



CALIFORNIA BUDGET PROJECT

Two Steps Back:

Should California Cut Its Way to a Balanced Budget?

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A PRESENTATION BY
THE CALIFORNIA BUDGET PROJECT
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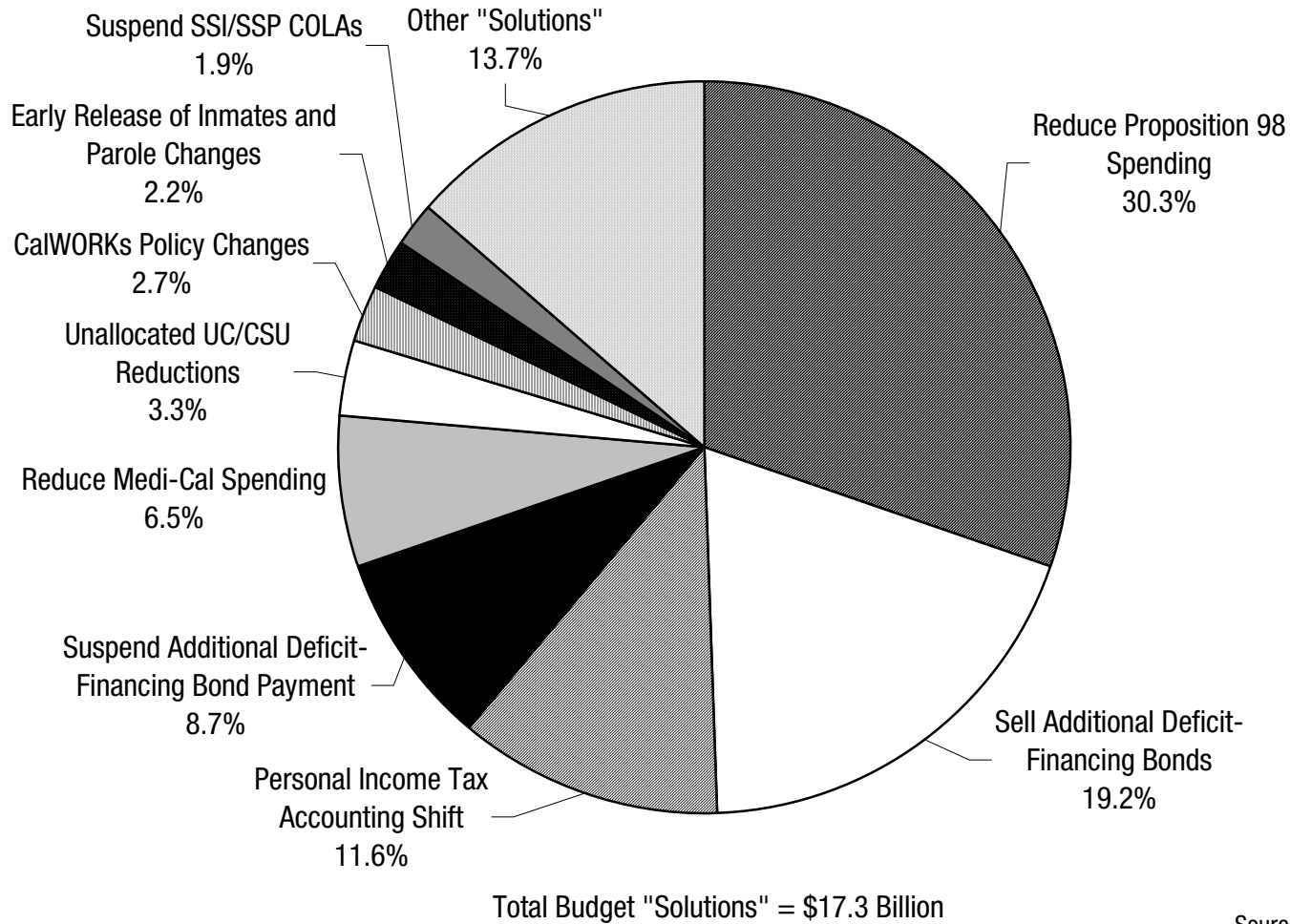
The Big Picture

- The Governor's Proposed 2008-09 Budget addresses a \$14.5 billion gap between the cost of providing the current level of public services and available revenues.
- The shortfall results from a deterioration of current and budget year revenue collections due to a slowing economy; higher than anticipated current year spending; and a structural imbalance between the cost of programs and services and the revenues raised by the state's tax system.
- The Governor proposes \$17.3 billion in "solutions" to close the gap and end 2008-09 with a \$2.8 billion reserve.

How Does the Governor Balance the Budget?

- The Governor proposes to close the state's \$14.5 billion budget gap by:
 - Cutting General Fund spending by \$9.3 billion;
 - Issuing \$3.3 billion of additional deficit-financing bonds;
 - Shifting \$2.0 billion in 2009-10 income tax revenues to 2008-09 for accounting purposes;
 - Reducing 2007-08 K-14 education spending by \$400 million; and
 - Eliminating a \$1.5 billion supplemental payment on the outstanding deficit-financing bonds.

How Does the Governor Propose to Balance the Budget? Percentage of Proposed Budget "Solutions"



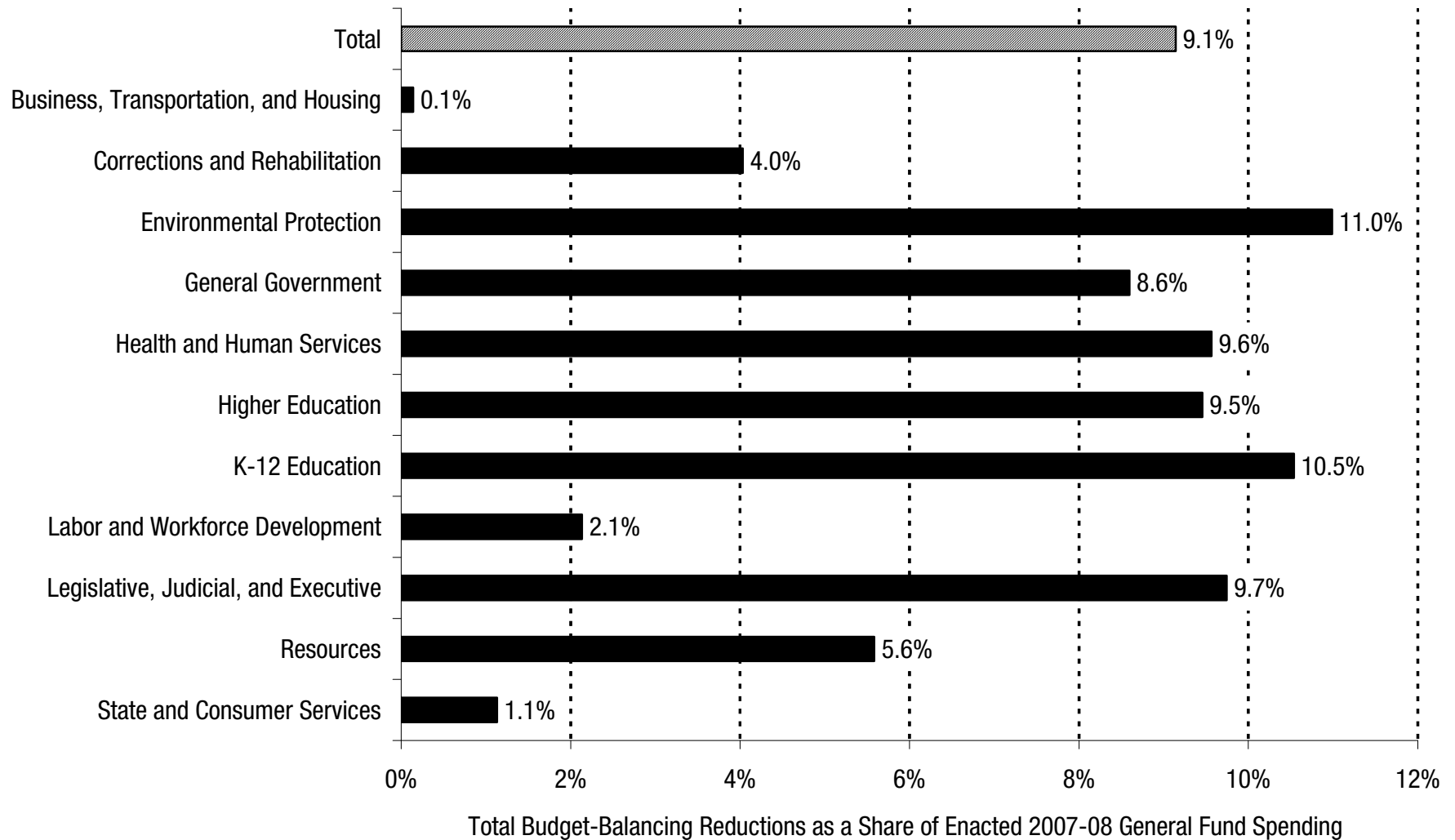
Source: Legislative Analyst's Office

Governor Would Make Deep Cuts to Schools, Health Care, and Human Services

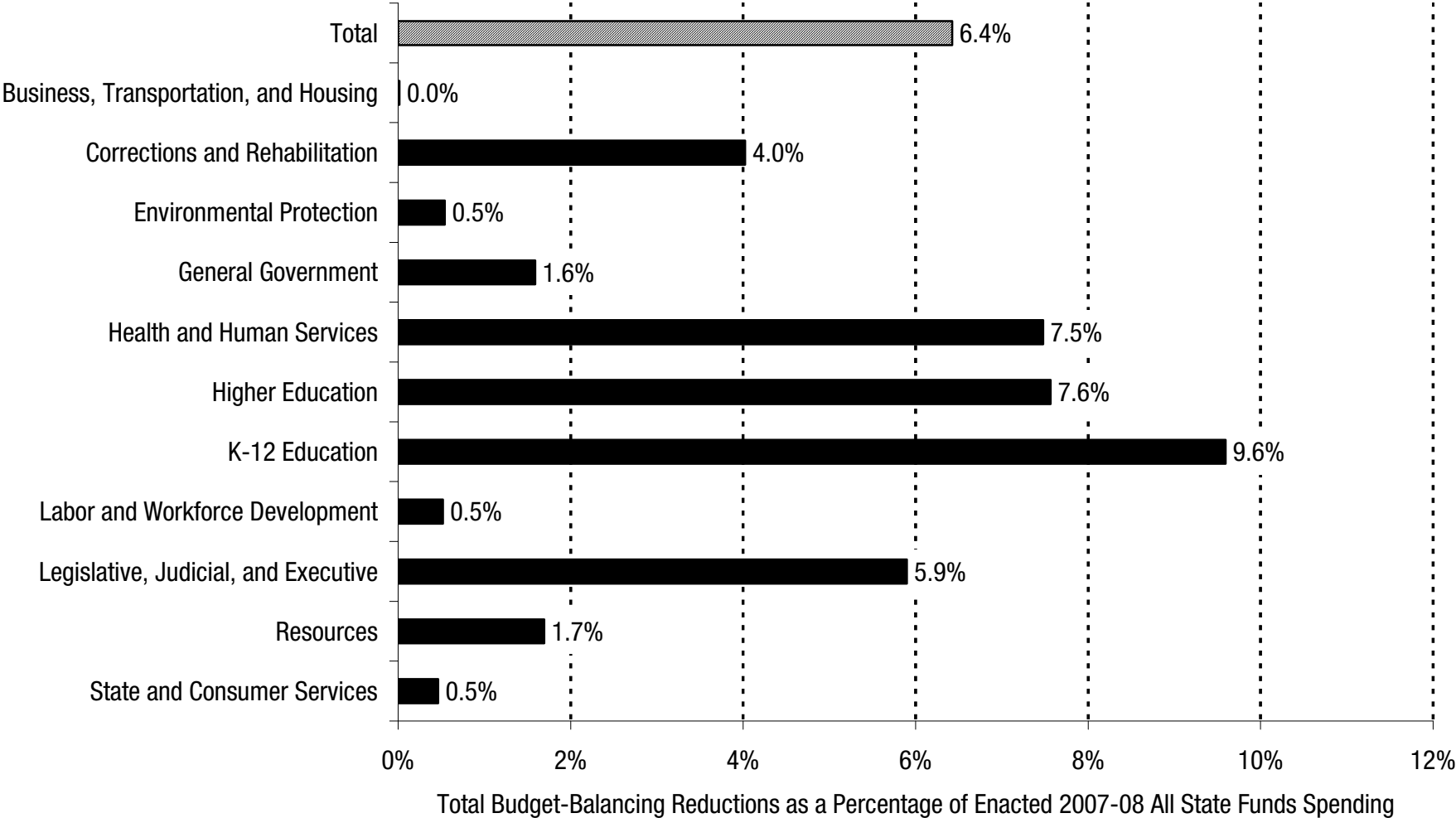
The Governor's proposals include:

- \$4.825 billion of cuts to spending covered by the Proposition 98 school funding guarantee. Proposed 2008-09 cuts to K-12 education, including the loss of federal matching funds, translate into a reduction of \$786 per student.
- \$1.126 billion of cuts to state Medi-Cal spending. The largest share of the savings would come from reducing payments to providers of a number of health services by 10 percent.
- \$463 million of reductions to the CalWORKs Program. The largest share of the savings would come from terminating aid to certain children who receive assistance through the state's "safety net" program.
- \$324 million in savings from suspending the June 2008 and June 2009 state cost-of-living adjustments (COLAs) for cash assistance grants for low-income seniors and persons with disabilities in the SSI/SSP Program.
- \$372 million in reductions to the Department of Corrections and Rehabilitation. These savings are largely due to proposals that would expedite release of more than 20,000 nonviolent offenders from state correctional facilities.

Proposed Budget-Balancing Reductions as a Share of 2007-08 Spending



The Impact of Budget-Balancing Reductions Varies by Program Area

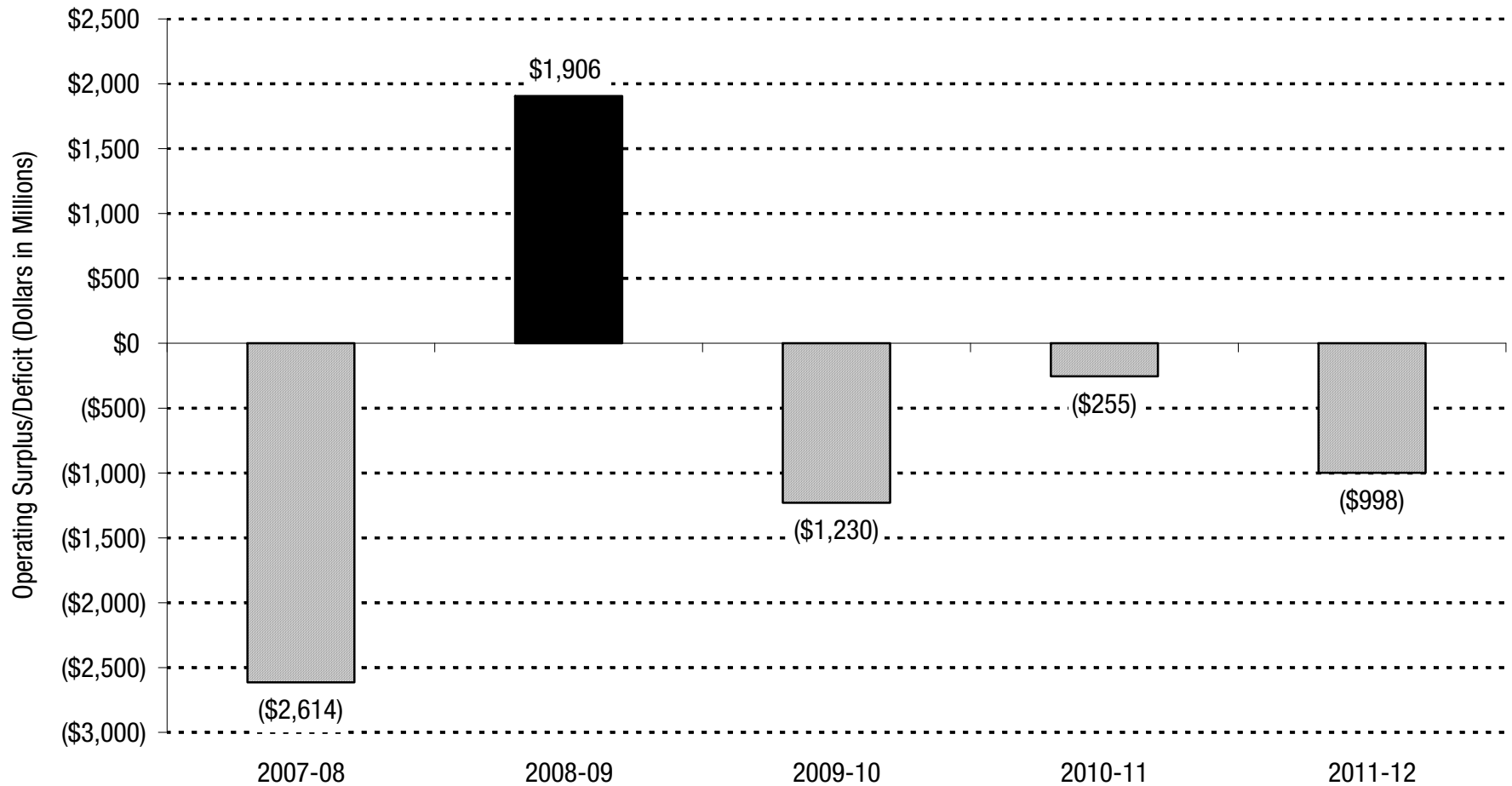


Source: Department of Finance

How Did Things Get So Bad

- Revenue forecasts for 2006-07, 2007-08, and 2008-09 have been downgraded by a total of \$7.5 billion since the 2007-08 Budget was signed into law in August.
- Spending is higher than anticipated due to lower than expected local property tax collections, which boosts the state's costs for education; firefighting costs; a recent court decision; and assumed, but not achieved, 2007-08 budget savings.
- An ongoing imbalance between revenues and expenditures that is exacerbated by the state's past reliance on one-time "solutions" to balance the budget and debt service costs attributable to deficit-related borrowing.

Despite the Magnitude of the Governor's Proposed Reductions, Operating Deficits Would Resume in 2009-10



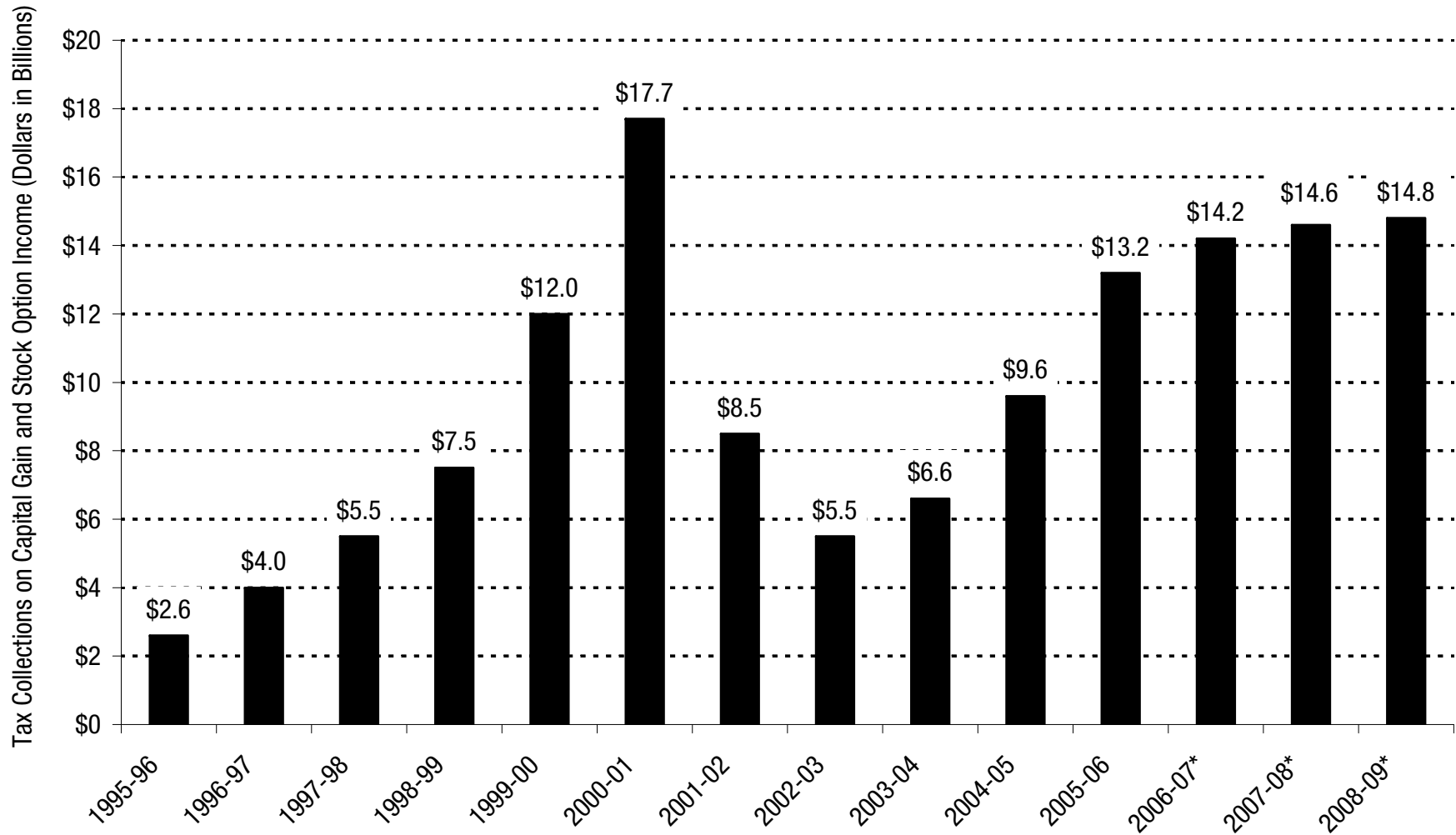
Note: Excludes transfers to Budget Stabilization Account for supplemental deficit-financing bond payment.

Source: Department of Finance

This Budget Crisis Is Different from the Last One

- The budget crisis that began in 2001 was precipitated by a sharp drop in personal income tax collections attributable to stock options and capital gains.
- This time around, the deficit is the result of an economic slowdown, largely led by the housing sector; the cost of the Vehicle License Fee (VLF) tax cut; and deficit-related debt service costs. Weakness in the state's housing markets has depressed property and sales tax collections.
- The budget crisis of the early 2000s primarily affected the state budget. The current crisis also will take a toll on county and city budgets that depend on property and sales taxes.

Revenues from Stock Options and Capital Gains Are Still Significantly Below Boom Levels



* 2006-07 preliminary and 2007-08 and 2008-09 estimated.

Source: Department of Finance

The VLF Tax Cut Equals Nearly Half of the Deficit

- The 1998 reduction in the VLF rate will cost the state an estimated \$6.1 billion in 2008-09. This is more than the combined savings generated by the Governor's proposed:
 - State park closings and reductions;
 - Cuts to environmental protection programs;
 - CalWORKs policy changes;
 - Reductions in K-12 education spending; and
 - Cuts to CSU, UC, and Community Colleges.

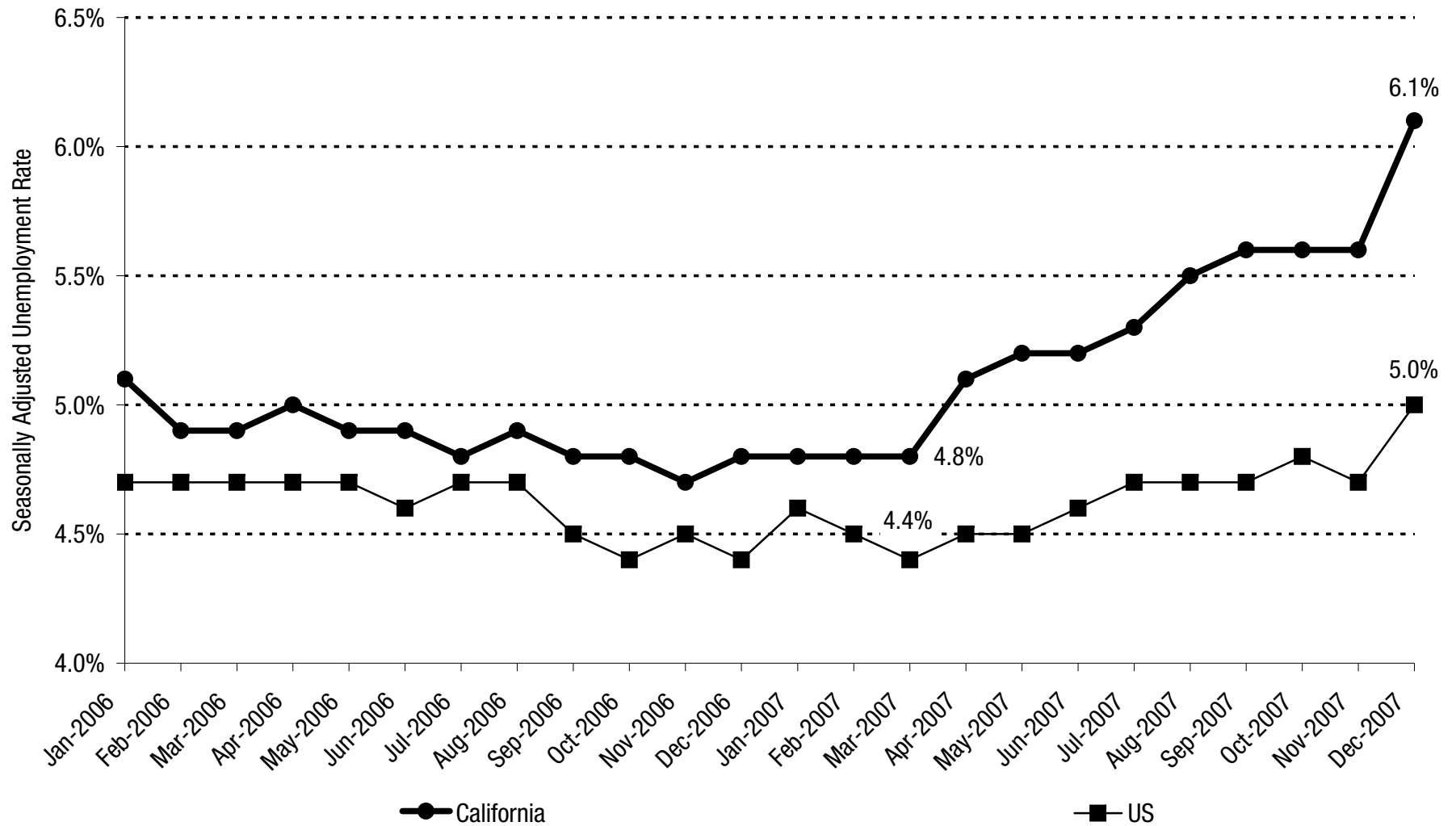
The Rising Cost of the VLF Backfill: A Brief Digression on the Roots of the State's Budget Problems

- The 1998 VLF tax cut backfilled revenues lost by cities and counties with an equivalent payment from the state's General Fund. Because of the backfill, the tax cut appears in the budget as a spending increase.
- In 2004, the state replaced payments to cities and counties from the General Fund with an equivalent amount of property taxes that had formerly gone to schools. The state increased its share of funding for K-14 education by an equivalent amount. Proposition 1A of 2004 constitutionally limits the state's ability to modify this transaction.
- Over time, local property tax revenues have grown more rapidly than the VLF and the VLF tax cut now costs the state \$1.2 billion more than it would have if backfill payments had been continued.
- As a result, cities and counties receive \$1.2 billion more per year and the state pays \$1.2 billion more for schools.

The Economy Has Weakened Substantially

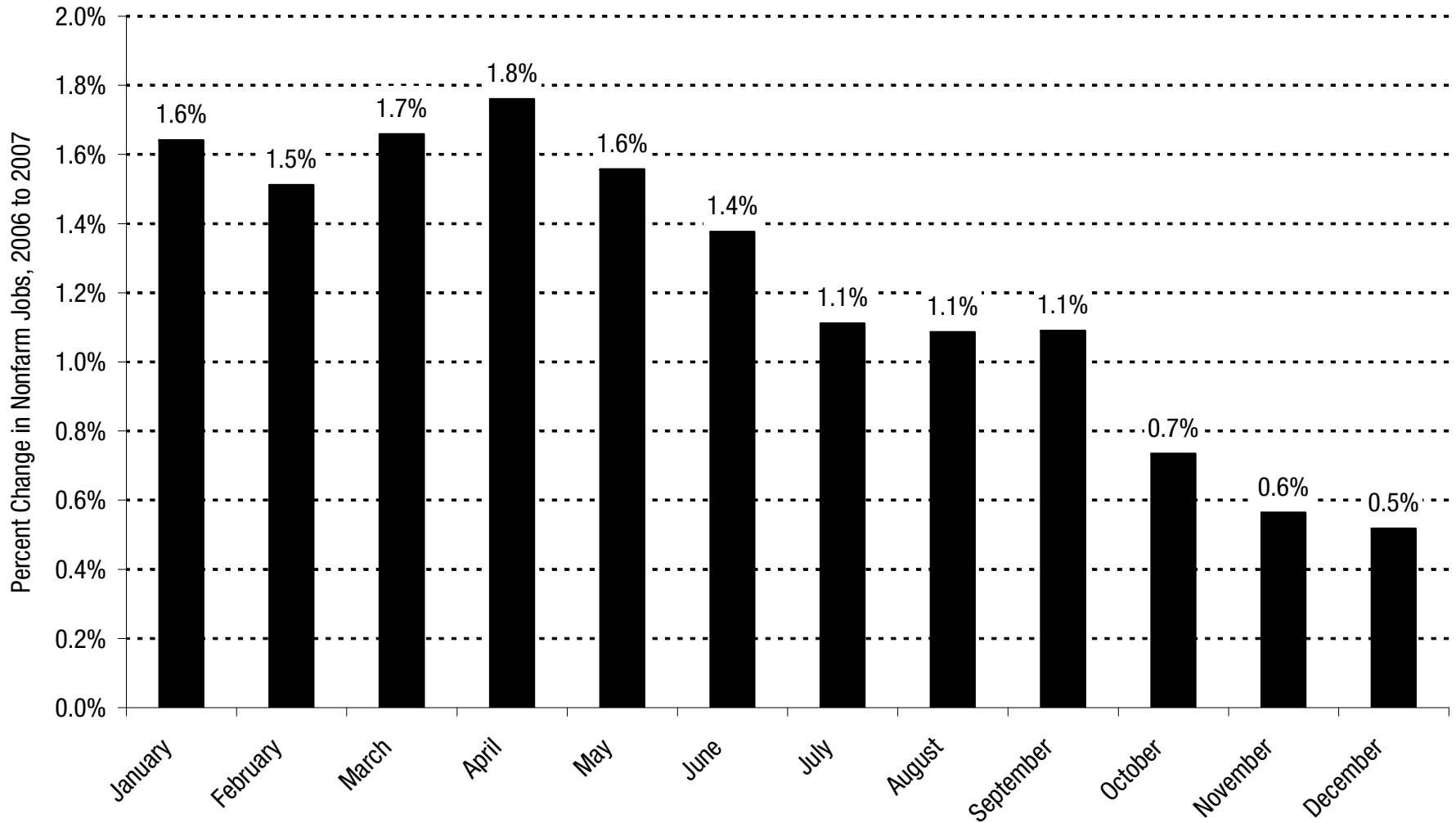
- During the past six months, economic conditions in the state and the nation have weakened substantially, causing many economists to argue that the nation has entered a recession. In California:
 - The unemployment rate rose by 1.3 percentage points between March and December, reaching 6.1 percent, the highest level in more than three years.
 - Third quarter taxable sales declined by 1.9 percent between 2006 and 2007, compared to a 2.3 percent increase between 2005 and 2006.
 - Annual growth in personal income slowed to 4.7 percent in 2007-08, from 5.8 percent in 2006-07 and 6.9 percent in 2005-06.

California's Unemployment Rate Increased Sharply in Recent Months



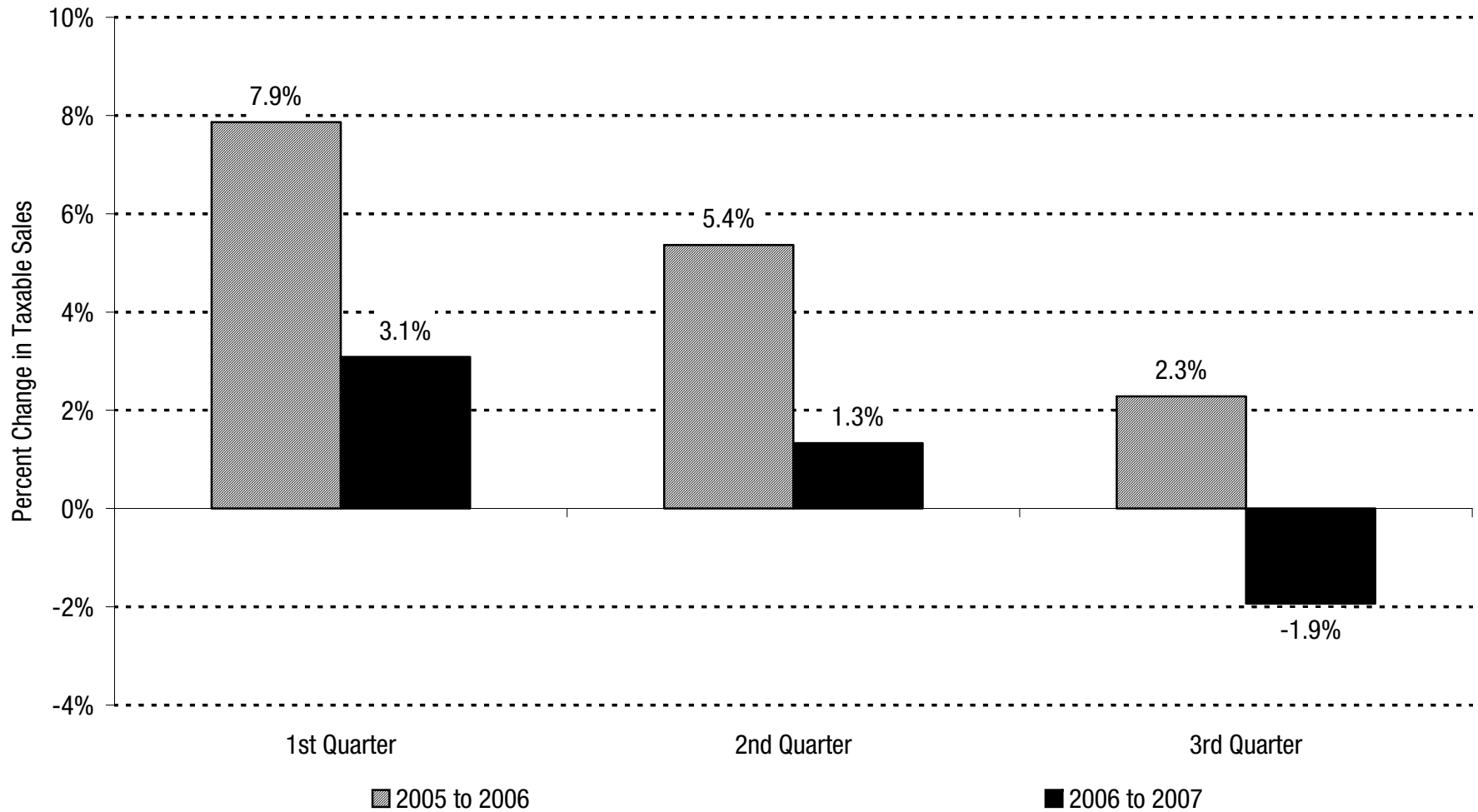
Source: Employment Development Department and US Bureau of Labor Statistics

California's Job Growth Slowed in 2007



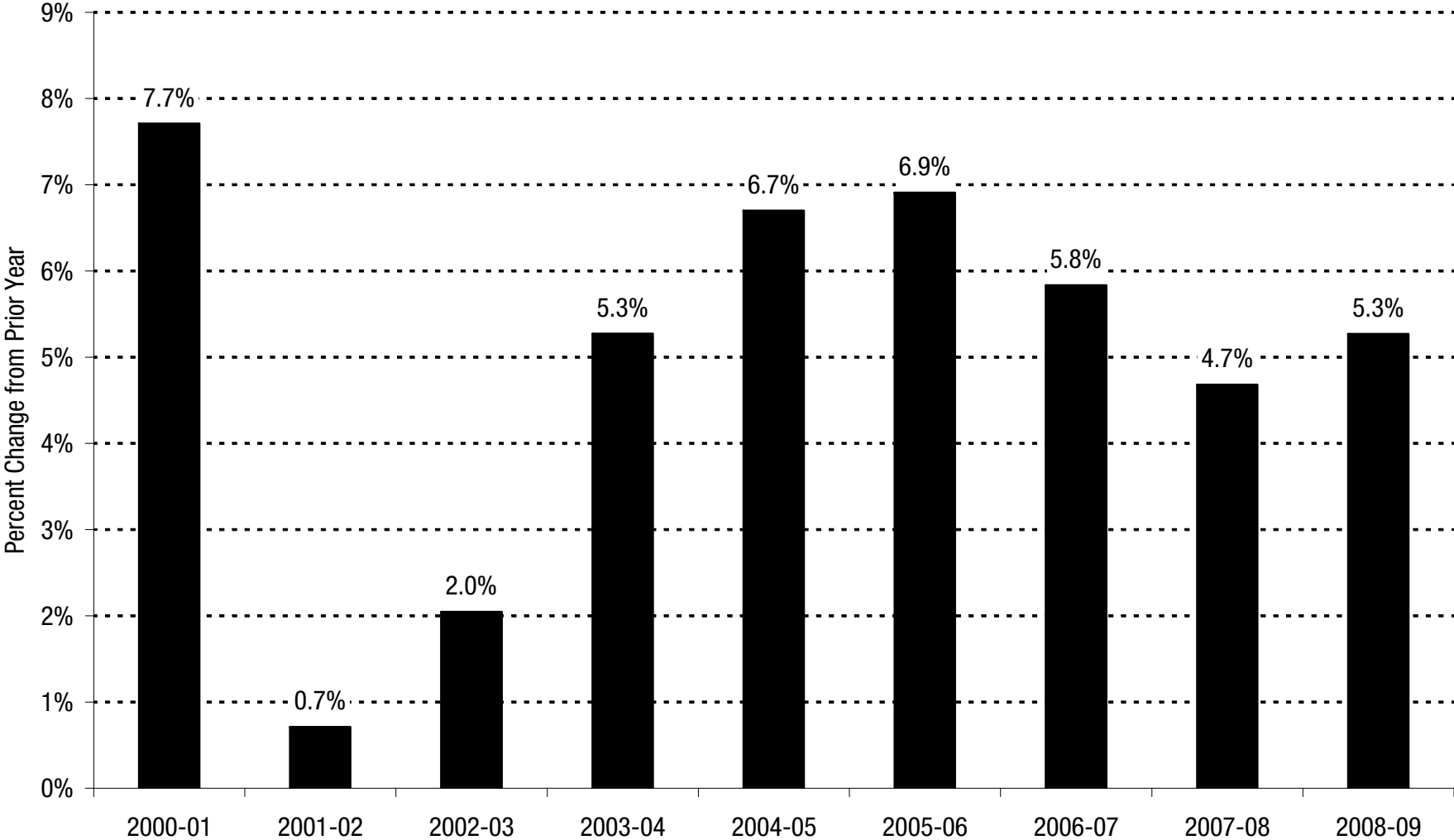
Source: Employment Development Department

California's Taxable Sales Declined in the Third Quarter of 2007



Note: 2nd and 3rd quarter 2007 data are preliminary.
Source: Department of Finance

Growth in California's Personal Income Slowed in 2006-07 and 2007-08

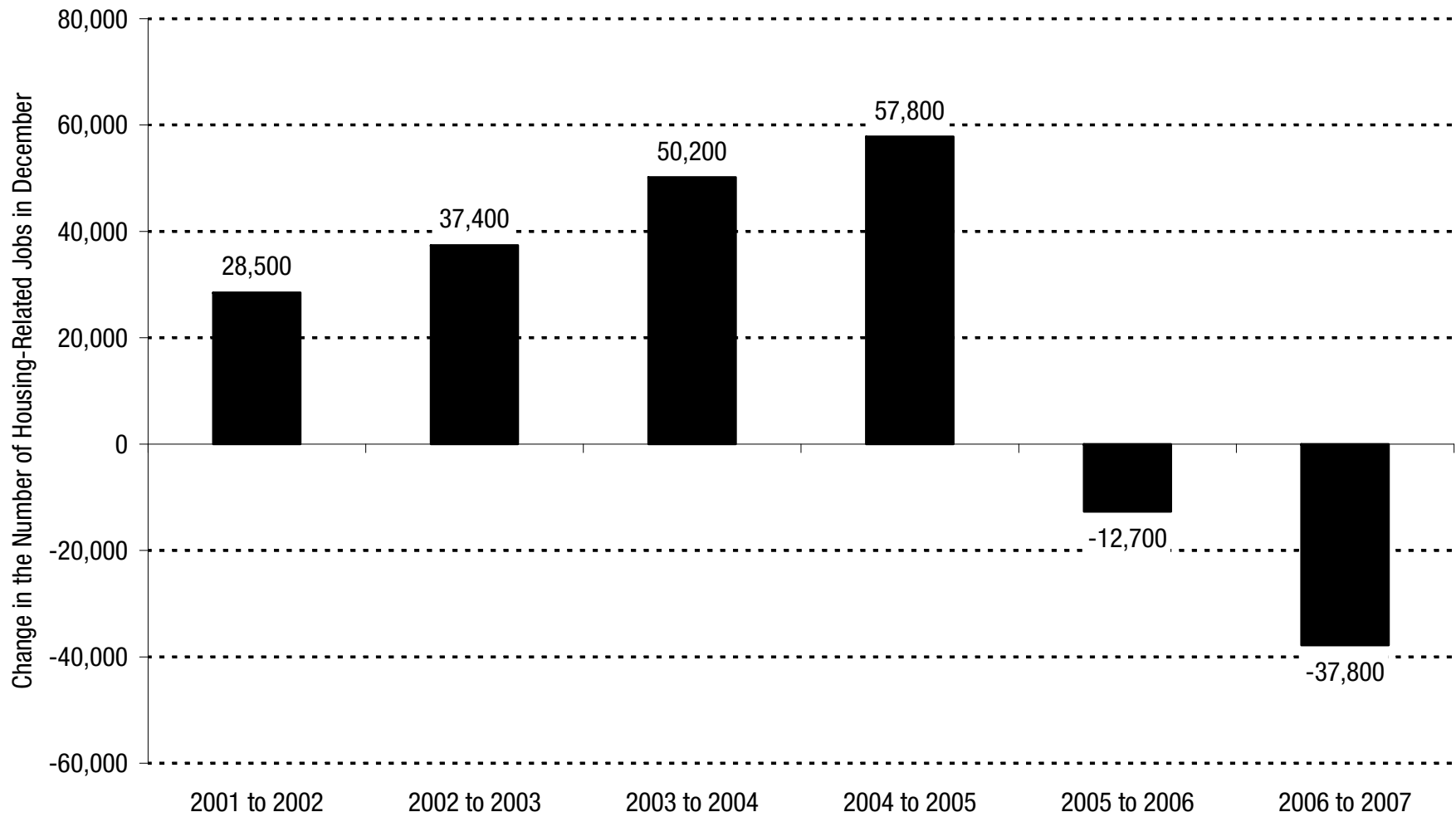


Source: Department of Finance and US Bureau of Economic Analysis

Housing Carried the Economy During the First Half of the Decade, Now Leads the Downturn

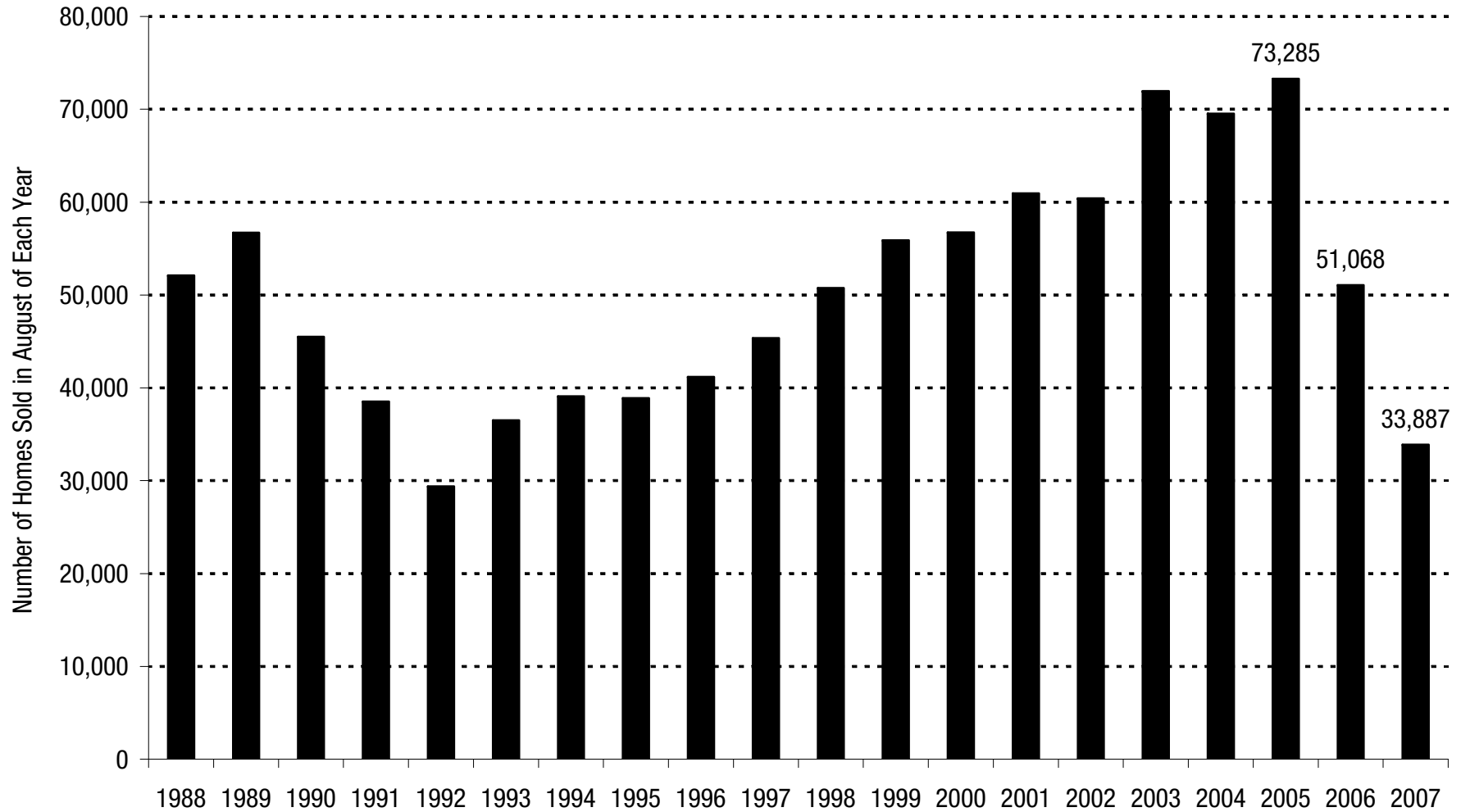
- Nearly six out of 10 jobs (59.4 percent) created in California between 2000 and 2005 were in housing-related industries even though the jobs in these industries accounted for just 3.7 percent of the total number of nonfarm jobs in 2000.
- California lost more than 50,000 housing-related jobs between December 2005 and 2007, after having gained more than 170,000 housing-related jobs between December 2001 and 2005.
- California home sales fell by more than half (53.8 percent) between August 2005 and August 2007.
- The number of foreclosures in the state skyrocketed by 2,788 percent between 2005 and 2007, while the number of default notices rose by 364 percent.

The Number of Housing-Related Jobs Declined Between December 2005 and 2007



Note: Housing-related industries include residential construction, residential specialty-trade contracting, and real estate.
Source: CBP analysis of Employment Development Department data

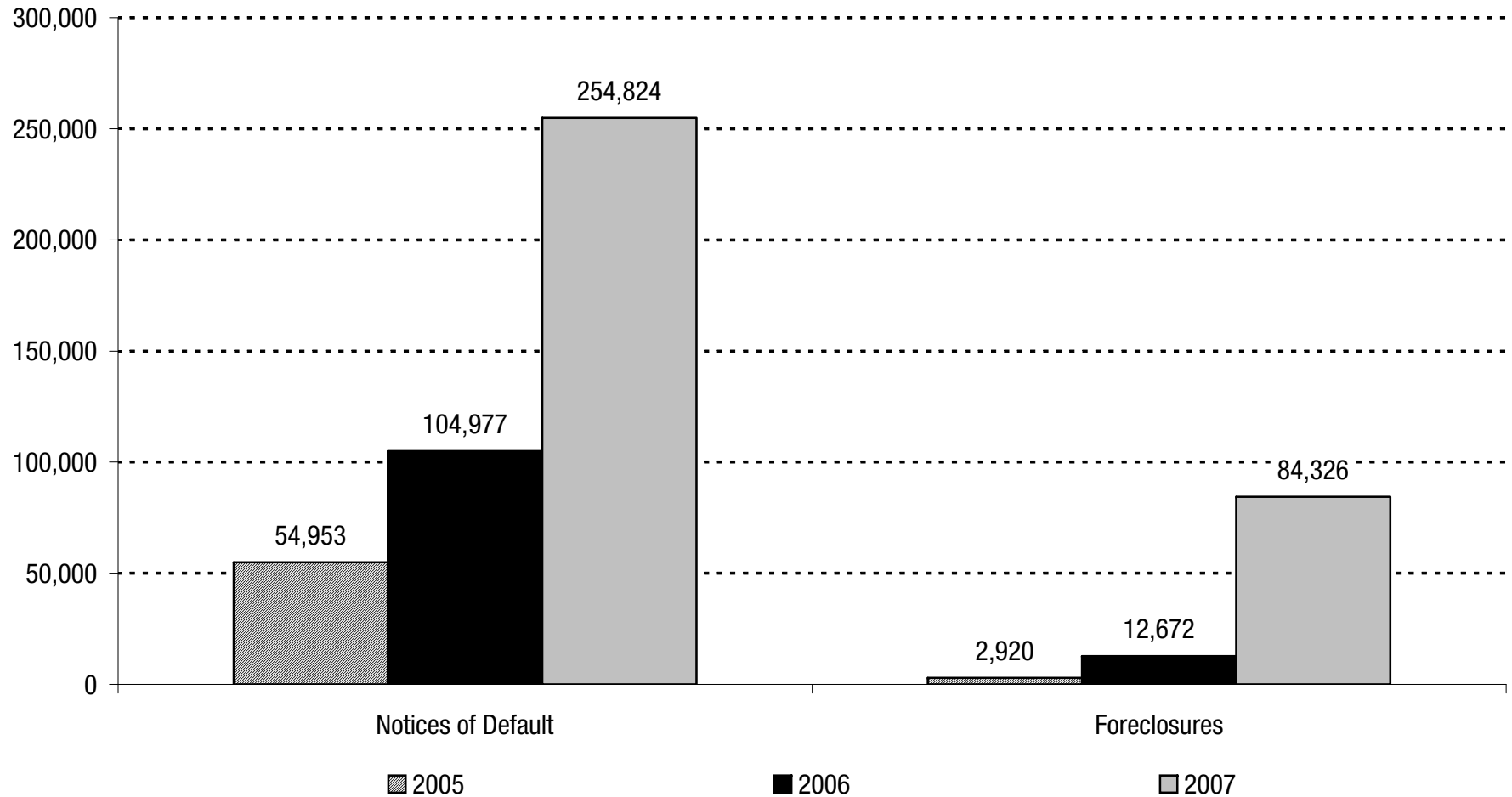
August Home Sales Plunged After 2005



Note: Includes new and resale condominiums and single-family detached homes.

Source: DataQuik Information Systems

Mortgage Delinquencies and Foreclosures Have Increased Substantially in California



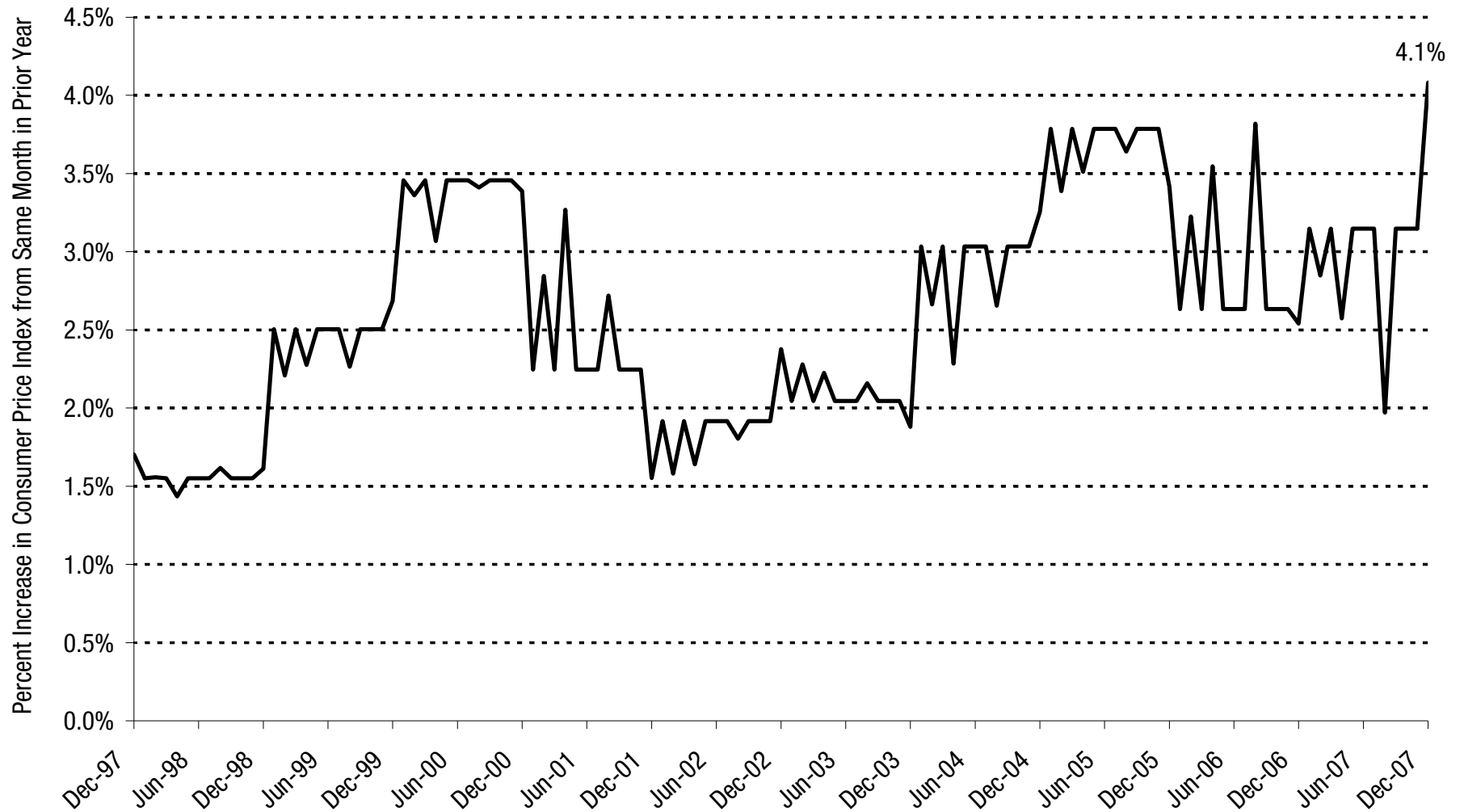
Note: Notices of default are sent to homeowners who are delinquent on their mortgage payments. Foreclosures reflect the number of homes that lenders have taken possession of or have been sold at auction.

Source: DataQuick Information Systems

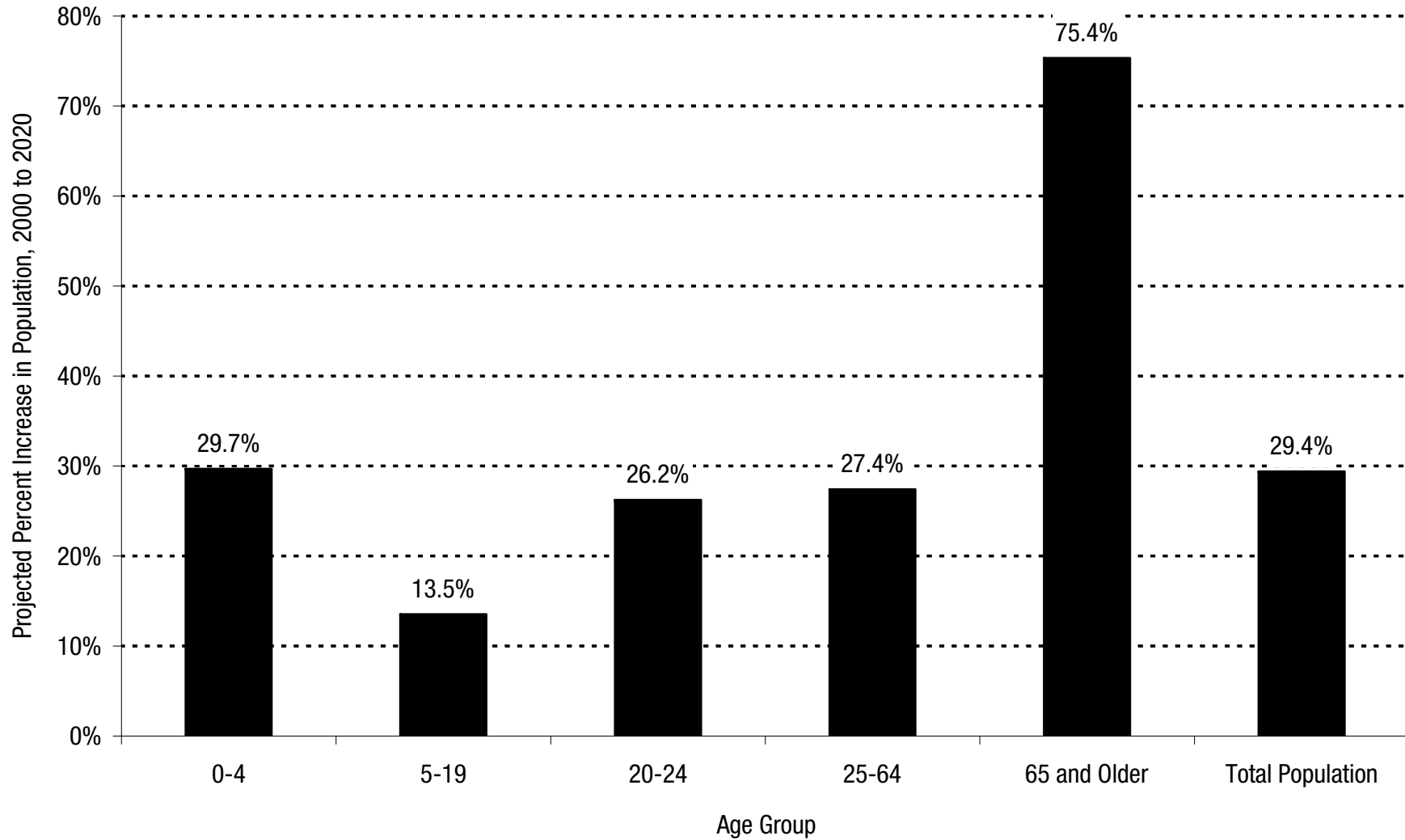
Why Has Spending Increased During a Period of Budget Shortfalls?

- Population growth and inflation push the cost of basic services higher:
 - California’s population grew by 438,455 between July 2006 and July 2007. Since 2000, the state’s population has increased by 3.7 million, an increase of 10.8 percent. The elderly are the fastest-growing segment of the population, increasing demands on health and age-dependent programs.
 - Inflation pushes the cost of goods and services purchased by the state higher. The Consumer Price Index – the most common measure of inflation – rose by 20.4 percent between 2000 and 2007.

Inflation Reached a 10-Year High in December 2007



California's Population Age 65 and Older Is Projected to Grow Rapidly Between 2000 and 2020



What Does the Increased Spending Pay For?

- Education for 275,846 students, the increase in K-12 enrollment between 2000 and 2007.
- Affordable health coverage for 514,846 children in working families, the growth in Healthy Families enrollment between June 2000 and June 2007.
- Higher education for 30,943 students at the University of California, 49,793 students in the California State University system, and 60,468 community college students, the increase in enrollment between 2000 and 2006.
- In-home care for 141,313 low-income seniors and persons with disabilities, the increase in the In-Home Supportive Services Program caseload between 2000-01 and 2007-08.
- Adoptions of 35,418 children with special needs, the increase in the Adoption Assistance Program caseload between 2000-01 and 2007-08.

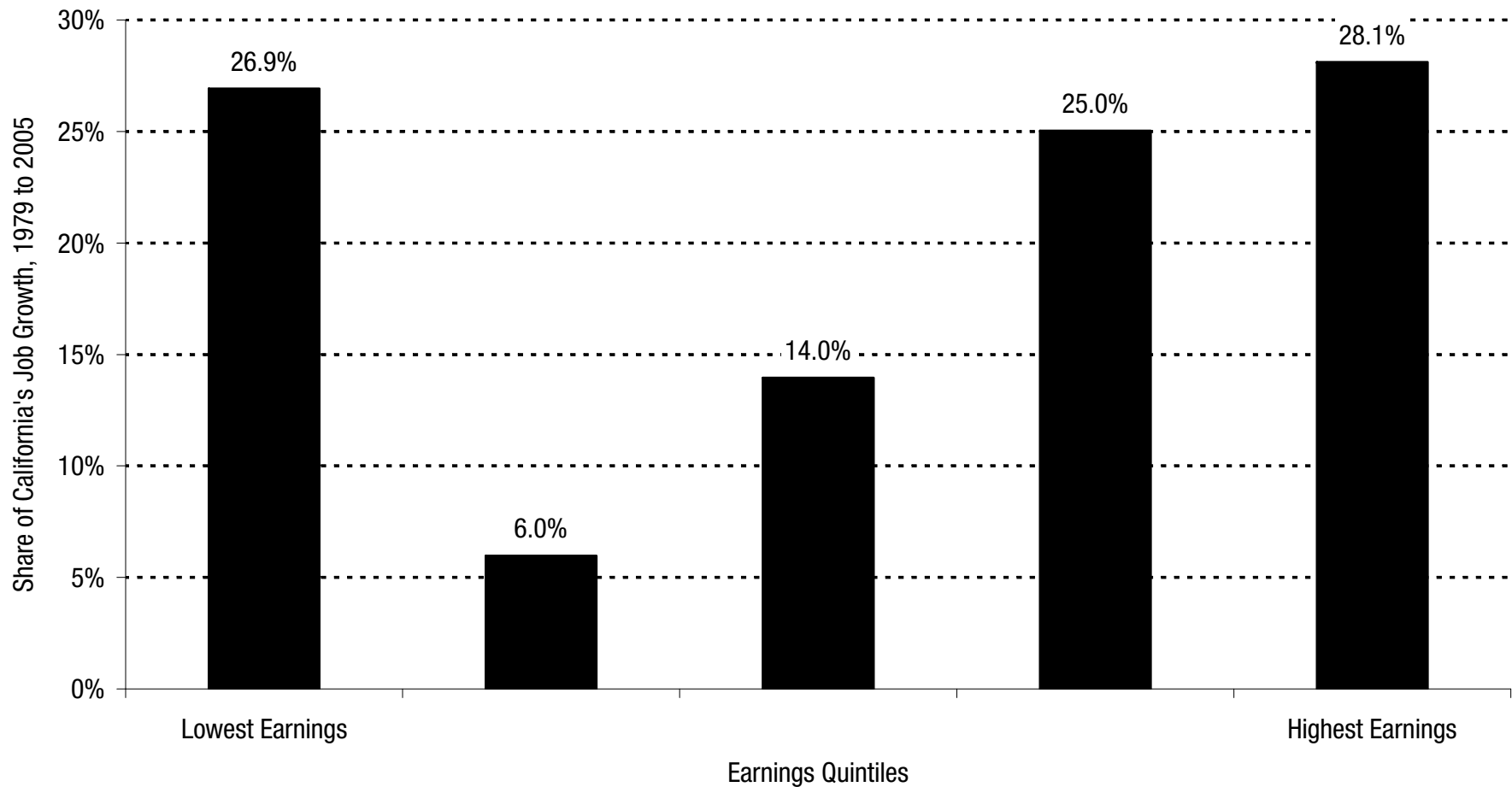
Voter-Approved Measures and Deficit-Related Borrowing Have Also Increased Spending

- A significant fraction of the increased spending identified by the Governor results from voter-approved measures:
 - \$1.485 billion in transportation spending mandated by Proposition 42 and “locked in” by Proposition 1A of 2006;
 - \$547 million in after-school spending mandated by Proposition 49 of 2002;
 - \$1.509 billion in debt service costs for the deficit-financing bonds authorized by Proposition 57 of 2004; and
 - \$4.037 billion in General Obligation bond debt service.

California Has Experienced a Generation of Widening Inequality

- More than half of the jobs created between 1979 and 2005 (55.0 percent) had typical hourly earnings in either the bottom or the top fifth of the distribution. In contrast, job growth in the middle and lower-middle of the earnings distribution was relatively weak.
- The hourly wage of the typical California worker – the worker exactly at the middle of the earnings distribution – barely kept pace with inflation between 1979 and 2006. Meanwhile, the hourly wage of the state’s low-wage workers lost purchasing power, while that of the state’s high-wage workers gained purchasing power.
- The average adjusted gross income of the top 1 percent of California taxpayers increased from 25.5 times that of the middle fifth of taxpayers in 1995 to 48.4 times that of middle-income taxpayers in 2005.

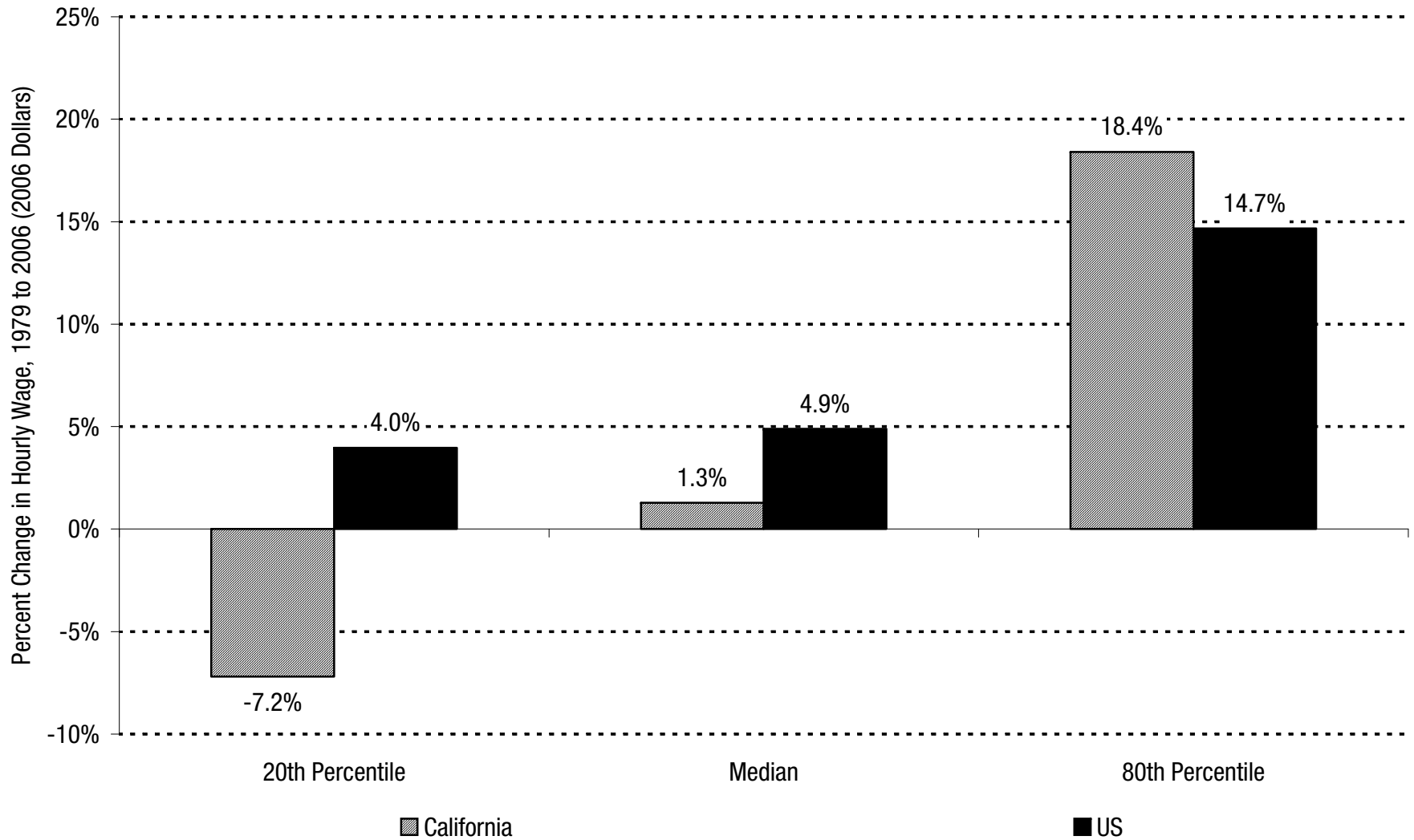
More Than Half of California's Job Growth Occurred at the Low and High Ends of the Earnings Distribution, 1979 to 2005



Note: Jobs are sorted into quintiles based on 1979 median hourly earnings.

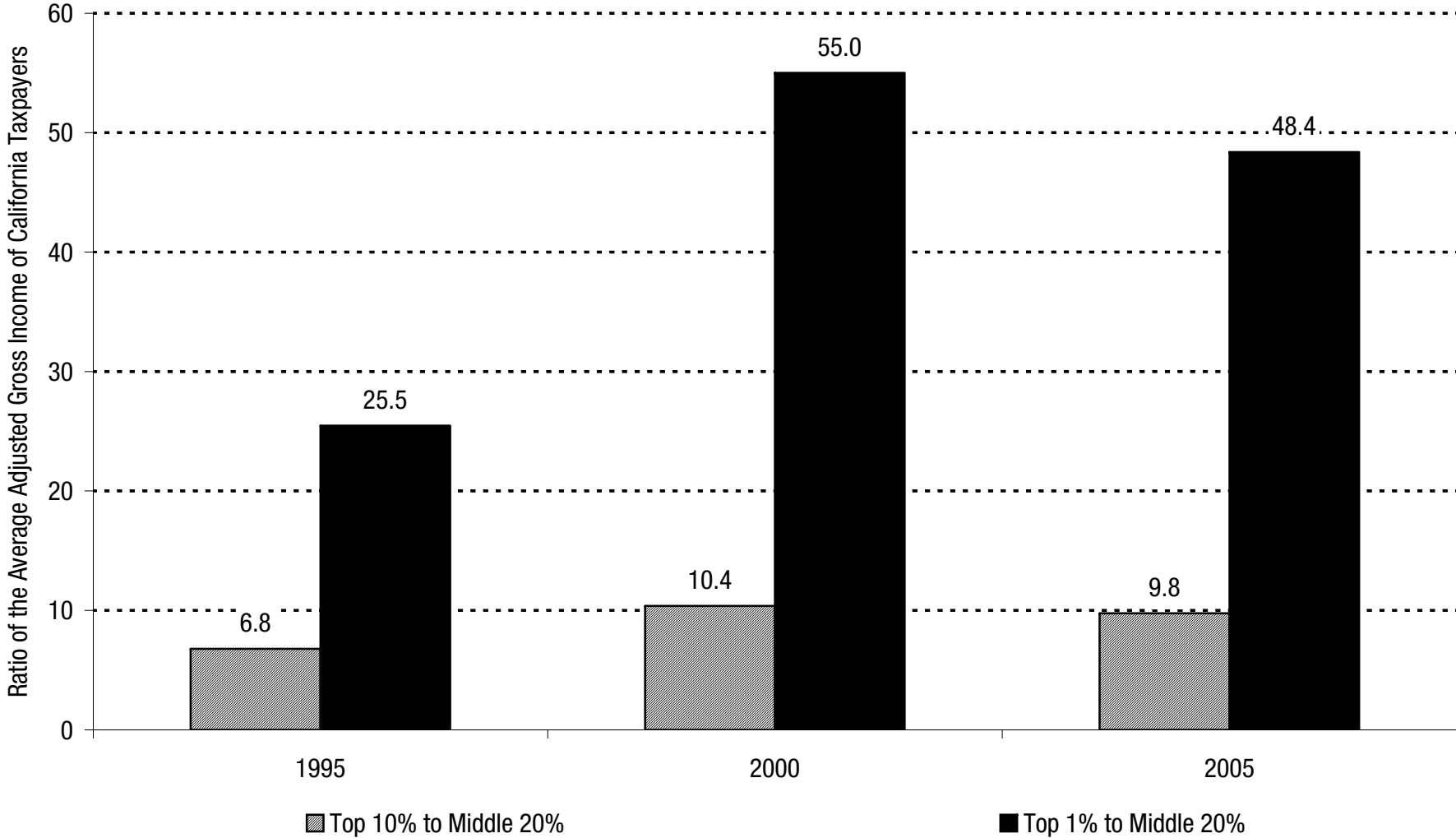
Source: CBP analysis of US Census Bureau data

Only California's High-Wage Workers Experienced Sizeable Wage Gains Between 1979 and 2006

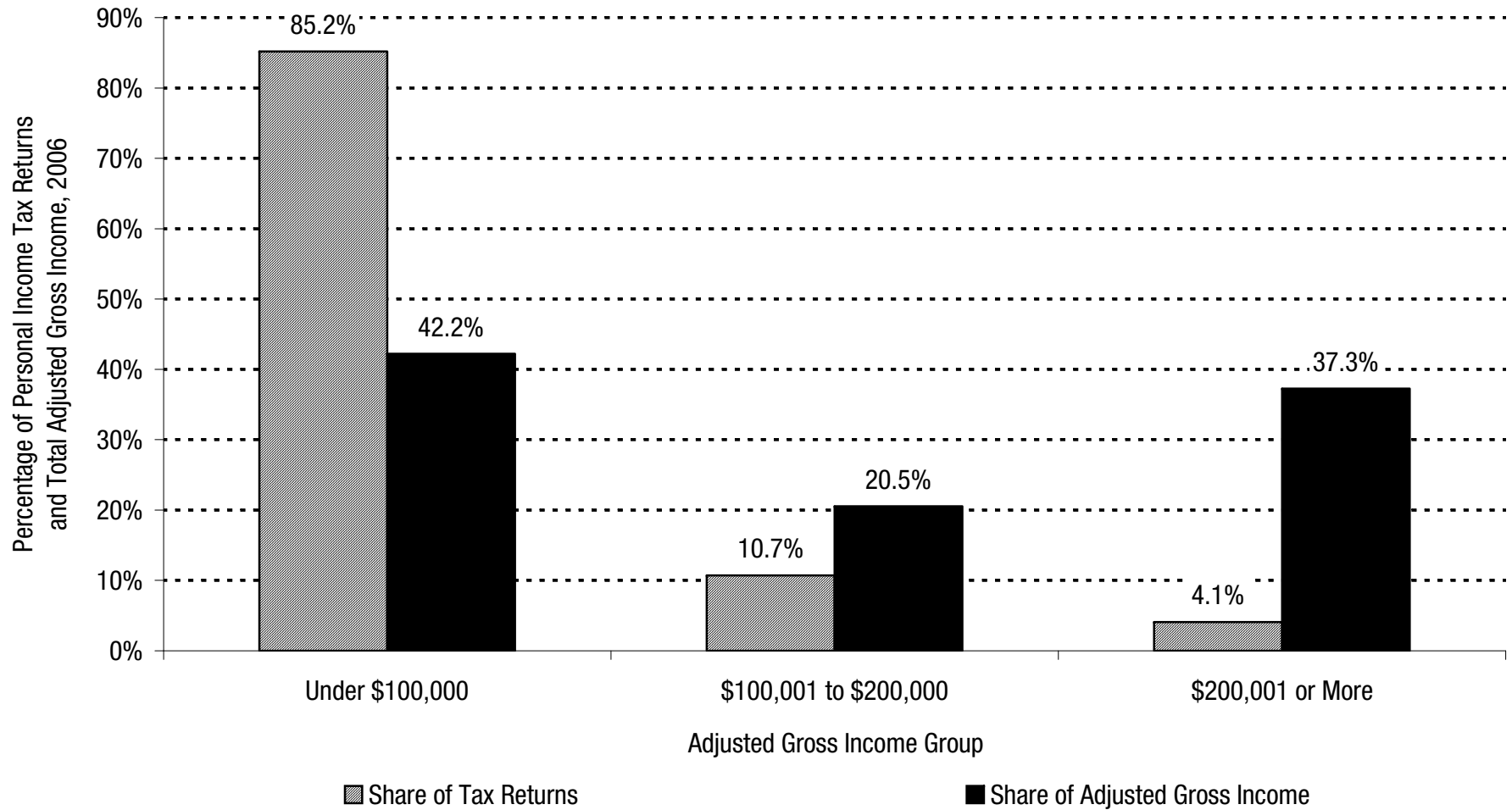


Source: CBP analysis of US Census Bureau data

The Gap Between Middle- and High-Income Californians Widened Between 1995 and 2005



Approximately 4 Percent of California's Taxpayers Earn More Than One-Third of the State's Adjusted Gross Income

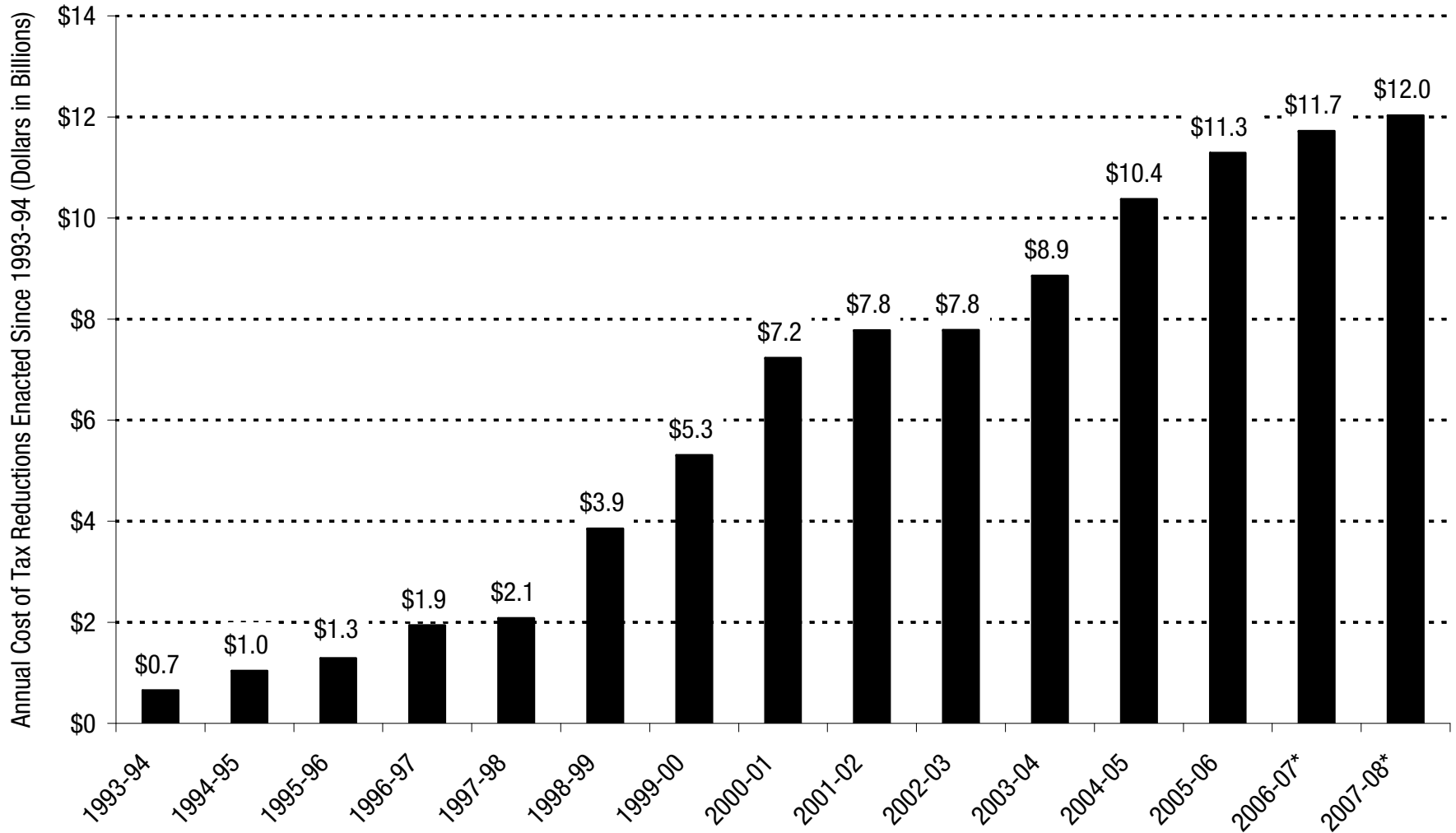


California's Tax System Contributes to the Budget Gap

Tax policies and economic trends contribute to the state's budget problems:

- Tax cuts enacted between 1993 and 2006 will cost the state \$12.0 billion in 2007-08. The largest reductions include the \$4.8 billion reduction in Vehicle License Fees, the \$1.0 billion expansion of the dependent tax credit, and the \$562 million 1996 corporate tax rate reduction.
- Corporate income taxes have declined over time as a share of General Fund revenues and as a share of corporate profits. If corporations had paid the same share of their profits in corporate taxes in 2005 as they did in 1981, corporate tax collections would be \$7.3 billion higher.
- The yield of the state's sales tax has declined over time, reflecting the shift in economic activity from goods to services and the rise of Internet and mail order sales that escape taxation. If taxable purchases accounted for the same share of personal income in 2008-09 as they did in 1966-67, the state would collect an additional \$15.9 billion in sales tax revenues.
- The phase-out of the federal estate tax will cost the state over \$1.1 billion in 2008-09. Current law reinstates the tax in 2011. However, the President proposes making the repeal permanent.

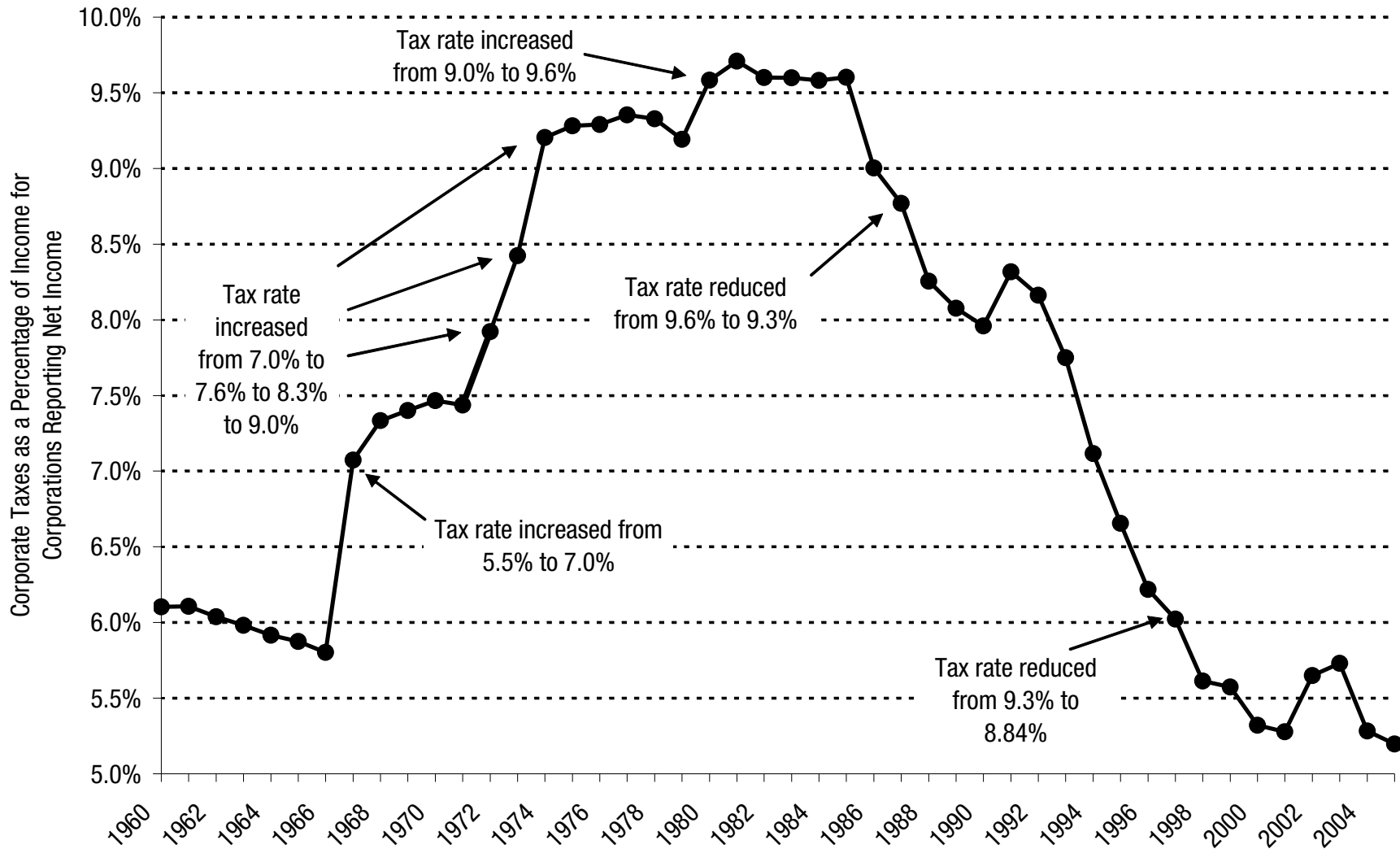
Tax Cuts Enacted Since 1993-94 Will Cost \$12 Billion in 2007-08



* 2006-07 and 2007-08 estimated.

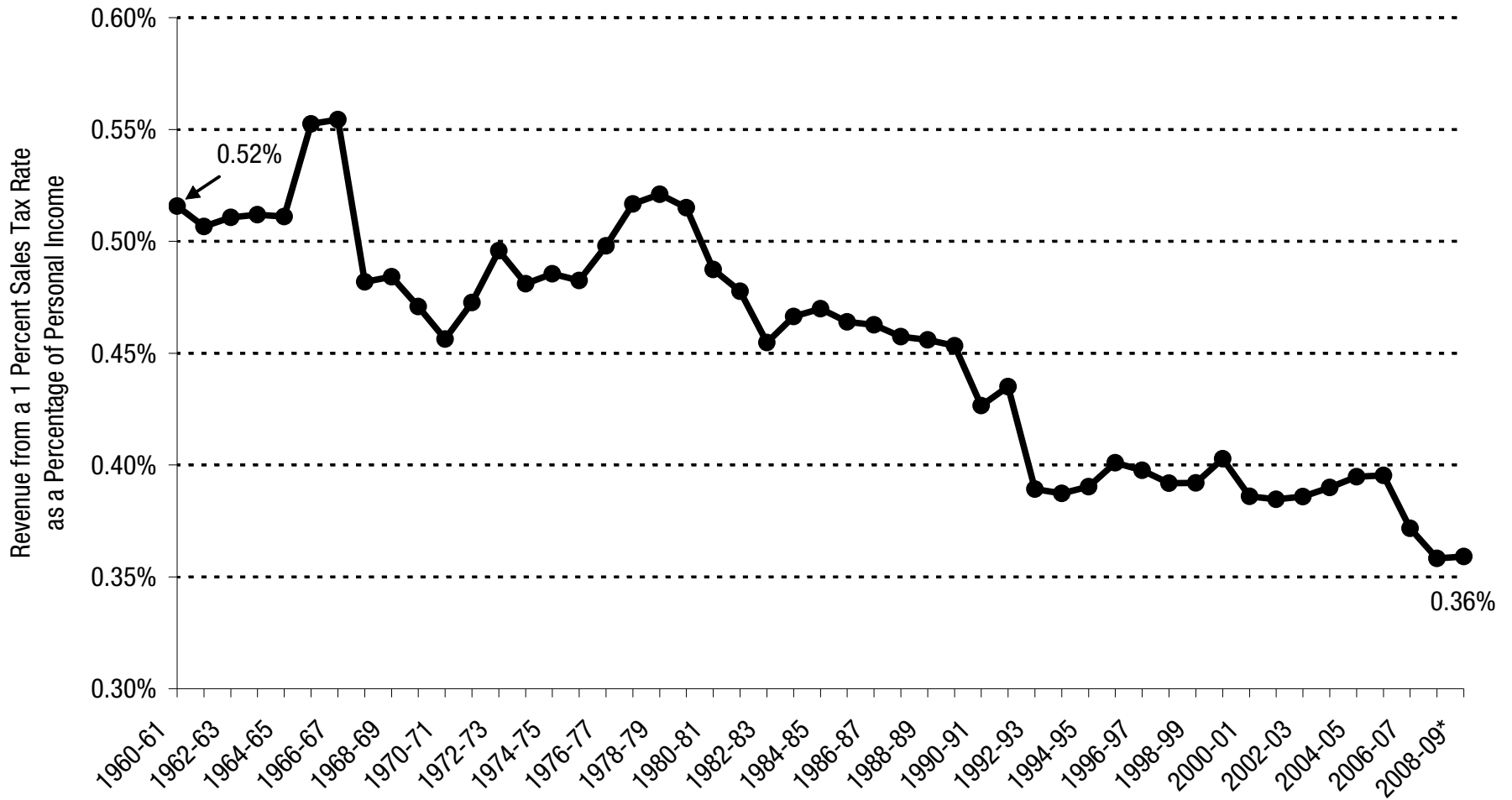
Source: Assembly Revenue and Taxation Committee, Board of Equalization, Department of Finance, Franchise Tax Board, and Legislative Analyst's Office

The Share of Corporate Income Paid in Taxes Has Fallen by Nearly Half Since 1981



Source: Franchise Tax Board

Sales Tax Collections Have Declined as a Share of Personal Income



* 2007-08 estimated and 2008-09 projected.

Source: Board of Equalization, Department of Finance, Legislative Analyst's Office, and US Bureau of Economic Analysis

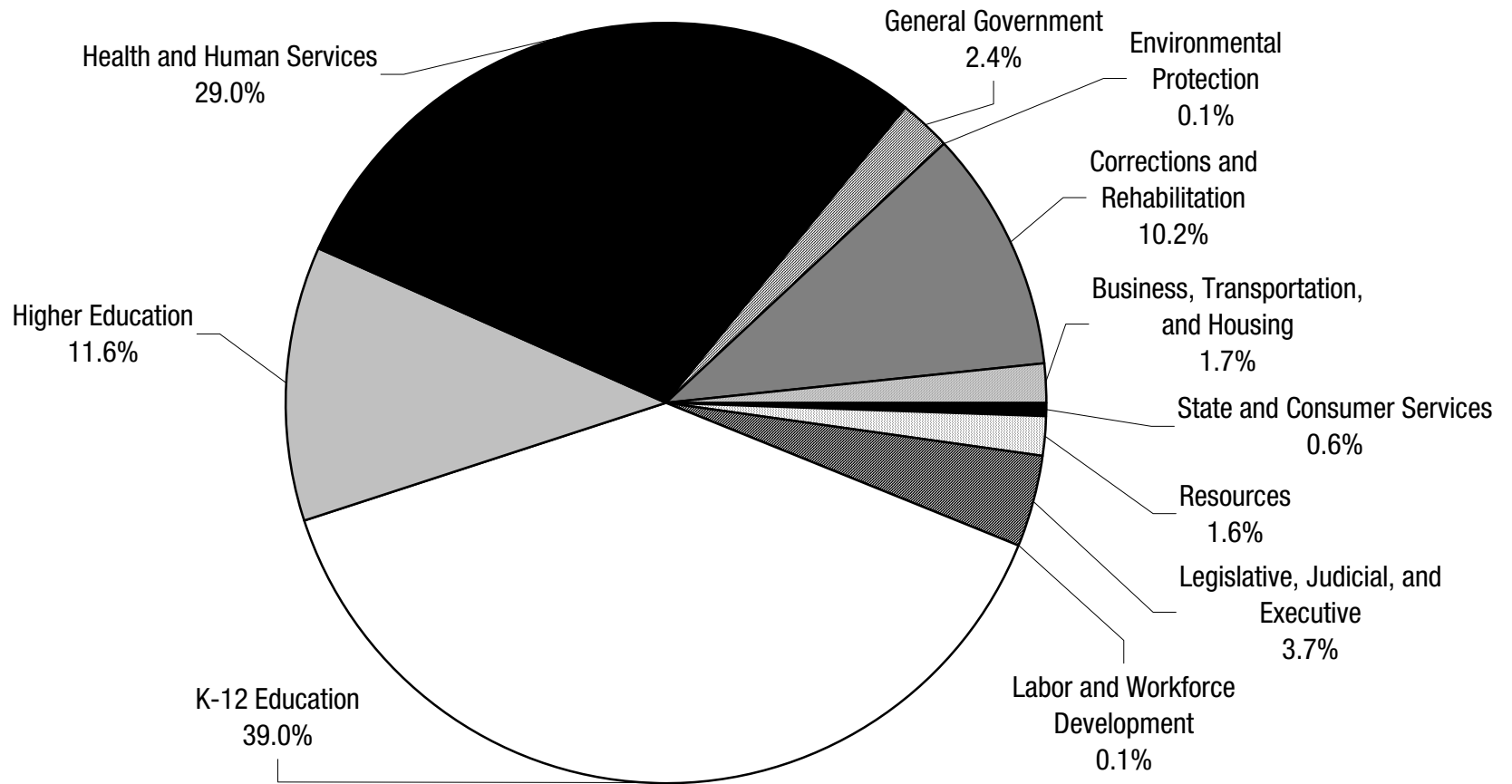
The Basics

The Governor's Proposed 2008-09 Budget:

- Would spend \$101.0 billion from the General Fund and assumes receipt of \$102.9 billion in General Fund revenues and transfers.
- Would spend \$1.3 billion (1.2 percent) less from the state's General Fund than the 2007-08 Budget signed in August. Spending would decline for K-12 and Higher Education and Health and Human Services, but increase for Business, Transportation, and Housing and Corrections and Rehabilitation.
- Would end 2008-09 with a reserve of \$2.8 billion.

Education Accounts for the Largest Share of 2008-09 Spending

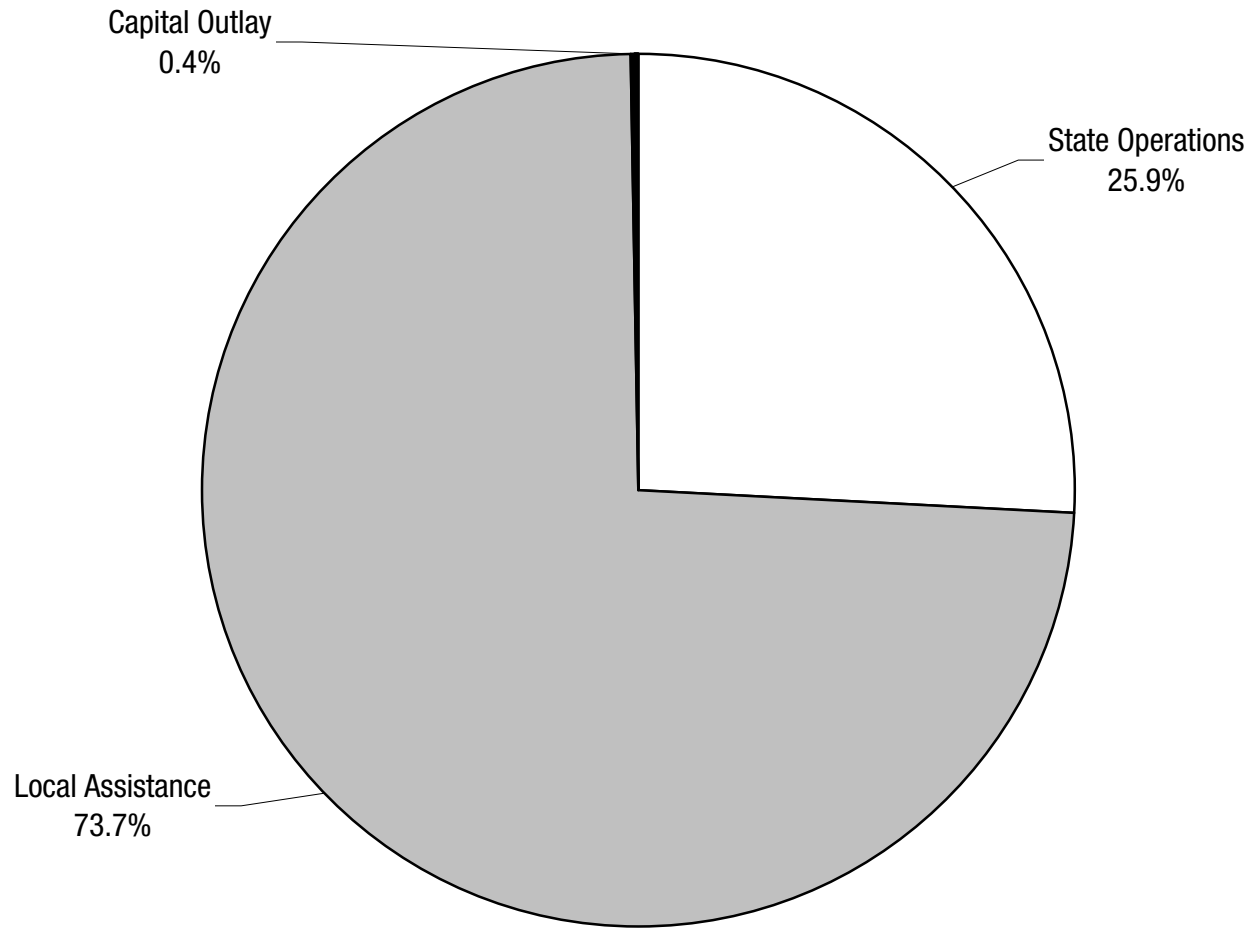
General Fund Spending by Agency



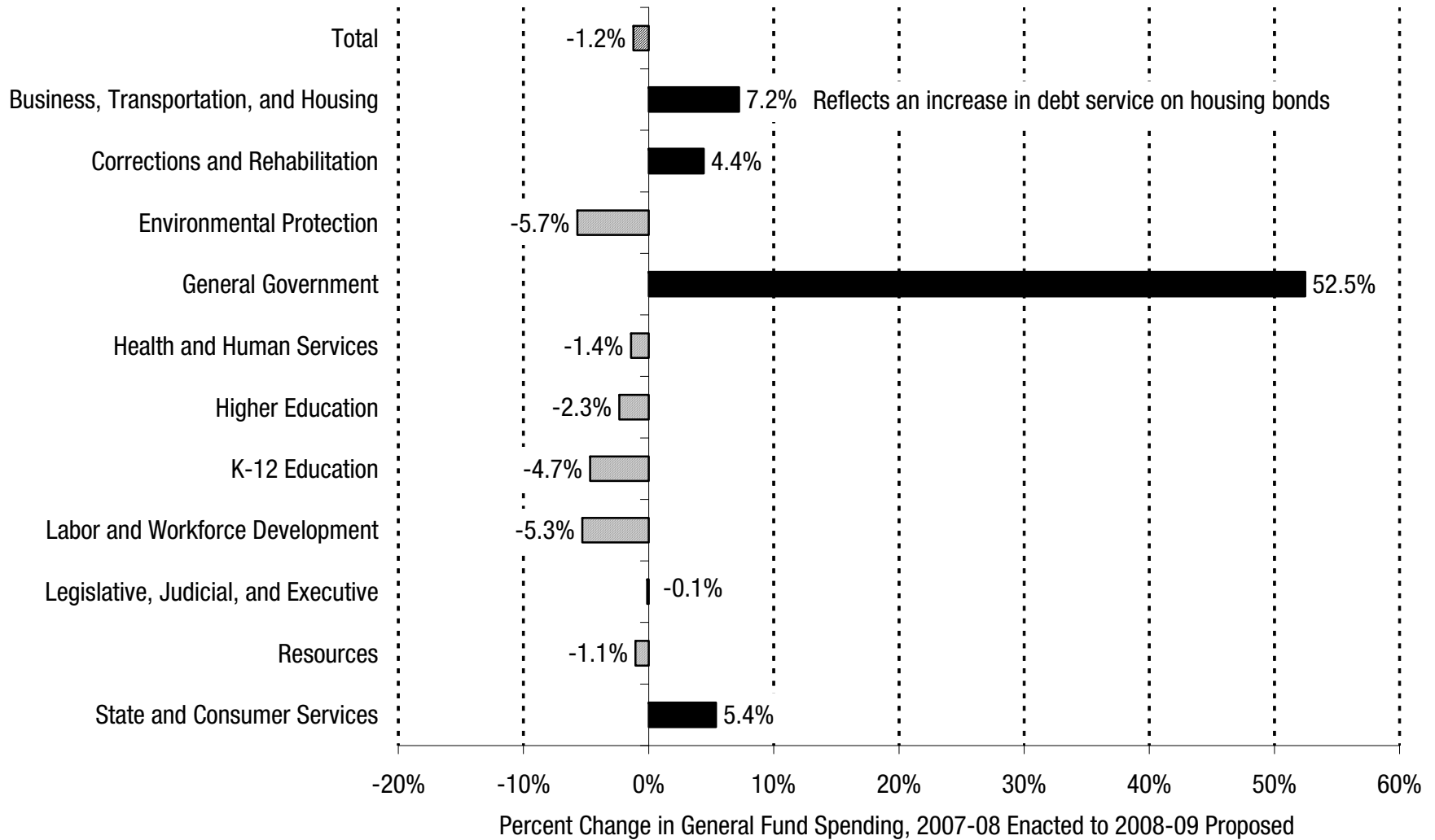
Proposed 2008-09 General Fund Expenditures = \$101.0 Billion

How Does the State Spend Its Money?

2008-09 Proposed General Fund Spending

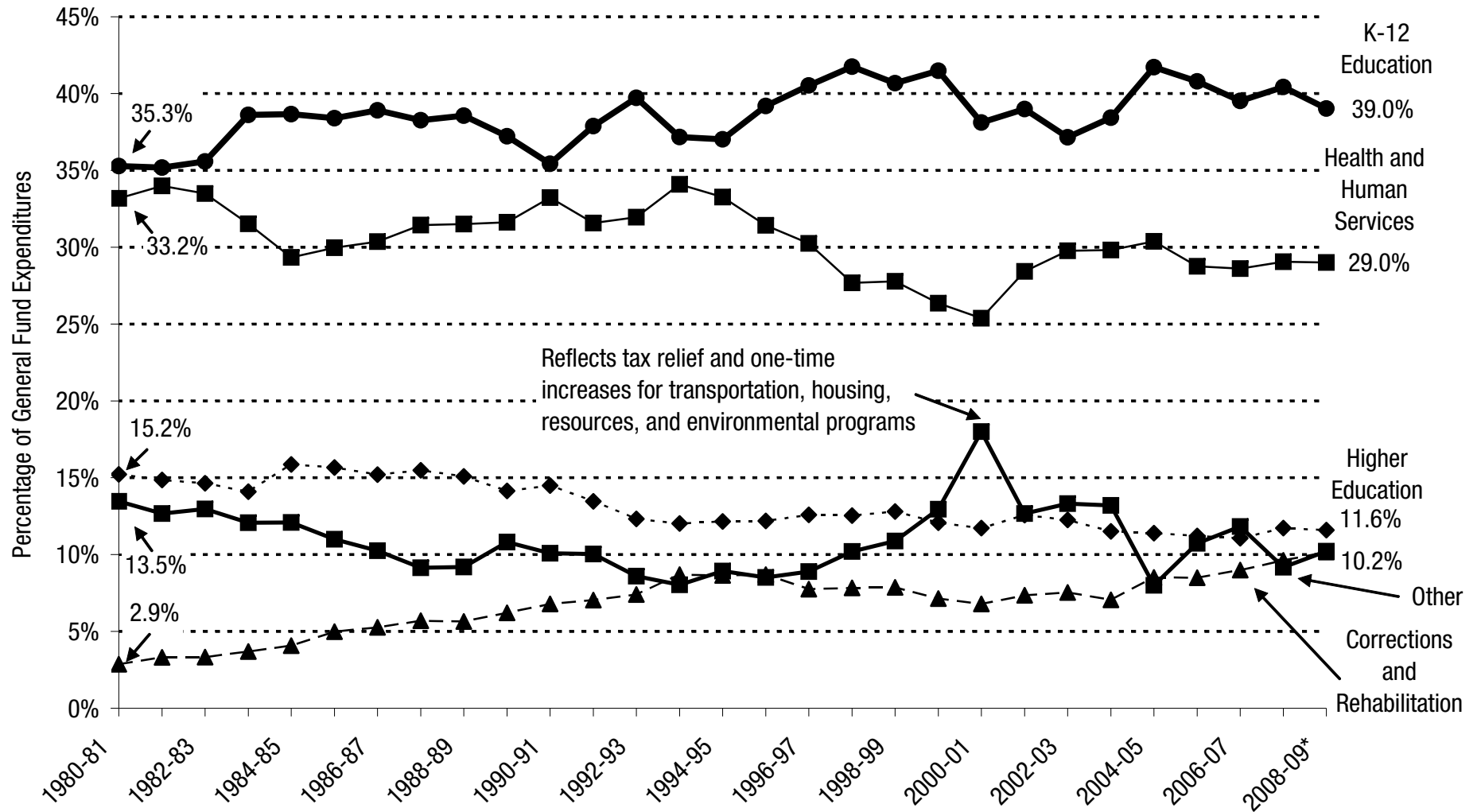


State Spending Is Down by 1.2 Percent



Source: Department of Finance

K-12 Education Accounts for the Largest Share of State General Fund Spending



* 2007-08 enacted and 2008-09 proposed.
Source: Department of Finance

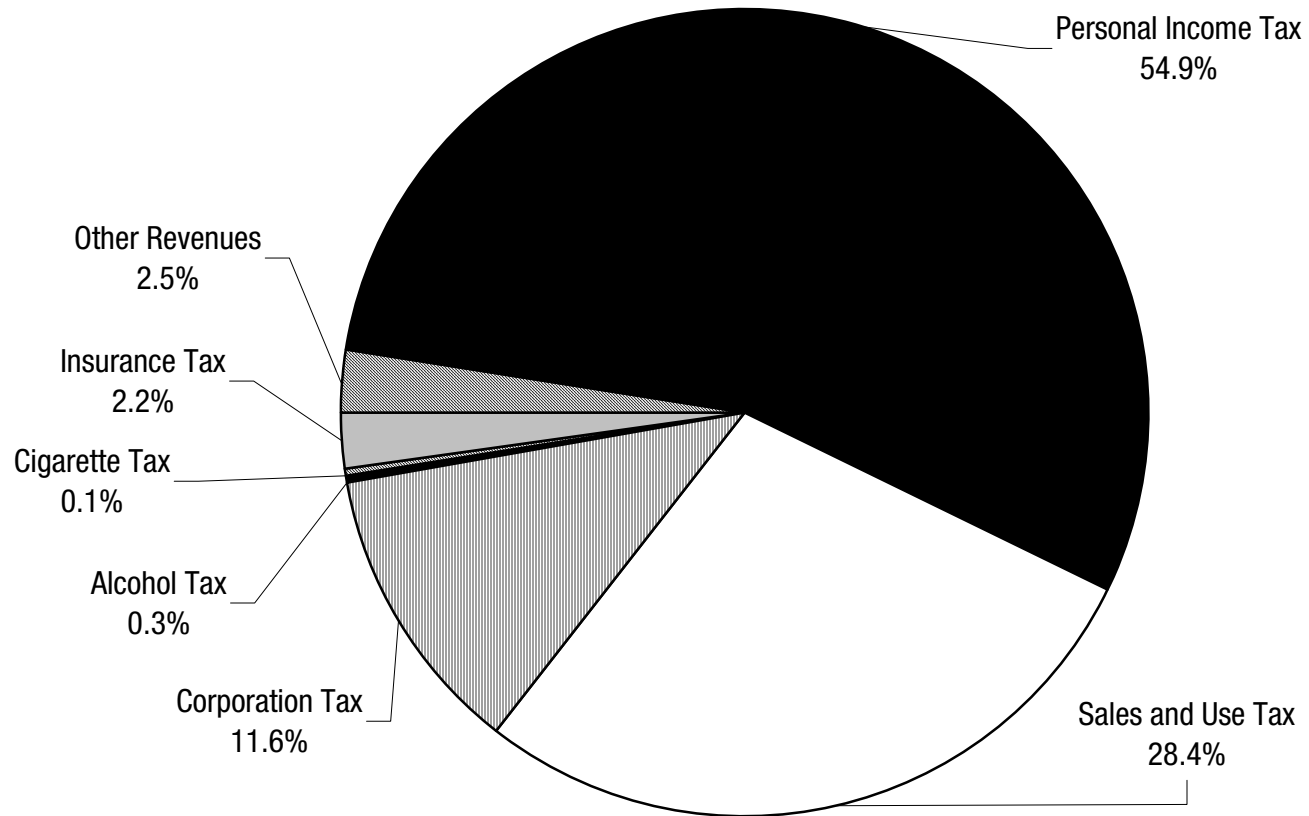
How Does California's Spending Compare?

Spending as a Percentage of State Personal Income, 2005-06

	California Rank	California	US
Total Expenditures	21	16.15%	14.63%
General Expenditures	26	13.73%	12.70%
Corrections	14	0.49%	0.40%
Education	29	4.96%	4.54%
Health	11	0.70%	0.48%
Highways	37	0.90%	0.94%
Hospitals	23	0.40%	0.42%
Natural Resources	15	0.31%	0.19%
Parks and Recreation	36	0.04%	0.05%
Police Protection	39	0.09%	0.12%

Source: US Bureau of Economic Analysis and US Census Bureau

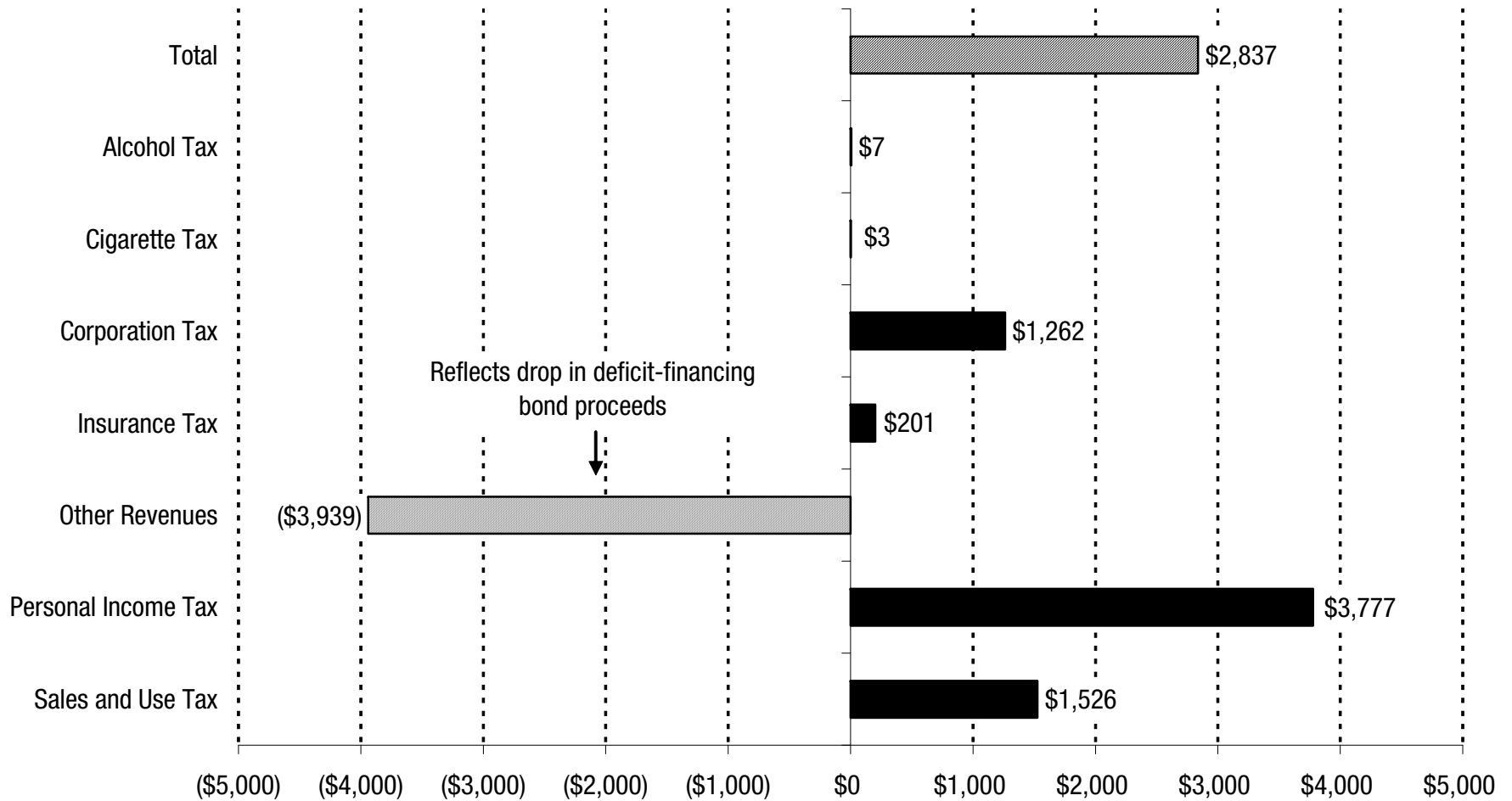
The Personal Income Tax Provides More Than Half of 2008-09 General Fund Revenues



Projected 2008-09 General Fund Revenues = \$102.9 Billion

Note: Includes loans and transfers.
Source: Legislative Analyst's Office

General Fund Revenues Are Forecast to Increase by \$2.8 Billion

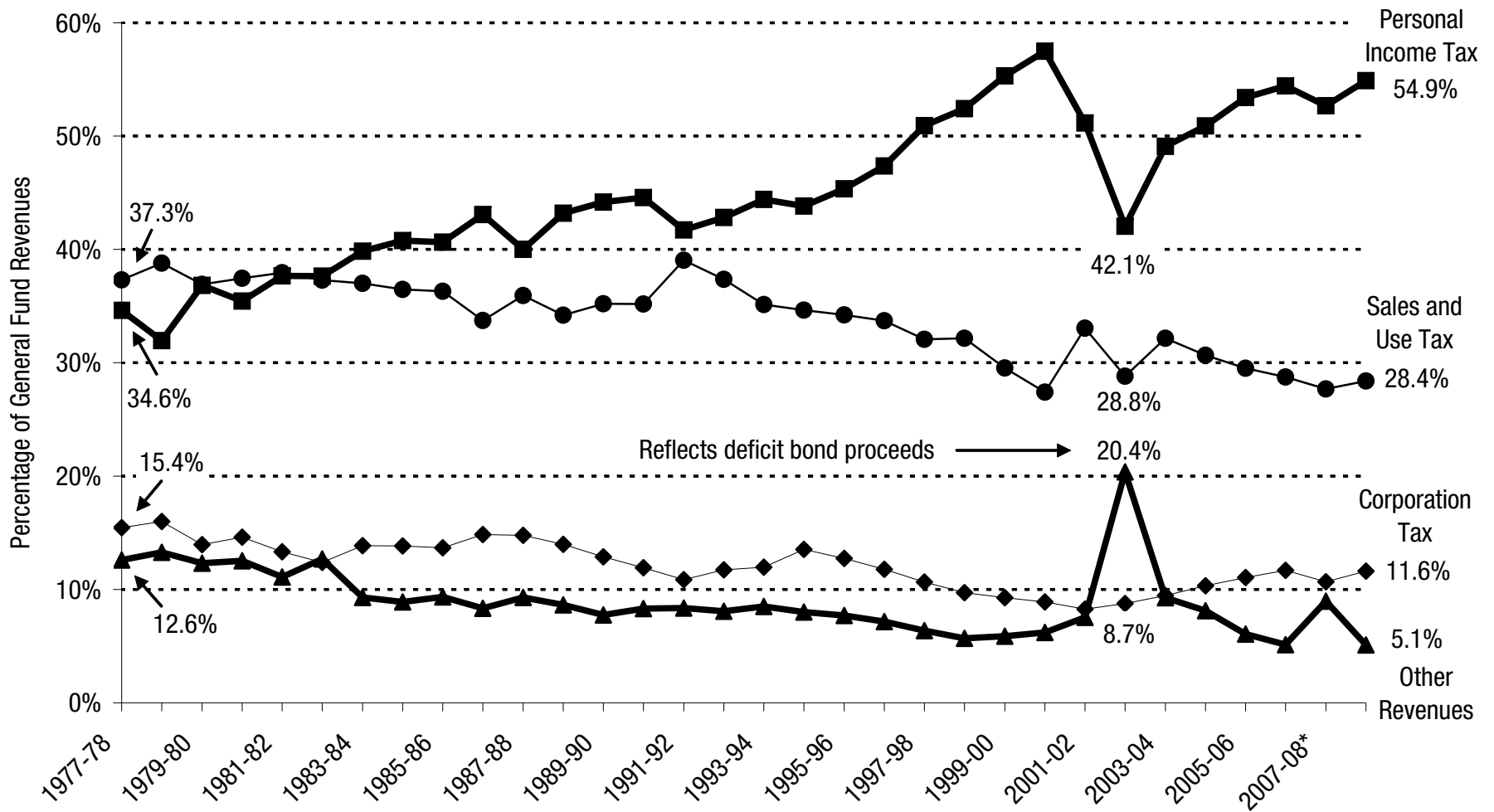


General Fund Revenue Change, 2007-08 Estimated to 2008-09 Projected (Dollars in Millions)

Note: Excludes loans and transfers.

Source: Legislative Analyst's Office

The Personal Income Tax Provides the Largest Share of General Fund Revenues

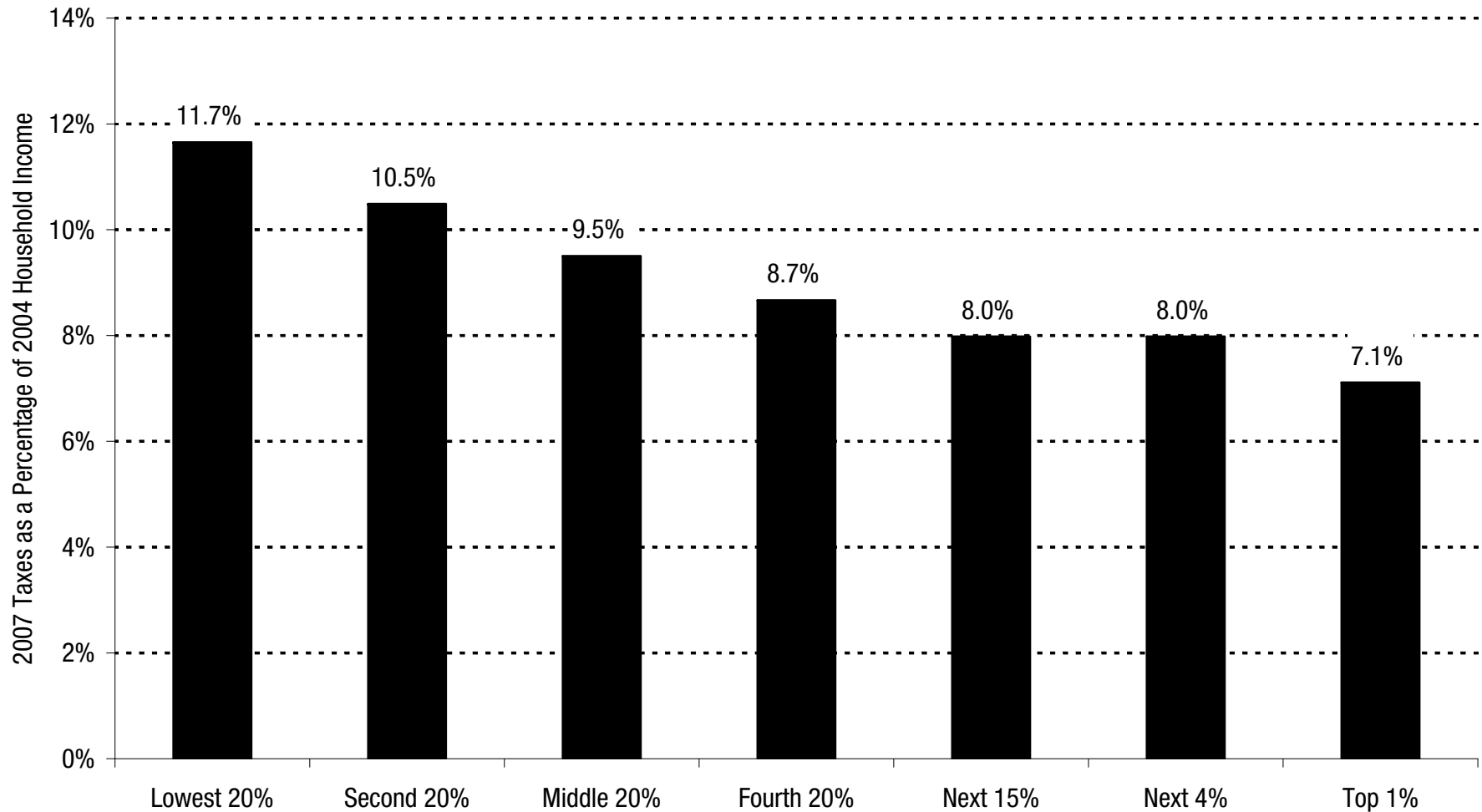


* 2007-08 estimated and 2008-09 projected.

Note: Excludes loans and transfers.

Source: Legislative Analyst's Office

Lowest-Income Households Pay the Largest Share of Their Income in State and Local Taxes



Note: Includes offset for federal deductibility of state taxes.
Source: Institute on Taxation and Economic Policy

How Does California Compare?

Revenues as a Percentage of Personal Income

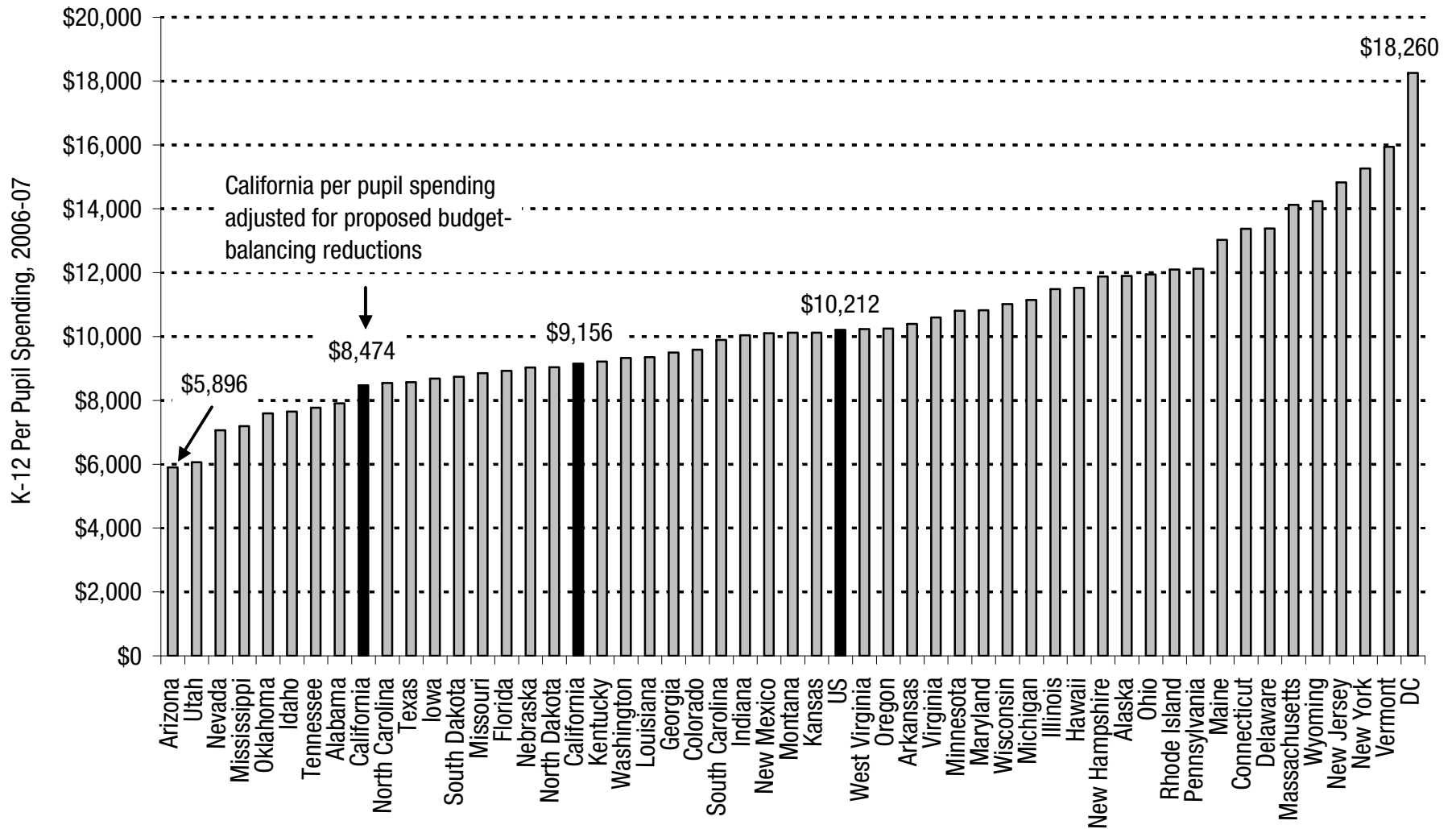
	California Rank	California	US
Total State and Local Own Source (2004-05)	18	16.51%	15.79%
Total State and Local Taxes (2004-05)	16	11.23%	10.93%
State Taxes (2005-06)	13	7.98%	6.66%
Local Taxes (2004-05)	32	3.69%	4.44%
State and Local General Sales Taxes (2004-05)	16	2.88%	2.62%
State and Local Property Tax (2004-05)	38	2.61%	3.35%
State General Sales Tax (2005-06)	20	2.31%	2.14%
State Motor Fuels Taxes (2005-06)	45	0.24%	0.34%
State Tobacco Tax (2005-06)	42	0.08%	0.14%
State Alcoholic Beverage Sales Taxes (2005-06)	41	0.02%	0.05%
State Individual Income Tax (2005-06)	3	3.67%	2.30%
State Corporate Income Tax (2005-06)	6	0.74%	0.45%

Source: US Bureau of Economic Analysis and US Census Bureau

The Governor Proposes to Suspend Proposition 98

- The Governor proposes to suspend the 2008-09 Proposition 98 guarantee, cut 2008-09 funding for K-14 education by \$4.825 billion, and reduce current year K-14 education spending by \$400 million.
- The Governor's proposal translates into K-12 Proposition 98 per pupil spending of \$8,458 in 2008-09, down from \$8,558 in 2007-08, a 1.2 percent decrease.
- The Governor's proposed cuts to K-12 education include:
 - A reduction in the “workload” or “baseline” budget of \$142.4 million to reflect a projected enrollment decline of 0.52 percent;
 - Reducing revenue limit funding by \$2.6 billion by eliminating the 4.94 percent COLA for school districts and county offices of education;
 - Eliminating COLAs and reducing rate allocations for a number of categorical programs to save \$1.1 billion; and
 - Reducing special education funding by \$357.9 million.
- The Governor also would eliminate the COLA and limit the adjustment for enrollment growth on the general purpose allocation provided to community colleges. The Governor also would cut funding for categorical programs.

California Would Fall Further Behind Under Proposed Budget Reductions

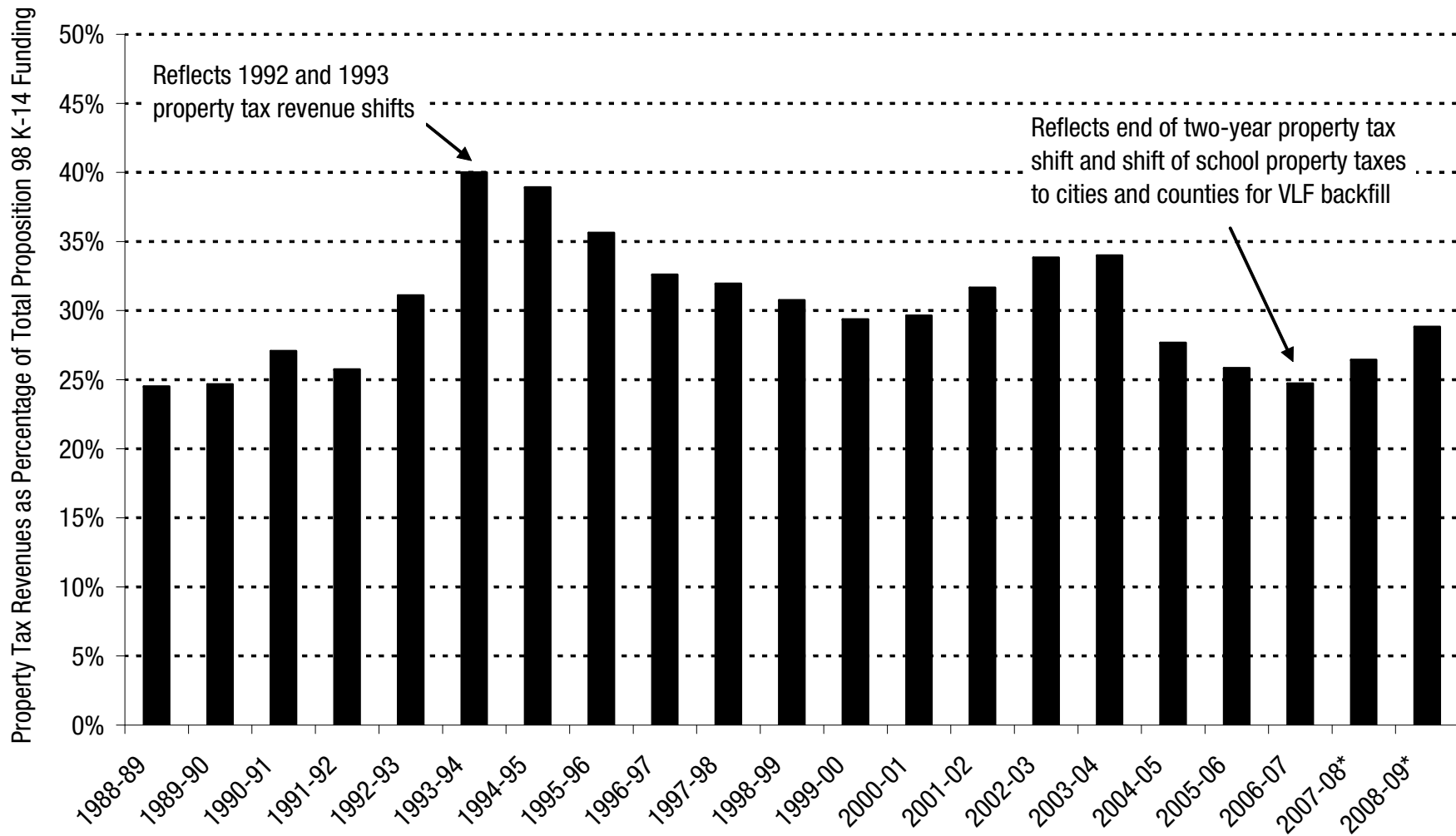


How Do California's Schools Compare?

	California Rank	California	US
K-12 Per Pupil Spending (2006-07)	35	\$9,156	\$10,212
K-12 Spending as a Percentage of Personal Income (2006-07)	40	3.76%	4.13%
Number of K-12 Pupils Per Teacher (2006-07)	49	19.9	14.4
K-12 Per Pupil Spending, Adjusted for Regional Cost Differences (2004-05)	48	\$7,081	\$8,973
Percentage of K-12 Pupils in Districts with Adjusted Per Pupil Spending at or Above the US Average (2004-05)	49	3.0%	46.1%

Source: Education Week, National Education Association, and US Bureau of Economic Analysis

The Share of Proposition 98 Spending Provided by Local Property Tax Revenues Dropped After 2003-04



* 2007-08 estimated and 2008-09 proposed.

Source: Legislative Analyst's Office

The Governor's Budget Proposals Would Drop More Than 150,000 Children from the CalWORKs Program

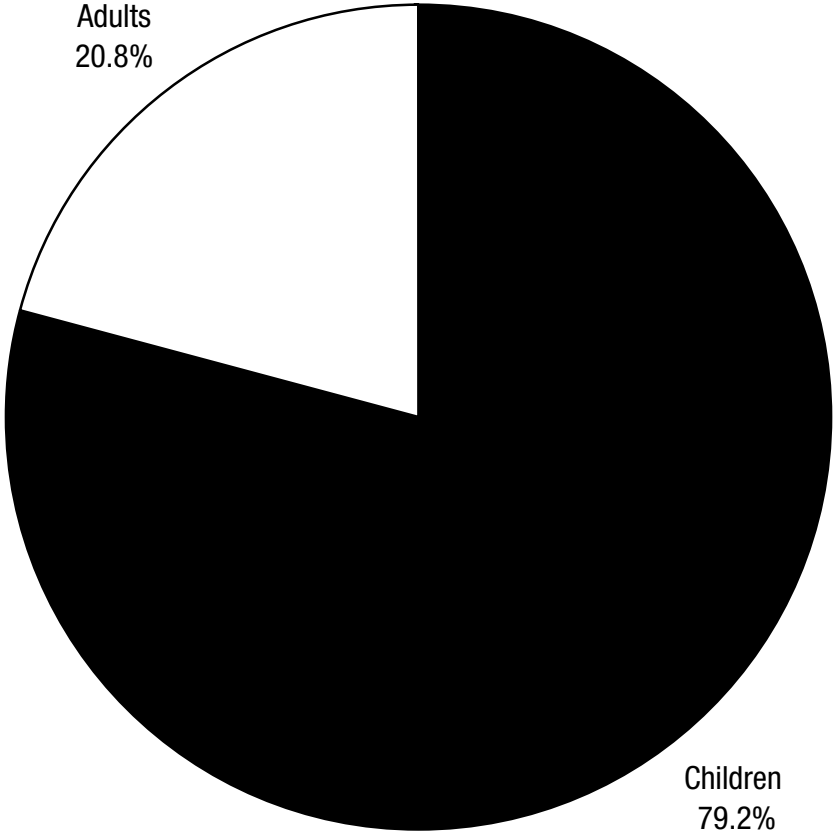
The Governor's proposals would:

- Eliminate “safety net” cash assistance for certain children after their parents have reached the state's 60-month time limit.
- Eliminate cash assistance after 60 months for certain children whose parents are ineligible for CalWORKs.
- Drop more than 150,000 children from the CalWORKs Program in June 2008 as a result of these two policy changes.

In addition, the Governor's proposals would:

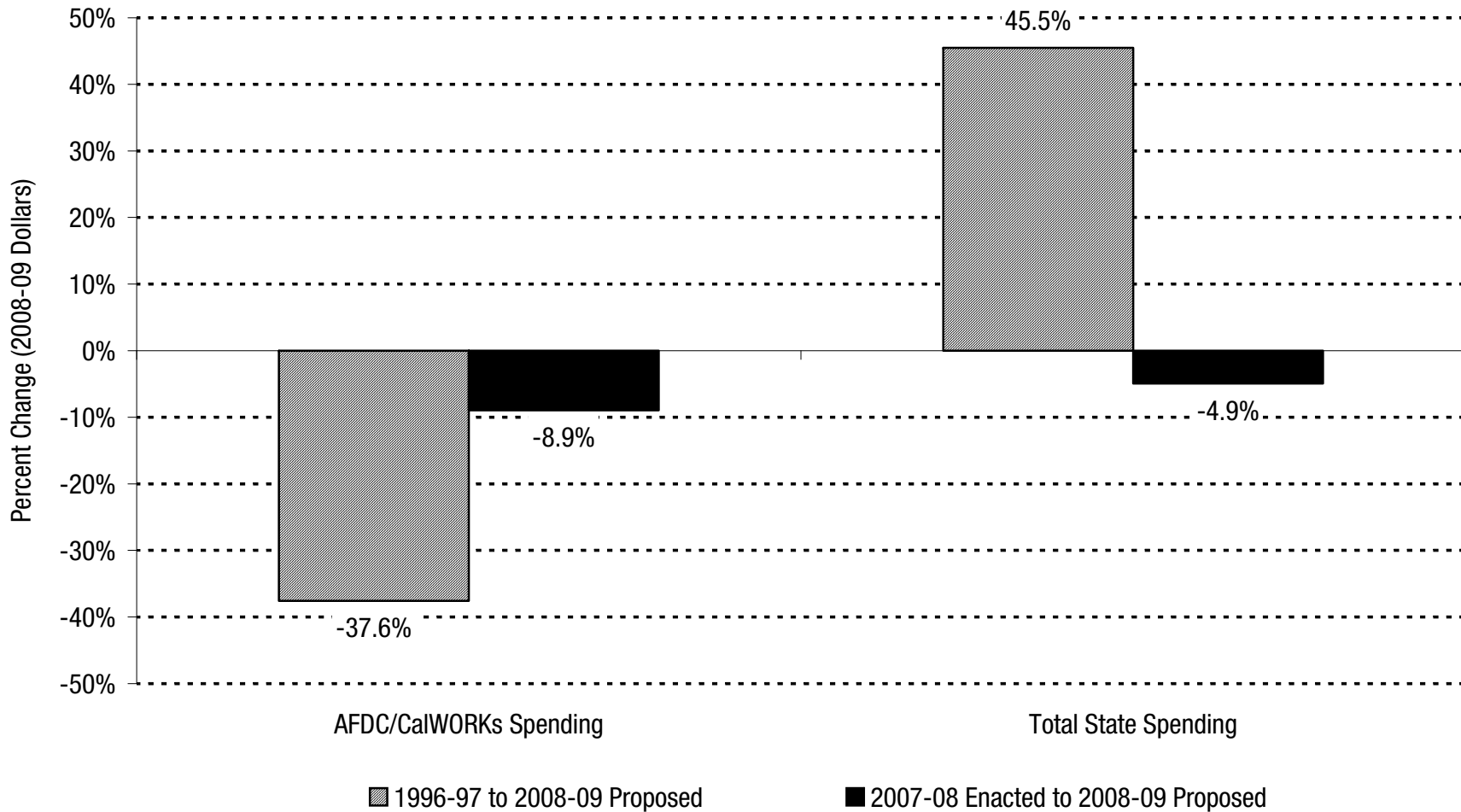
- Reduce, and then eliminate, cash assistance for children if their parents do not comply with CalWORKs requirements within 12 months.

Nearly Four Out of Five CalWORKs Recipients Are Children



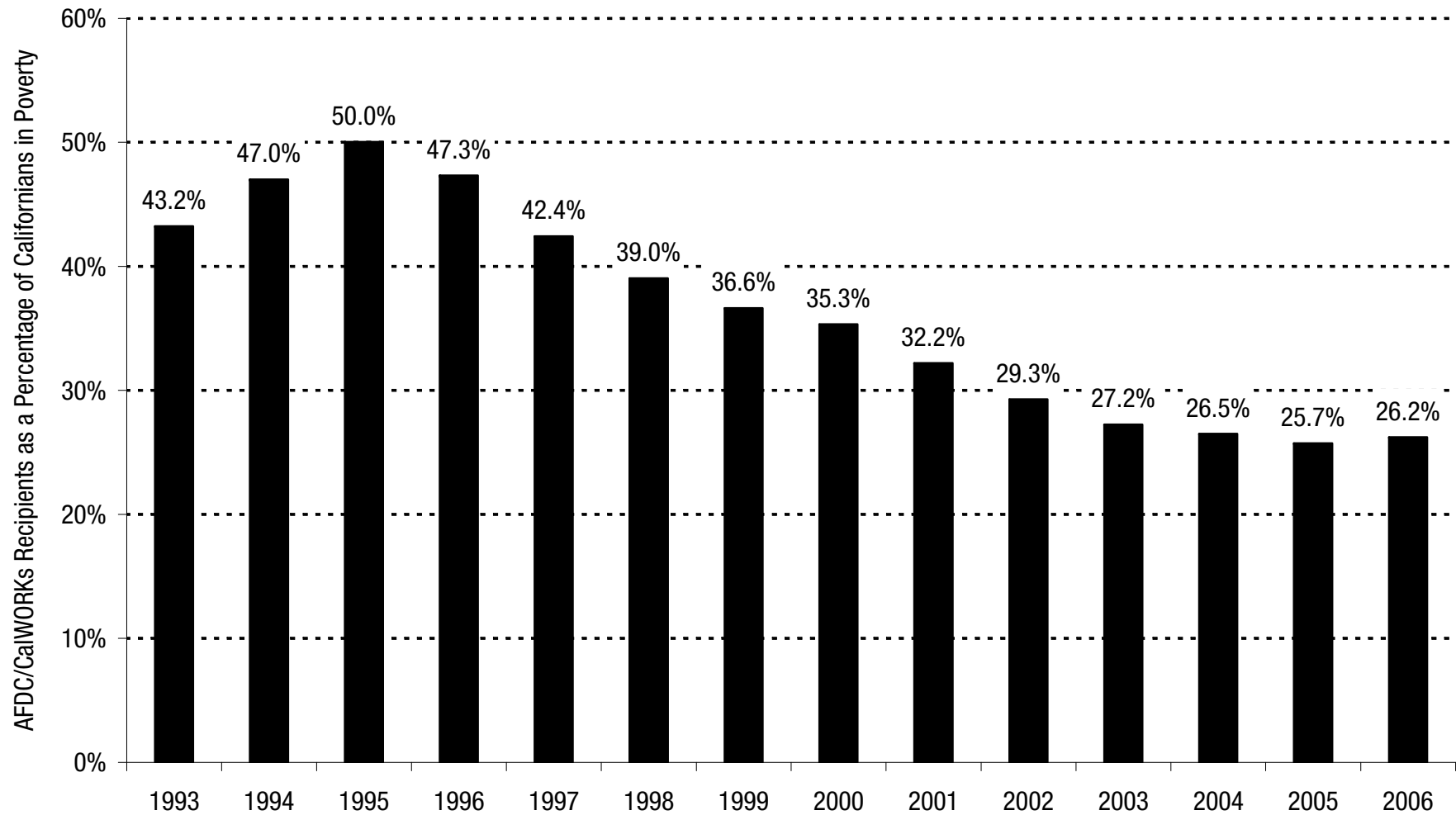
Number of Individuals Receiving CalWORKs Cash Assistance in September 2007 = 1.1 Million

Welfare Spending Has Declined by More Than One-Third Since 1996-97



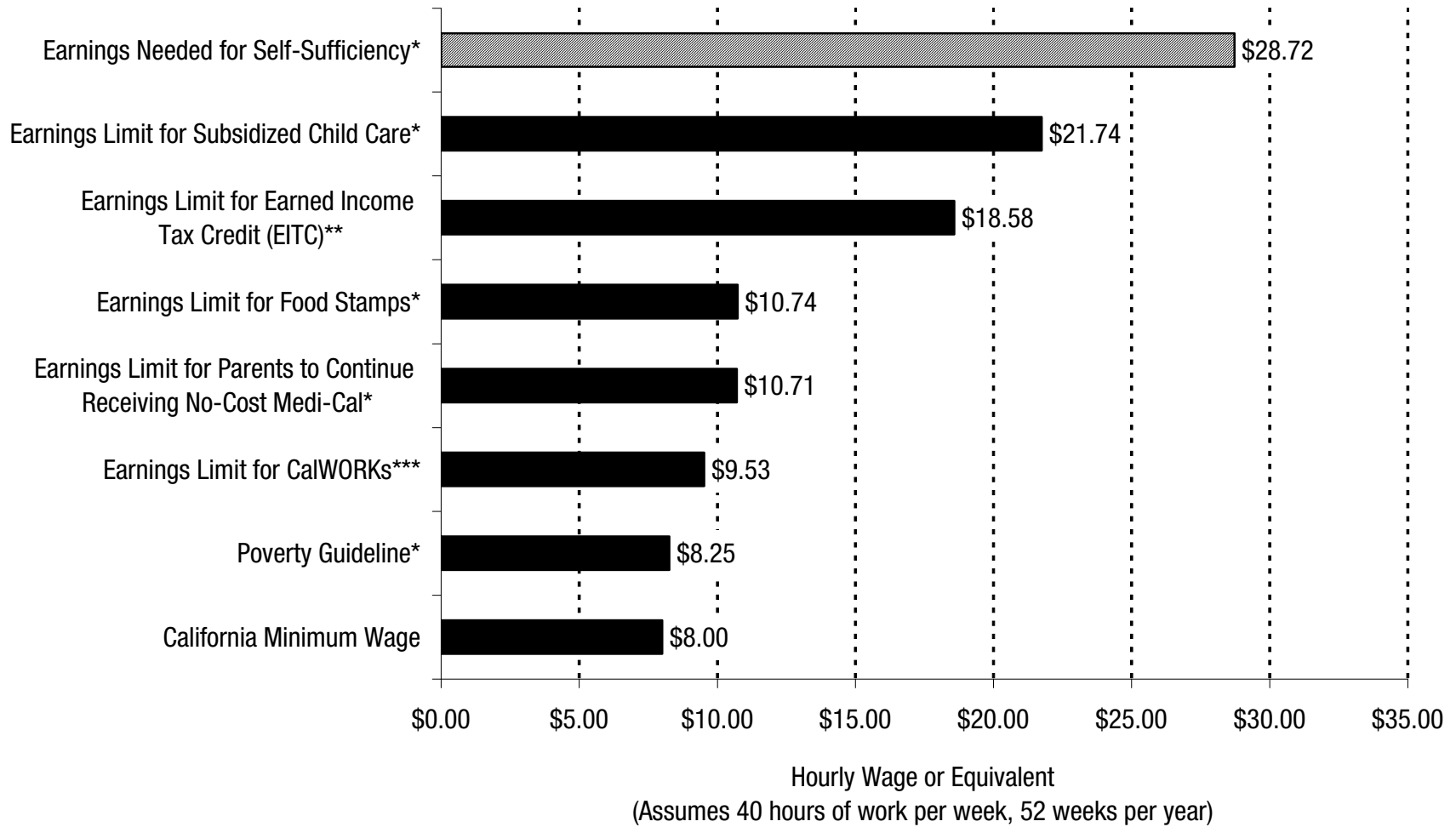
Note: AFDC/CalWORKs spending includes federal, state, and county funds.
 Total state spending includes federal and state funds.
 Source: Department of Finance and Department of Social Services

Californians in Poverty Are Less Likely to Receive Cash Assistance



Source: Department of Social Services, US Census Bureau, and US Department of Health and Human Services

Supports for Working Families End Before Families Reach Self-Sufficiency



* Family of three.

** One-parent family with two or more children.

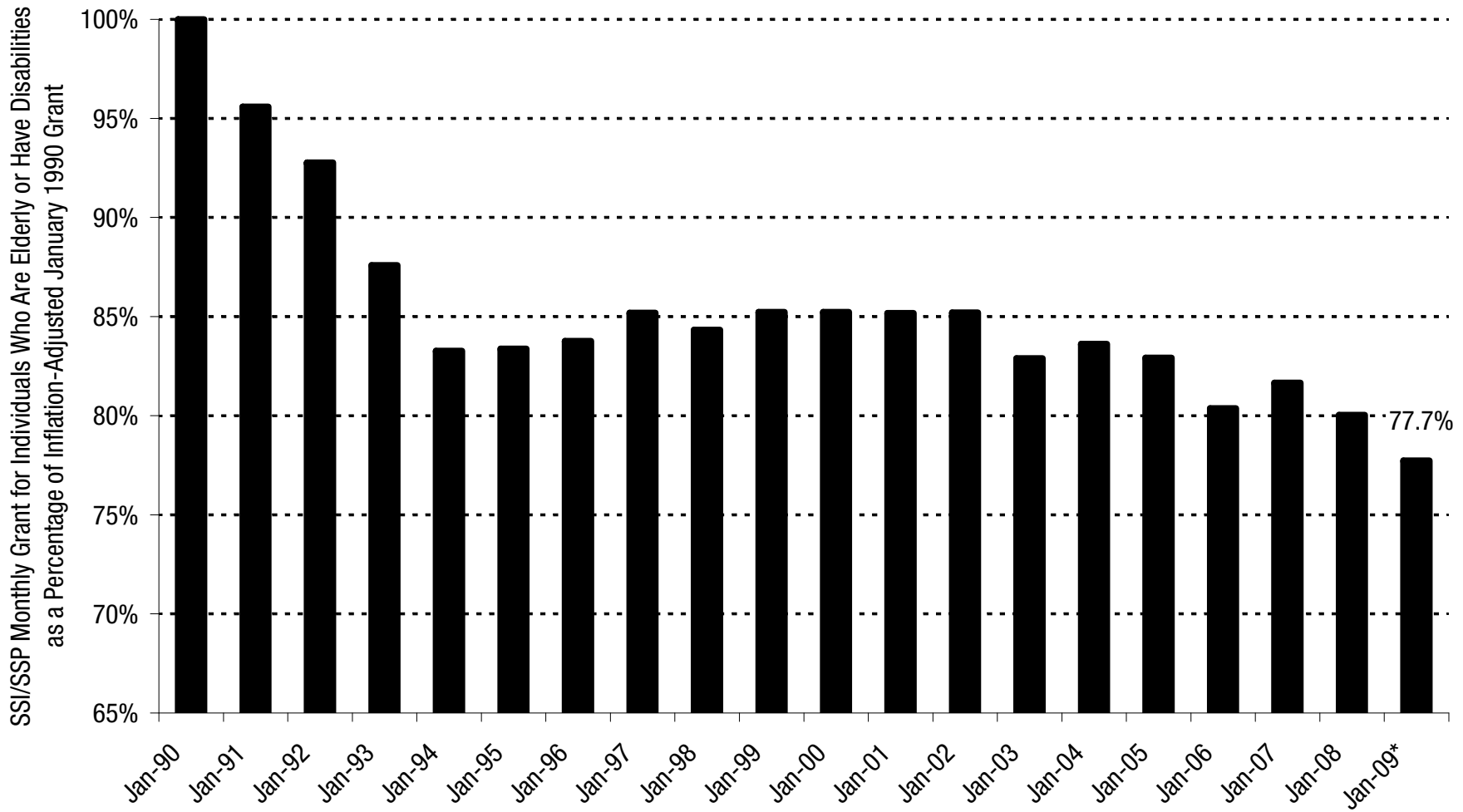
*** Family of three in a high-cost county.

The Governor's Budget Proposals Would Suspend State COLAs for SSI/SSP Grants

The Governor's proposals would:

- Suspend the state's June 2008 and June 2009 COLAs for savings of \$23.3 million in 2007-08 and \$300.3 million in 2008-09. SSI/SSP grants will help an estimated 1.3 million low-income seniors and people with disabilities meet basic living expenses in 2008-09.
- "Pass through" the federal January 2009 COLA, which would increase the monthly SSI/SSP grant for individuals from \$870 to an estimated \$881 and for couples from \$1,524 to an estimated \$1,540.

Purchasing Power of SSI/SSP Grants Would Decline Further Under the Governor's Proposal to Suspend the State COLA



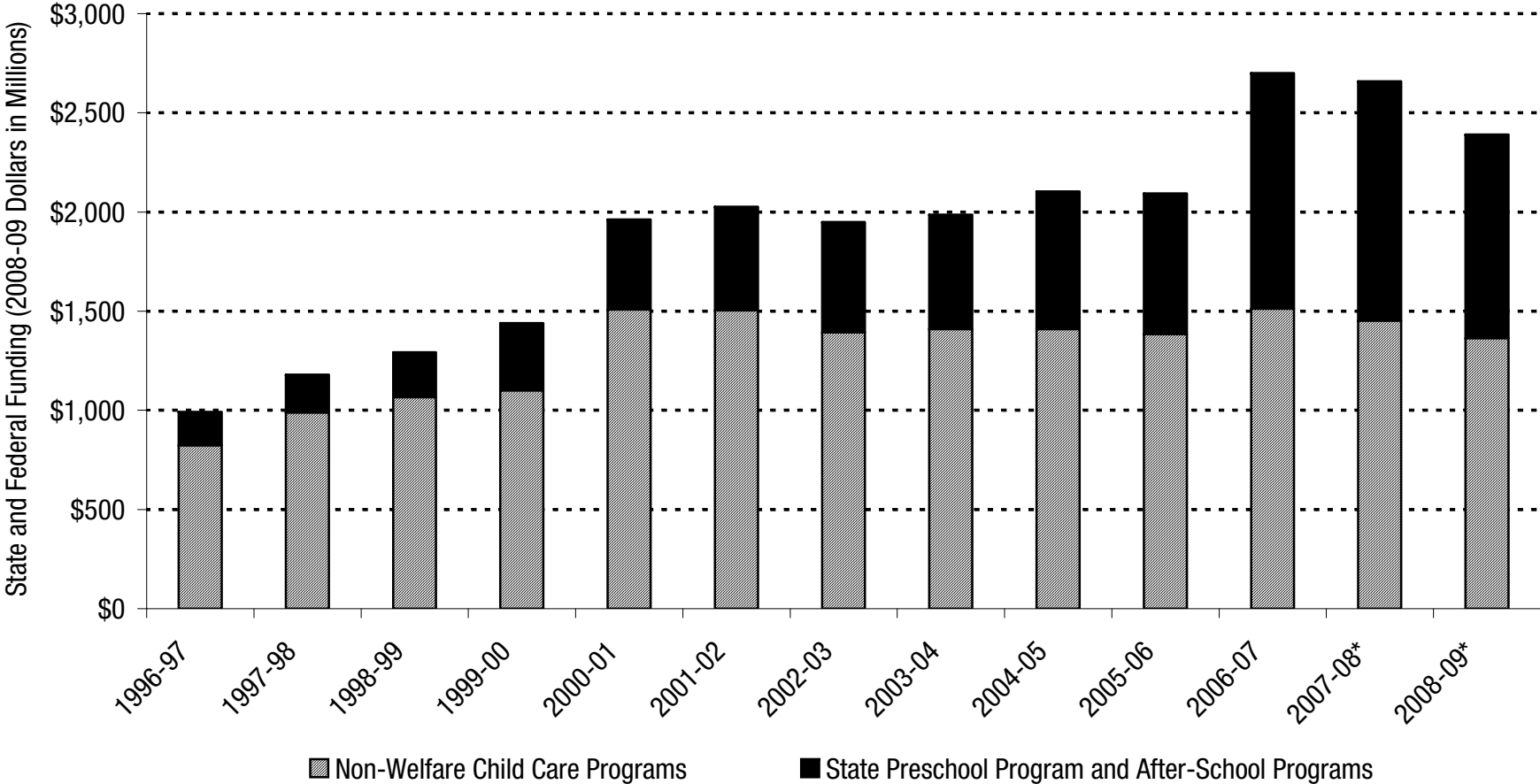
* January 2009 proposed.
Source: Department of Social Services

The Governor's Budget Proposals Would Reduce Funding for Child Care, Preschool, and After-School Programs

The Governor's proposals would:

- Reduce funding for preschool and certain child care programs by \$198.8 million in 2008-09. This reduction includes the proposed elimination of the 2008-09 COLA and “growth” funding.
- Reduce funding for the After School Education and Safety Program, for savings of \$59.6 million in 2008-09. This change would require voter approval of a ballot measure to amend Proposition 49, which substantially increased funding for after-school programs.
- Freeze the income eligibility limit for child care services at the 2007-08 level in 2008-09.

Funding for California's Child Care Programs Has Declined Since 2000-01, While Funding for Preschool and After-School Programs Has Increased Substantially



* 2007-08 enacted and 2008-09 proposed.

Source: Department of Education, Department of Finance, Department of Housing and Community Development, and Franchise Tax Board

The Governor's Budget Proposals Would Cut Funding for Additional Human Services Programs

The Governor's proposals would:

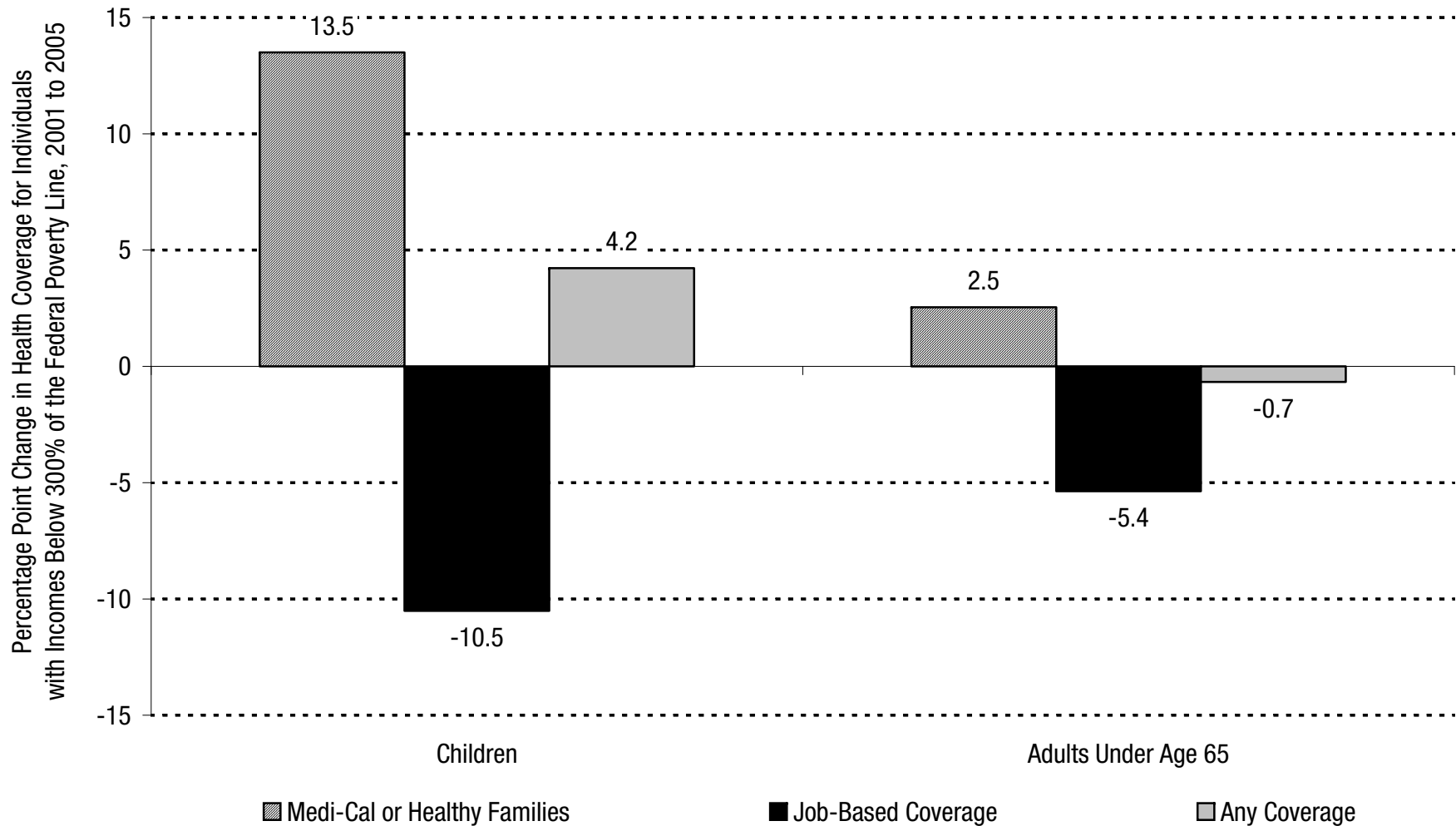
- Reduce the number of hours provided for certain non-medical domestic services in the In-Home Supportive Services Program, for state savings of \$109.4 million in 2008-09.
- Cut counties' Child Welfare Services Program allocation, for state savings of \$83.7 million in 2008-09.
- Reduce Foster Care and related payments by 10 percent, for state savings of \$81.5 million in 2008-09.
- Cut funding for the Adult Protective Services Program by 10 percent, for state savings of \$6.1 million in 2008-09.

The Governor's Budget Proposals Would Decrease Access to Health Care

The Governor's Proposed 2008-09 Budget would:

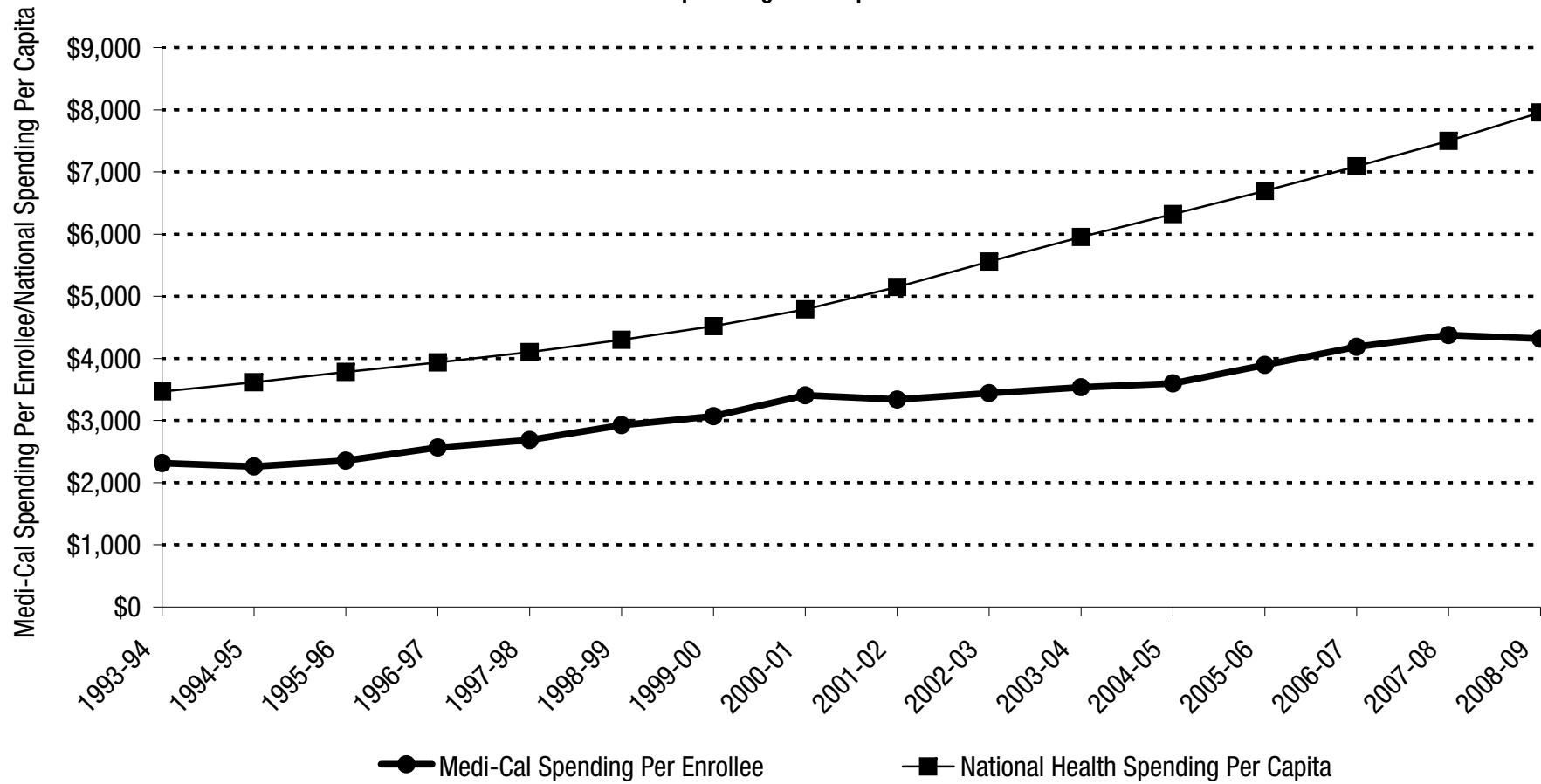
- Result in more than 150,000 fewer children and adults with health coverage by requiring them to submit paperwork four times annually to retain access to Medi-Cal services.
- Reduce payments to most Medi-Cal providers by 10 percent.
- Discontinue dental and other services for adult Medi-Cal recipients.
- Reduce dental benefits, raise family premium contributions, and increase copayments for children covered by Healthy Families.

Medi-Cal and Healthy Families Have Helped Offset the Erosion of Job-Based Coverage



Source: UCLA Center for Health Policy Research

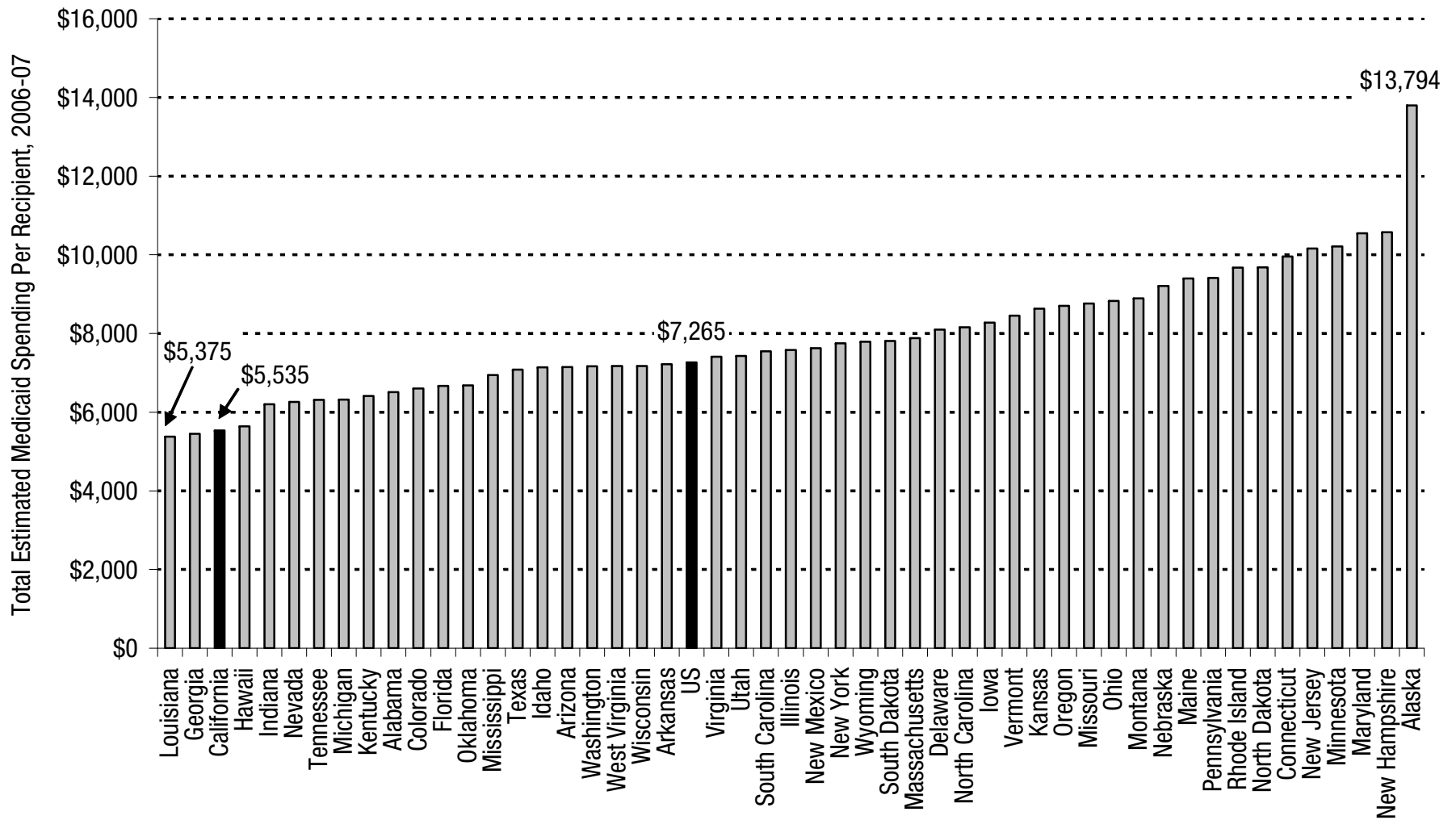
Spending Per Medi-Cal Enrollee Flattened in Recent Years, While National Health Spending Per Capita Has Continued to Rise



Note: Medi-Cal spending includes state and federal funds. National health spending includes public and private health expenditures.

Source: Centers for Medicare & Medicaid Services and Department of Health Care Services

Only Louisiana and Georgia Spend Less Per Medicaid Recipient Than California



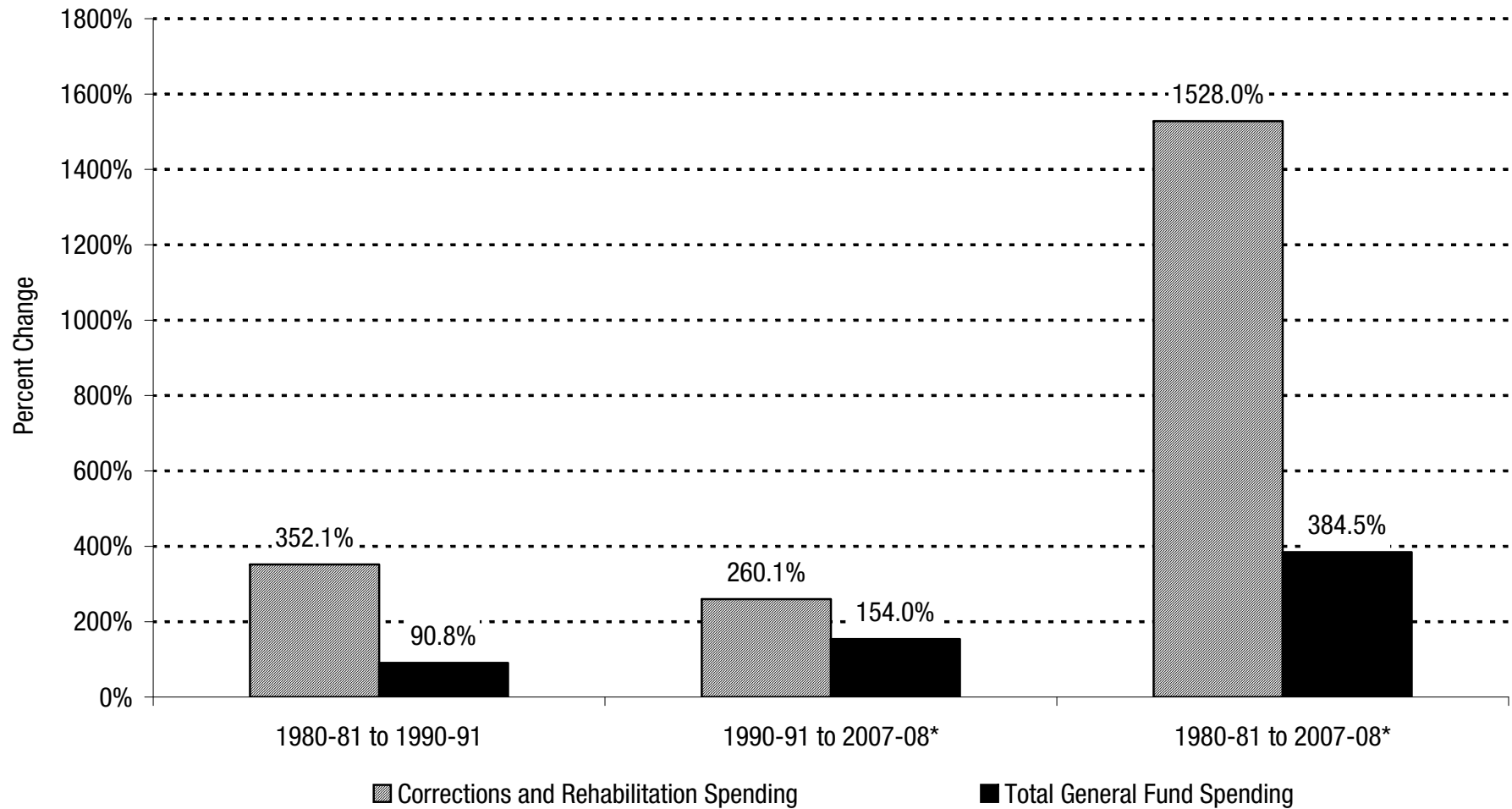
Note: Number of recipients is for June 2006.

Source: Kaiser Commission on Medicaid and the Uninsured and National Association of State Budget Officers

The Governor Proposes Early Release for Inmates

- The Governor proposes an ambitious early release proposal that would reduce the number of inmates in the state's prison system by more than 20,000.
- The Governor also proposes changes to parole practices that would reduce the number of individuals on active parole by nearly 20,000.
- In addition, the Governor proposes to expand the number of beds at prison medical facilities by using funds the Legislature approved for expanding the number of beds at existing prisons and for building new "re-entry" facilities for offenders returning to their communities.

Corrections Spending Has Grown at Nearly Four Times the Rate of General Fund Spending as a Whole



* 2007-08 enacted.

Source: Department of Finance