CITIZENS'
Budget
2003–05

A 10-Point Plan to Balance the California Budget and Protect Quality-of-Life Priorities

Reason

The Performance Institute

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Part 2

Identify the Problem: Out-of-Control Spending

"Total General Fund spending rose from $57.8 billion in 98-99 to $76.8 billion in 01-02, an increase of $18.9 billion, or 33 percent. About 60 percent *of the growth was attributed to general inflation and population increases. The remaining* 40 percent *represents such factors as new or expanded programs; increased levels of services; and—in some instances—caseload growth in excess of population and/or cost increases above general inflation."[emphasis added]*

– LAO Analysis of Sources of General Fund Spending Growth, March 25, 2003

In order to craft an effective solution to California's budget crunch, one must first start by identifying—correctly—the root cause of the problem. Moreover, without a clear understanding of the problem, the state is bound to repeat its mistakes in the future. Unfortunately, with all of the finger-pointing going on over the budget in Sacramento, it has been difficult to sort out fact from fiction and rhetoric from reality. A close analysis of data provided by the non-partisan Legislative Analyst's Office provides an ironclad case that the state has a spending problem, rather than a revenue problem.

Putting to Rest the "Myth" that Revenue is to Blame for the Crisis

Many have claimed that the state's budget troubles arose as the result of an overall decline in revenues. Due to a bad economy and tax decreases (notably the vehicle license fees), everyone is paying less in taxes and the state is taking in less revenue. The solution according to this theory is to raise vehicle license fees and increase taxes.

California Budget FACTS:



26%
Increase in state revenue from 1998-99 to 2002-03

45%
Increase in total state spending from 1998-99 to 2002-03

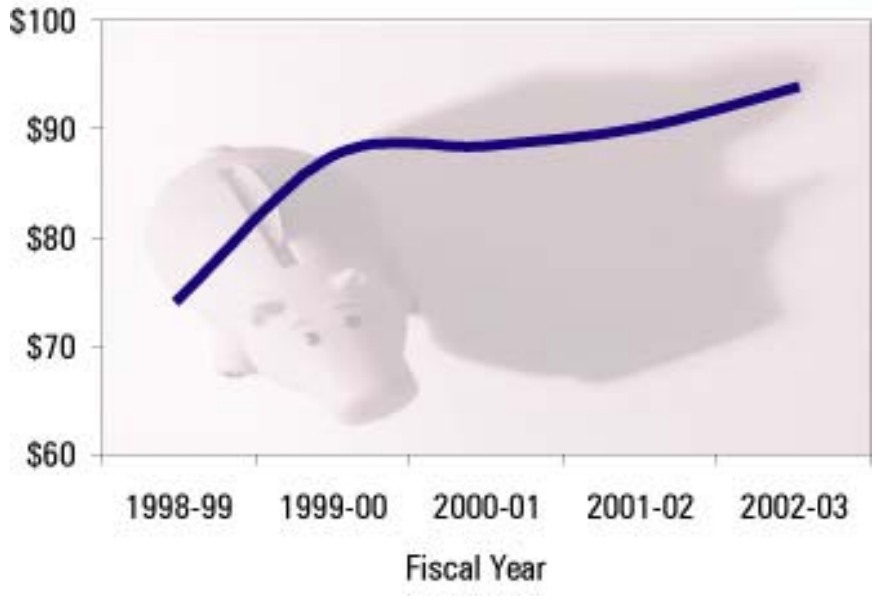
37%
Increase in just the General Fund portion of state spending from 1998-99 to 2002-03

9,000
The number of new workers hired as of September 2002 in state government since the Governor's "hiring freeze" was imposed March 2002

37,000
The number of new workers hired as of March 2003 in state government since the Governor's "hiring freeze" was imposed March 2002 (that's 37,000 new hires in ONE year!)

Yet, despite the many assertions to the contrary, California's revenue stream is most certainly *not* the cause of the current budget crisis. In fact, revenues actually rose 26 percent from FY 1998-99 to FY 2002-03, from $74.3 billion to $93.8 billion (see Figure 3).[10] Revenues to the General Fund, the largest source of state funding, have likewise grown. After realizing a 22.7 percent increase between FY 1998-99 and FY 1999-2000, general fund revenues leveled off and have remained about the same into the current fiscal year (see Figure 4).

Figure 3: State Revenues, Fiscal Years 1999-2003 ($ in Billions)



Note: Revenues include General Fund & Special Fund revenues and transfers to the General Fund from other state funds.

Source: Legislative Analyst's Office

Unrealistic Revenue *Expectations* by Sacramento Led to Unsustainable Spending Increases

When Sacramento says there is a revenue problem, it should more correctly say there is a revenue expectation problem. At the heart of this problem of unrealistic revenue expectations is the stock market and the capital gains portion of the state's annual revenue. As everyone knows, the dot-com revolution created a meteoric rise in the stock market. Indeed, during 1999 and 2000, as the nation "cashed out" of the stock market, state receipts from capital gains spiked exponentially.

Figure 4 illustrates the amount of revenue from stock options and capital gains, compared with all other General Fund revenues. During the height of the economic expansion, revenues rose from $7.5 billion in FY 1998-99 to $12.7 billion in FY 1999-00, then to $17.6 billion in FY 2000-01, before falling to $8.2 billion in FY 2001-02. Revenues from these sources are expected to fall further to $5.6 billion in FY 2002-03 and remain about the same at $5.7 billion in FY 2003-04.

Figure 4: Stock Options and Capital Gains Tax Revenue as a Share of Total General Fund Revenues ($ in Billions)



Sources: 2003-04 Governor's Budget Summary and Department of Finance Budget Documents

Of course, everyone knows how the dot-com stock market bubble finally burst. Moreover, most investors were wise enough to cash out at some point during 2000—and those that didn't took losses in 2001 and 2002. Unfortunately, the state of California was not one of the wise actors in this scenario. Not only did it not "cash out," it continued to spend as though it were a dot-com billionaire. Rather than stashing away enough of the revenues to ensure a smooth transition and continuation of public services during and after the inevitable economic decline, the state spent to its limits—and beyond.

Even after 2000 when the entire world realized the party was over, the Governor and the legislature spent money at a rate they expected revenues to increase, based on the high-flying stock market. When actual revenues did not meet their expectations, it was too late to "unspend" spent money. Moreover, as it became clearer that capital gains revenues were dropping, the Governor and legislature looked the other way and adopted totally unrealistic and "rosy" revenue forecasts. Rather than rolling back spending following the economic downturn that took place after FY 2000-01, the state largely maintained General Fund spending, cutting it by only 1.7 percent. It was not until 2003 that the Governor suggested any significant rollbacks in spending.

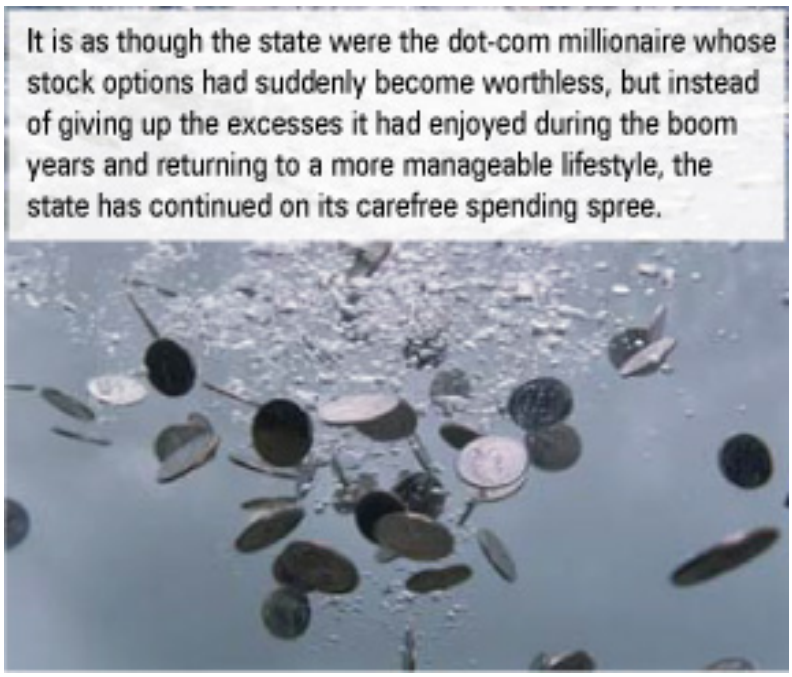
Proof of the expectations problem can be found in both the 2002-03 and 2003-04 budget documentation:

In the 2002-03 Governor's Budget Summary, it declared:

> *Year-over-year losses in personal income tax withholding* are believed to be attributable primarily to the loss of stock option income*, which plunged with the slowing economy and the market's retreat. Taxpayers are also anticipating less non-wage income—primarily capital gains—which has eroded estimated payment receipts. Similarly, consumers have cut back, resulting in a deterioration in*

purchases of taxable goods. This softness in revenues is expected to be short-lived*, and growth is expected to resume by mid-2002.*[11]

In 2000-01, the contribution to total General Fund revenues from [stock options and capital gains] had grown to 25 percent from 6 percent five years earlier. It was clear that phenomenal gains in stock prices that boosted revenues to double-digit growth over the past few years could not continue indefinitely *and that revenues were increasingly vulnerable to a market turnaround. What was not clear, however, was when that turnaround would come or how steep it would be.*[12] *[emphasis added]*



Ironically, the Department of Finance notes "it was clear…boosted revenues…could not continue indefinitely." It may have been clear to the average investor and working family, but not our leaders in Sacramento. Instead of owning up to the expectations problem, Sacramento is blaming the market and the economy for not recovering quickly enough to support a dot-com-like spending binge the state had become accustomed to.

Even more irony is seen in the Governor's current budget proposal. The state's disastrous experience with relying on stock market income begs the question: given that the vast majority of these revenues are derived from the richest 5 percent of Californians, does not Governor Davis's proposed increase in income taxes for the state's top earners seem all the more foolish? Could it only lead to greater dependence on this volatile source of revenue and require even more speculation on the state of the stock market and the economy as a whole in crafting the state's budget?

The short-term revenue problem has been the unrealistic expectations of Sacramento. The Long-term revenue problem facing the state will remain the state's increasing reliance on revenues from personal income taxes, and especially on revenues from stock options and capital gains. Thus, volatility is built into the California tax and revenue structure. Any Long-term solution to the current budget crisis must address this issue.

Clear and Convincing Evidence of Over-spending in California

As established above, the stock market capital gains fueled an unrealistic expectation of massive revenue increases as far as the political eye could see. And as expectations were raised, so were the budgets of every state agency. In fact, state spending increased 45 percent over a four-year period, from $75.3 billion in FY 1998-99 to $109.4 billion in FY 2002-03. During this time, General Fund expenditures rose over 36 percent,

from $57.8 billion to $78.9 billion. To underscore the extent of the spending spree during the economic expansion and the stock market's meteoric rise, consider that this includes a record one-year spending increase of 15 percent from FY 1998-99 to FY 1999-00, which was surpassed by a 17.4 percent increase the following year!

The most important indicator of whether the state engaged in "over-spending" is benchmarking increases in the total state budget, as well as increases in specific program areas, to the growth in population and inflation. Why benchmark against population and inflation? If a state increases in budget at the same rate of population and inflation, it is maintaining a static level of services (assuming it doesn't "do more with less.") In other words, state government would increase spending only to provide expanded services to satisfy an expanding population and to keep pace with rising operating costs.

Examining California's spending in relation to population and inflation growth exposes the state's over-spending. Had the state held its increases to meet population growth and inflation, spending should have increased by 21 percent between 1998-99 and 2002-03—not the 36 percent by which the spending actually increased. Using this benchmark, the state engaged in severe overspending.

Table 1: General Fund Spending Compared to Inflation and Population Growth Baseline

1998-99 Actual	2002-03 Appropriate	2002-03 Actual	Difference	Appropriate Increase	Actual Increase
$57.8 billion	$69.9 billion	$78.9 billion	$9.0 billion	21.0%	36.5%

Table 2: Comparison of General Fund Spending by Program Area, 1998-99 to 2002-03
(Dollars in Thousands)

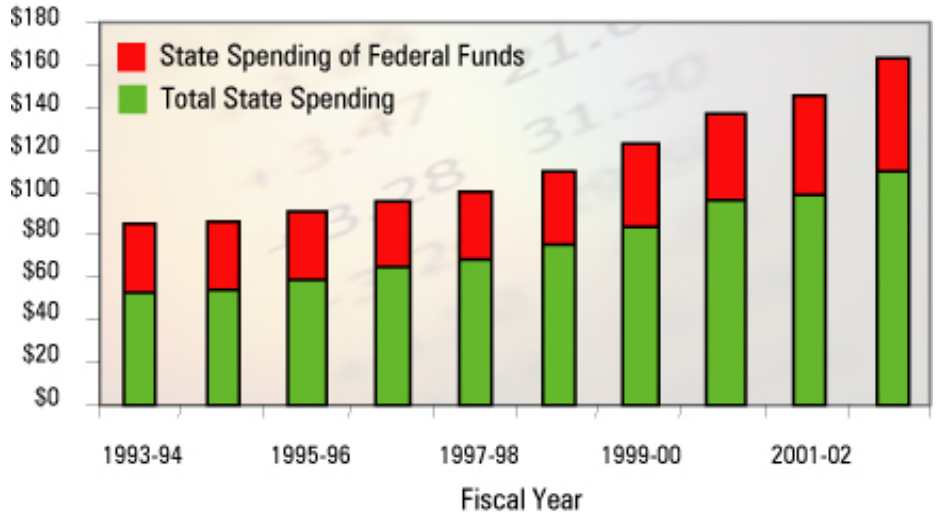
Program Area	1998-99 Actual	2002-03 Enacted*	Difference, 1998-99 Through 2002-03	Percentage of Total Growth 1998-99 Through 2002-03	Percent Growth, 1998-99 Through 2002-03	Combined Inflation and Population Growth
Education – Prop. 98	$24,656,705	$31,766,000	$7,109,295	38%	29%	21%
Education (K-12 & Higher)–Non-Prop. 98	6,440,736	8,533,102	2,092,356	11%	32%	21%
Health and Human Services	16,063,177	21,632,674	5,569,497	29%	35%	21%
Youth and Adult Correctional Agency	4,547,387	5,284,526	737,139	4%	16%	21%
Resources and Environment	1,280,331	1,214,668	-65,663	0%	-5%	21%
Business, Transportation, and Housing	311,238	228,270	-82,968	0%	-27%	21%
Tax Relief**	931,845	4,422,496	3,490,651	18%	375%	21%
Other	3,595,656	3,640,004	44,348	0%	1%	21%
Total General Fund	$57,827,075	$76,721,740	$18,894,655	100%	33%	21%

* Does not include mid-year spending adjustments **Tax relief reflects on-budget cost of VLF backfill.
Sources: Spending data are from the Legislative Analyst's Office; Inflation and population growth data are from Department of Finance documents

Finally, a number of other dimensions of the state's spending practices illustrate the true extent of the spending problem:

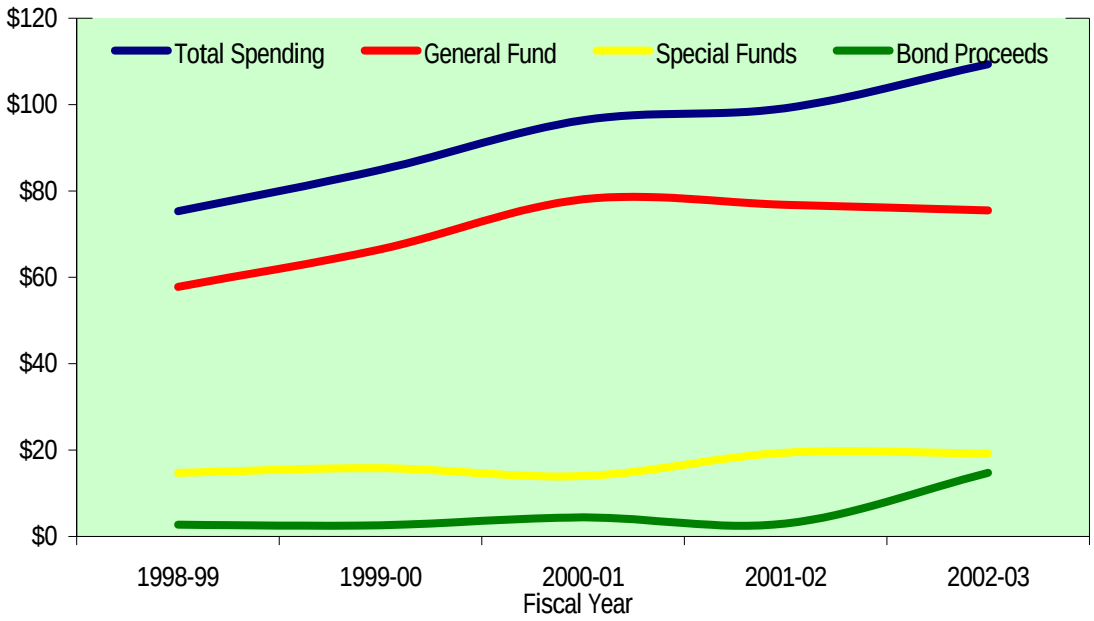
- **Comparison to Other State Spending Practices:** California's spending is not only high in absolute terms, but also relative to that of other states. In fact, California's 9.4 percent average General Fund growth from fiscal 1997 to 2002 was a full percentage point higher than the second-highest spending growth state—Rhode Island—and well over the U.S. average of 5.6 percent (see Table 3).[13]
- **Explosion of State Workers: During Governor Davis's first four-year term, nearly 44,000 employees were added to the state's payroll.**[14] In fact, according to Ross DeVol of The Milken Institute, even during the height of the tech boom, "State and local [government] jobs were the fastest growing job category in the state in 1999, 2000 and even 2001."[15]
- **Elimination of a Record Surplus:** In 1998 Gov. Gray Davis inherited a $12 billion surplus. As already noted, today the state has a $26.1 billion deficit. Had the state kept its spending increases to population and inflation growth, the state would face a $5.5 billion *surplus* this year (assuming all previous surpluses had been given back to the taxpayer through tax rebates.)
- **Per Capita Spending Up:** An excellent [change chart (right) to "Figure 4"]gauge of *real* spending increases can be gained by looking at per capita spending of the state government. According to the LAO, "per capita spending—which adjusts for both inflation and population growth—has increased by about 17 percent…(to) $2,469 per capita in 2003-04, up from $2,109 in 1993-94."[16]
- **Elimination of Potential Taxpayer "Rebates":** A recent study by the Cato Institute found that if aggregate spending growth of the 50 states had been held to a benchmark of inflation plus population growth from fiscal years 1990 to 2001, and if revenues above this benchmark had been returned to the taxpayers, the states would have realized a savings of $93 billion by FY 2001.[17] (This approach to state funding will be explored further in the next section of the paper.) The study also ranked the states by the amount of their per household "tax windfalls" above the benchmark, money that would have remained in the pockets of taxpayers if the state had stuck to the benchmark spending growth. California's $22.2 billion tax windfall amounted to a per household windfall of $1899, the third-highest in the nation.[18]

Figure 5: State Spending Over Time (Dollars in Billions)



Source: Data from California Department of Finance and Legislative Analyst's Office

Figure 6: State Spending by Fund Category ($ in Billions)



Source: Department of Finance Budget Documents

Table 3: Fastest Growing State General Funds		
State	**Average Annual Change, 1997-2002**	**Projected Change, 2003**
California	**9.4%**	**-0.2%**
Rhode Island	8.4%	0.8%
Maryland	8.2%	-3.5%
Colorado	8.1%	-2.7%
Virginia	8.0%	1.6%
Maine	7.9%	4.9%
Idaho	7.3%	-1.7%
Georgia	7.0%	4.5%
Nebraska	6.8%	0.8%
Delaware	6.8%	2.4%
United States Average	***5.6%***	***1.5%***

Sources: National Association of State Budget Officers and USA Today research

Other Spending Habits of Concern: Bonds and Special Funds

Any budget plan has to take into account state spending that occurs outside of the "General Fund" in the area of "Bond Proceeds" and in the "Special Fund." For the purposes of the budget, Bond Proceeds represent the debt service cost for principal and interest on bonds, not the actual use of these proceeds. While the state

may have little latitude in affecting the cost of bonds approved by the voters, it is worth noting that Bond Proceeds expenditures never exceeded a few billion dollars throughout the 1990s, before suddenly jumping from $3 billion in FY 2001-02 to nearly $15 billion in FY 2002-03. While this cost is expected to drop to a little over $7 billion in FY 2003-04, this is still significantly higher than the historical average.

Even more disturbing is the spending trend for Special Funds. Special Funds are furnished mostly by motor-vehicle related levies, but also by gasoline, cigarette, and sales and use taxes, as well as other licenses and fees revenues. They are used to direct state income to particular government functions or activities designated by law. Many transportation projects, for example, rely upon Special Funds. Since 1998, Special Funds spending has gone in exactly the *opposite* direction as the economy, declining slightly between FY 1998-99 and FY 2000-01 before rising from $14 billion in FY 2002-03 to over $19 billion in FY 2003-04. Incredibly, the Governor's Budget proposes to raise Special Funds spending by 38 percent to nearly $26.5 billion in FY 2003-04!