social Services	8.3	0.6	8.9
Prisons		4.9	4.9
VL Tax Relief	3.8		3.8
Other	1.1	6.7	7.8
Total	\$58.6	\$19.4	\$78.0

Source: California Department of Finance, Legislative Analyst's Office

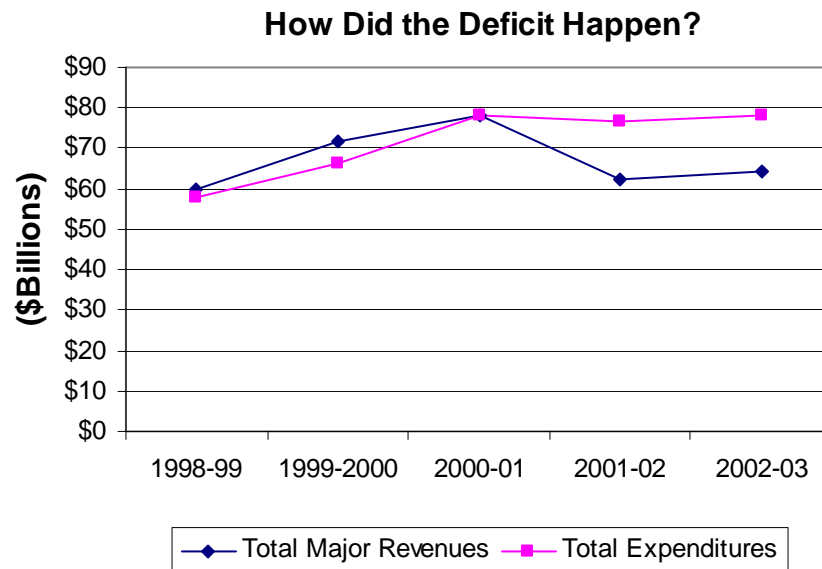
In the 2002-2003 budget, state agency spending was concentrated in the UC and CSU systems (\$6.4 billion), state prisons (\$4.9 billion), and debt service (\$2.2

billion). Other program and administrative expenses in the General fund budget were just under \$6 billion.

Spending administered by **local governments and school boards and payments to providers of health and social services** accounted for \$60 billion or 75% of all General fund spending. K-12 and community college spending alone was \$31.9 billion or 41% of General fund spending in 2002-2003. Added to that is money to local governments for reimbursement of reduced vehicle license fee revenues and other reimbursements for prior state takeaways of local revenue. Finally, counties administer many of the health and social service programs, with state money also going directly to providers.

6. How Did the Deficit Get So Large?

General Fund revenues and spending both increased by approximately 1/3 (\$20 billion) between the 1998/99 and 2000/01 budgets. In the following two years, General Fund spending remained near \$80 billion while revenues dropped as a result of the recession and from the sharp drop in stock market related income.



The deficit accumulated over two to three years and was the result of the legislature being unable to reach agreement on either raising revenues or cutting spending in response to the recession and loss of stock market related income.

Spending did rise sharply during this period, but tax cuts also contributed to the deficit increase. For example, cuts in the vehicle license fee cost the state \$16 billion during these four years, more than enough to eliminate the need for major borrowing in the 2003-2004 budget. There were also business tax cuts during this

period. It was the continuation of both higher levels of spending and tax cuts that contributed to the steady rise in the deficit.

7. How Was the Deficit Cut?

The potential \$38.2 billion deficit was eliminated in the 2003-2004 budget through a combination of savings in program expenditures, revenue increases, one-time measures and a \$10.7 billion deficit bond to be repaid over five years.

Closing the \$38.2 Billion Budget Gap	
(\$Billions)	
Program Savings	\$9.2
Deficit Bond	10.7
One-Time Measures	14.5
Revenue Increases	5.0
Total	\$39.4

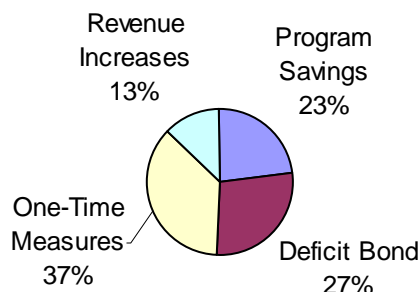
Source: Legislative Analyst's Office

The revenue increases included money from restoring vehicle license fees (since reversed by Governor Schwarzenegger), \$700 million in proposed Indian gaming revenues, and approximately \$400 million in increased court-related and other fees.

The one-time measures included \$2.2 billion in federal funds which covered Medi-Cal cuts, \$1.9 billion in borrowing to pay pension costs (since invalidated by a court ruling), \$2.0 billion from selling future tobacco settlement funds, \$1.2 billion in borrowing from transportation and other special funds and several billion in deferred education, transportation and other expenses.

The program savings represented approximately \$9 billion of cuts spread over the 2002-2003 and 2003-2004 budget years. Some of the cuts, for example \$1 billion in higher education spending, were partially offset by fee increases for students.

Closing the Potential \$38.2 Billion Budget Gap



8. Deficit Cause --“Too Much” Spending or “Not Enough” Revenue?

There are no objective standards for either “too much” or “not enough”. Ultimately, the choices facing residents depend on how they value the services provided by their tax dollars and on the consequences of either cutting service levels or raising tax levels.

The table below examines the program areas where the \$20 billion in General Fund spending growth was approved.

Spending Increases			
1998-99 to 2002-03			
(\$Billions)			
	1998-99	2002-03	Change
K-12 Education	\$23.5	\$29.3	\$5.8
Higher Education	7.3	9.0	1.7
Health and Social Services	16.1	23.2	7.1
Corrections	4.5	5.8	1.3
Tax Relief	0.9	4.4	3.5
Other	5.5	6.3	0.8
Total General Fund	\$57.8	\$78.0	\$20.2

Source: California Department of Finance, Legislative Analyst's Office

K-12 education received \$5.8 billion in added funds. One part went to fund reductions in class size and one part went to move per pupil spending closer to the national average. In addition, K-12 enrollment continued to grow between 1998 and 2002. Higher education received \$1.7 billion in additional funds to account for enrollment growth and increased financial aid to students.

Health and social services spending increased by \$7.1 billion. The largest single portion of the money went to fund a 30% increase in Medi-Cal caseloads and an approximately 25% increase in the health-care price index. There were caseload increases in all other social service programs except welfare. In addition, eligibility for health care and childcare was extended to more poor and near-poor families.

The other large increase was \$3.5 billion for aid to local governments to “backfill” the funds lost by cuts in the vehicle license fee. The state budget accounts for this tax cut by labeling it as an increase in spending.

One way to help residents and legislators assess whether California is spending “too much” is by comparing state spending in specific categories to the national average. Subsequent memos will address this question and information is available from the Legislative Analyst’s Office (www.lao.gov) and from the California budget project (www.cbp.org).

One example comes from recently published education statistics from the National Education Association (www.nea.org). Based on data before the last round of K-12 spending cuts, California ranked 30th in per pupil spending for the 2002-2003 academic year.

How Much did Spending Rise Between 1998 and 2002?

The figure of a 35% increase in General Fund spending has been widely reported in the budget debate and recall campaign. The 34.9% figure is derived by comparing General Fund spending of \$57.8 billion in 1998-99 with \$78.0 billion in 2002-2003.

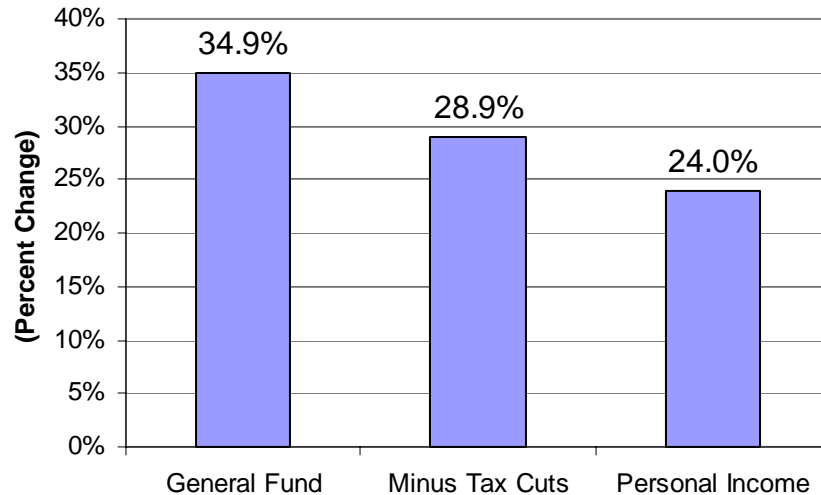
How Much Did Spending Grow?			
(\$Billions)			
	1998-99	2002-03	Percent Change
General Fund	\$57.8	\$78.0	34.9%
Gen. Fund Minus VLF Backfill	57.8	74.5	28.9%
Personal Income	\$931.6	\$1,155.2	24.0%

Source: California department of Finance

Part (\$3.5 billion) of this “spending increase” was to compensate local governments for the cut in vehicle license fees. If this “tax cut” spending is removed, then General fund spending increased by 28.9%, not 34.9%. For the same period, which includes a recession, personal income in California increased by 24.0%.

Longer-term trends in state spending relative to income are discussed in point 10 below.

Growth Rates 1998-99 through 2002-03



9. Does California Have “Too Many” Government Employees?

There are no objective standards for “too many” government employees just as there are no objective standards for “too much” or “too little” spending. However, it is possible to present information on trends in the number of government employees in California.

In 2002, California had 2.2 million full and part-time state and local government employees. Approximately 1 in 8 Californians worked for state or local government. Nearly 80% of these residents worked for local government and just over 50% worked in education.

Government Jobs in California				
(Thousands)				
	1998	2002	Change	Percent Change
State Government	230.3	263.8	33.5	14.5%
State Education	182.7	208.2	25.5	14.0%
Local Government	636.7	741.1	104.4	16.4%
Local Education	843.8	980.9	137.1	16.2%
Total State and Local	1,893.5	2,194.0	300.5	15.9%

Source: California Employment Development Department

Between 1998 and 2002, the number of government employees increased by 300,500 or 15.9%, mainly in local government and education.

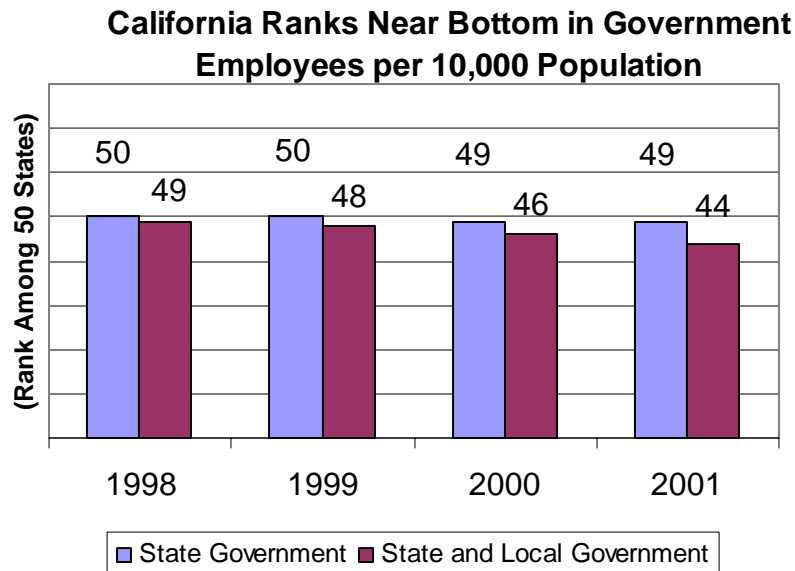
The Census Bureau recently released data on the number of full-time equivalent employees in state and local government. The EDD data above include both full-time and part-time workers.

California has significantly fewer workers per 10,000 population than the national average. For state government employees alone, California has ranked 50th or 49th among states for the lowest number of employees.

Full-time Equivalent Employees per 10,000 Population					
	1998	1999	2000	2001	2002
State Government					
California	103	106	105	108	107
United States	147	148	145	147	146
CA as Percent of U.S.	70.1%	71.6%	72.4%	73.5%	73.3%
State and Local Government					
California	474	486	495	503	503
United States	536	541	535	540	541
CA as Percent of U.S.	88.4%	89.8%	92.5%	93.1%	93.0%

Source: United States Census Bureau

For state and local government combined, California ranked 44th in 2001 for the lowest number of government employees per 10,000 people.



The constraints on state and local government budgets will result in California falling further behind the national average in government employees per capita in 2003 and 2004.

Where Were Increases in State Government Employees?

The table below compares the number of full-time equivalent employees in state government between 1998 and 2002. Five areas accounted for 3/4 of state employees in 2002—the University of California (74,507), Youth and Adult correctional Agency (50,419), Health, Labor and Social Services (44,987), California State University (44,203), and State Department of Transportation (41,186).

State Employees Full-Year Equivalents (Payroll in \$Billions)				
	2002- 2003	1998- 1999	Change	Percent Change
University of California	74,507	58,513	15,994	27.3%
Correctional Agency	50,419	46,838	3,581	7.6%
Health, Labor and Social Services	44,987	36,733	8,254	22.5%
California State University	44,203	38,814	5,389	13.9%
Transportation	41,186	37,756	3,430	9.1%
Other	72,052	64,206	7,846	12.2%
Total	327,354	282,860	44,494	15.7%

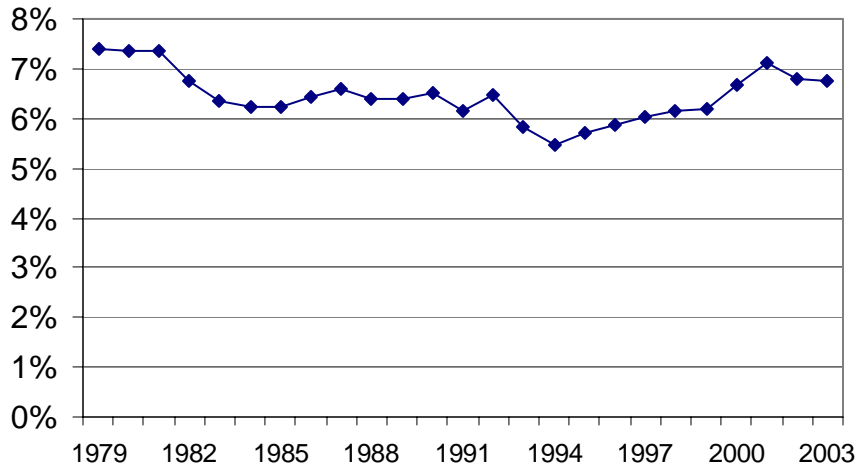
Source: California Department of Finance

Approximately 50% of the increase in the number of full-time equivalent state employees was in higher education and 50% in other program areas. The Other category includes the Executive Branch of state government, Resources, Environment, Consumer Services and other general government program areas.

10. What are the Long-Term Trends in Spending?

General Fund spending has ranged from 5.5% of personal income for California residents to 7.5%. In 1989-90, before the early 90s recession, spending was 6.5% of personal income. In 1999-2000, before the current recession, spending was 6.7% of personal income. In 2002-2003, a recession year, spending was 6.8% of personal income.

State General Fund Spending as Percent of Personal Income in California



Spending as a percent of income fell sharply to a low of 5.5% in 1994-1995, recovered to 7.1% in 2000-2001 and fell slightly to 6.8% in the 2002-2003 budget year.

These data provide no way to avoid the difficult policy choices between cutting spending and raising revenues. Was the recent rise in spending “catch-up” for the earlier slow growth? Is the 2002-2003 spending level “too high” or was the 1994-95 spending level “too low”? Answers ultimately depend on what public services Californians want from government and whether they are willing to pay for what they want.

11. Summary

--The 2002-2003 General Fund budget allocated 50% to education, 29% to health and social services, 6% each to state prisons, 5% to tax relief and 10% to other spending.

--75% of General Fund spending goes directly to local governments and service providers including \$31.9 billion for K-12 education and \$21.8 billion for health and social services.

--25% of General Fund spending is spent directly by state agencies — higher education, prisons and general government.

--The deficit entering 2003 was accumulated over two + years and was the result of the legislature being unable to reach agreement on either raising revenues or cutting spending in response to the recession and loss of stock market related income. The deficit might have reached \$38 billion if no changes were made in the 2003-2004 budget.

--General Fund spending rose from \$58 billion to \$78 billion between 1998/99 and 2002/03. The major increases were \$7.5 billion for education, \$7.1 billion for health and social service and \$3.5 billion to compensate local governments for the vehicle license fee cut.

--The potential \$38.2 billion deficit was eliminated in 2003-2004 through a combination of program savings and revenue increases (36%) and one-time measures plus long-term borrowing (64%). A \$10.7 billion short-term deficit bond was approved when legislators could not agree on additional spending cuts or revenue increases.

--A deficit of approximately \$15 billion will re-emerge in the 2004-2005-budget year, including \$4 billion from lowering vehicle license fees.

--The number of state government employees increased by 15% between 1998/99 and 2002/03 — half in education and half in other program areas. California ranks 49th in the number of state employees per 10,000 people (50th is the lowest) and 44th in the number of state and local government employees per 10,000 residents.

--In 2002/03, Californians spent 6.8% of their personal income on General Fund expenditures. In 1989/90, the share was 6.5%. In the late 1970s and early 1980s, the share was 7.4%. At the low point in 1994/95, after four years of recession, the share was 5.5%.