

FISCAL RESEARCH CENTER

THE “ROLLER COASTER” OF CALIFORNIA STATE BUDGETING AFTER PROPOSITION 13

Robert W. Wassmer

Fiscal Research Center
Andrew Young School of Policy Studies
Georgia State University
Atlanta, GA

FRC Report No. 131
July 2006



ANDREW YOUNG SCHOOL
OF POLICY STUDIES

The “Roller Coaster” of California State Budgeting After Proposition 13

Acknowledgments

This report was prepared at the request of the Fiscal Research Center and was presented at a conference on intergovernmental relations and fiscal conditions sponsored by the Fiscal Research Center.

The paper is one of three papers that the Fiscal Research Center asked experts from other states to prepare. This paper focuses on California, the other two papers consider Pennsylvania and Florida. Each paper addresses the state’s fiscal condition, exploring the factors that explain the conditions and the likely future trends. The objective was to learn more about the fiscal conditions in these other states and how the states have or haven’t dealt with the situation. We hope that by considering the fiscal conditions that other state governments have faced perhaps Georgia can learn something from the experiences of those states.

The “Roller Coaster” of California State Budgeting After Proposition 13

Table of Contents

Acknowledgments.....	ii
I. Introduction.....	1
II. California State Budget Patterns Compared to All States.....	5
III. Fiscal Restrictions in California’s Constitution	9
IV. State Revenue Reliance.....	13
V. Previous Spending and Future Demographics	17
VI. Other Concerns on the Horizon	21
VII. Opinions on State Budget Reform	24
VIII. California’s Last Business Cycle and Suggestions for Budget Reform.....	26
California’s Last Business Cycle	26
Suggested Reforms to California’s State Budget Process and Finances.....	28
The Political Feasibility of Suggested Budget and Revenue Reliance Reforms	31
IX. Conclusion	36
References.....	38
About the Author	41

The “Roller Coaster” of California State Budgeting After Proposition 13

I. Introduction

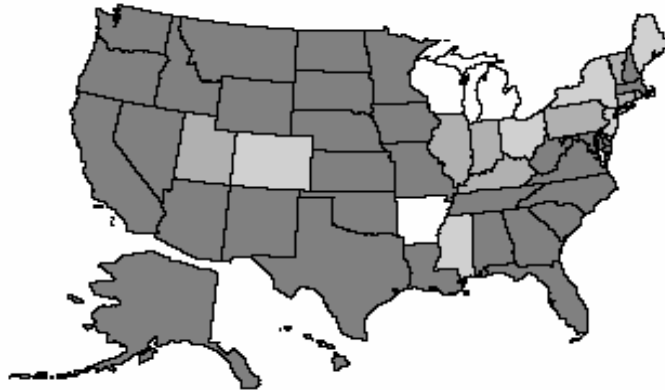
The National Association of State Budget Officers (NASBO, 2005, p. ix) open their recent edition of *The Fiscal Survey of States* with the statement that “[s]tate fiscal conditions rebounded noticeably in fiscal 2005.” This nationwide recovery was characterized by a marked improvement in revenues that allowed states to restore much of the funding to programs that were severely cut in the nationwide recession that began in 2001. State budget officers also report that general fund expenditures across all states are expected to grow by 6.3 percent in fiscal year (FY) 2006-07, which is just below the 6.4 percent average recorded over the last 28 years.¹ In FY 2005-06 all states reported an expected \$38.5 billion end-of-year surplus that is equivalent to 6.9 percent of all expected general fund expenditures.² However, as shown in Figure 1, this nationwide average masks important differences in how well some states have recovered from the last downturn. More than one-third of the states are expected to display year-end reserves that are less than 4.9 percent.

¹ General fund expenditures are from general revenue sources that comprise all state revenue except that classified as liquor store, utility, or insurance trust revenue. General revenue is classified by four main categories: taxes, intergovernmental revenue, current charges, and miscellaneous general revenue. For details see <http://www.census.gov/govs/www/class.html>.

² As defined by NASBO (2005, p. 11), the end-of-year surplus for a state includes both an ending balance between general fund revenue and expenditures and any amount accumulated in a budget stabilization (rainy-day) fund.

The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 1. EXPECTED YEAR-END STATE GOVERNMENTS RESERVES AS A PERCENT OF EXPENDITURES, FY 2005-06



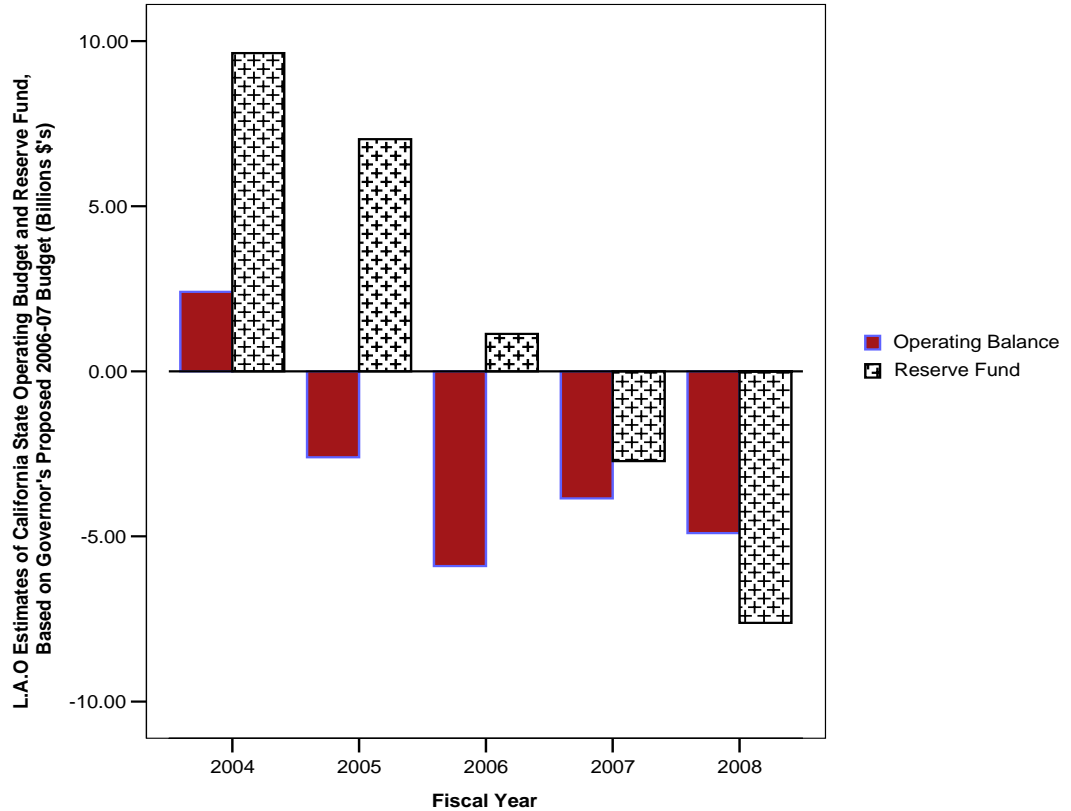
Black – 5.0% or more (33 states)
Dark Gray – 3.0 to 4.9% (8 states)
Light Gray – 1.0 to 2.9% (6 states)
White – Less than 1.0% (3 states)

Source: National Association of State Budget Officers (2005), Figure 4, p. 16.

Based upon only Figure 1, the State of California looks in relatively good fiscal shape. The California Legislative Analyst’s Office (LAO) in February of 2006 reported the State’s expected reserve at the end of FY 2005-06 to be \$6.5 billion, or 7.2 percent of general fund expenditures. However, this positive reserve is not due to the State spending less than it takes in. In FY 2005-06 California is expected to run an operating deficit of \$2.6 billion. It will finance this with a reserve from the previous year of \$9.1 billion. This reserve, which amounts to 11.4 percent of state government expenditure in FY 2004-05, is attributed to unexpected increases in state personal income, corporate income, and sales taxes revenue; the proceeds of a state tax amnesty program, and \$10.4 billion raised through deficit-financing bonds issued in FY 2003-04. But as Figure 2 illustrates, because the pattern of State deficits is expected to continue, both California’s yearly operating balance and reserve fund is predicted to go negative after FY 2006-07.

The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 2. ESTIMATES OF FUTURE CALIFORNIA STATE BUDGET OUTCOMES



Data source: Legislative Analyst’s Office (2006).

In an article titled “State Budgets: Bliss or Blues,” Eckl (2005) expects a future of unsustainable state budgets in the United States to be more the rule than the exception. On a scale of one to ten (with ten being her assessment of a state most at risk for exhibiting factors expected to contribute to future structural state budget deficits), she only awards Minnesota, Nebraska, New Jersey, North Dakota, Vermont, and Wisconsin a score below a five. California is rated a seven, and there are 18 states thought to be at even greater risk. Eckl’s (p. 24) conclusion on future state budget trends is that “cutting spending, raising taxes – or both – will become painful realities.”

Using California as a case study, the purpose of this paper is to investigate the factors that have produced the ominous budget outlook characterized by Figure 2. I do this first by examining budget patterns for the State of California to see if there is

The “Roller Coaster” of California State Budgeting After Proposition 13

any evidence that they differ from what has been observed for states as a whole. Sections 3 through 7 are then used to describe some of the specific circumstances in California – constitutional restrictions, revenue reliance, demographics, future concerns, and public opinion – that are responsible for the previous patterns observed, and future patterns expected in California state government expenditures and revenue. Finally, Section 8 concludes with a description of how the State’s budget fared during the last business cycle and suggested policy reforms that could help alter the expected course of California’s budget outcomes over such future cycles.

The “Roller Coaster” of California State Budgeting After Proposition 13

II. California State Budget Patterns Compared to All States

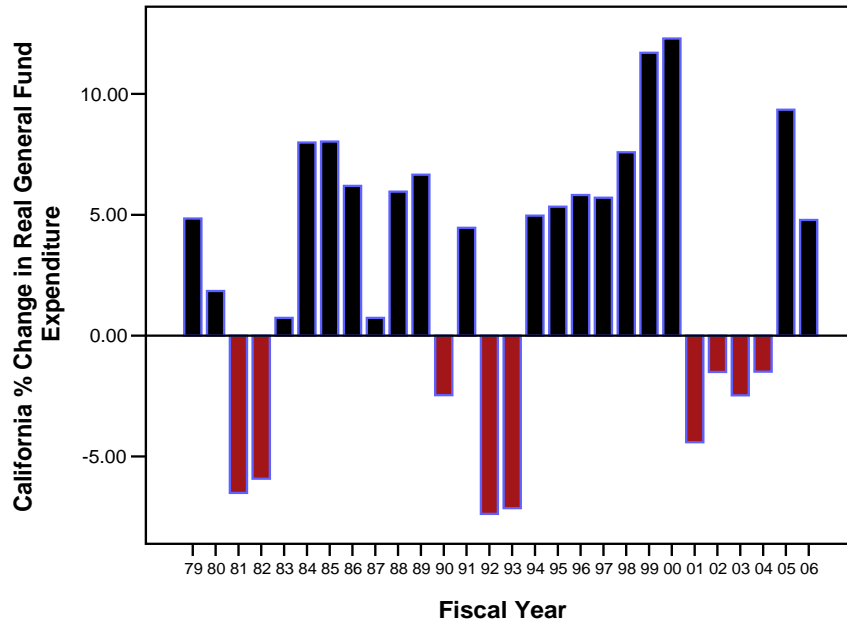
Historical data on state budgeting outcomes in California are next compared to the same measures calculated for all states in the country. The specific measures of comparison are restricted to ones collected annually by NASBO for all states. FY 1979-80 is chosen as a starting point because it is the first full fiscal year following the implementation of Proposition 13. Though Proposition 13 is simple in its tenants (a maximum rate of statewide property taxation at one percent, property value assessments rolled back to 1975 levels and allowed to increase a maximum of two percent per year unless sold, new “special” taxes require a two-thirds approval by voters, and property tax revenue is to be distributed among local governments “according to law”), it is now widely believed to have produced a legacy of further “unintended consequences” on California’s system of state-local public finances (Chapman, 1998). Data offered throughout this paper for FY 2005-07 must be considered preliminary, while data for FY 2006-07 and beyond are estimates from state budget officers.

Figure 3 presents the percentage change in real general fund expenditure for the State of California from the previous fiscal year. Notice that in the early parts of the 1980s, 1990s, and 2000s this real growth rate was negative. Also notice the consistent growth rates between five and 13 percent that occurred from FY 1994-94 to FY 2001-02. A comparison to Figure 4, which includes the same percentage change in real general fund expenditure for all states, shows that the pattern observed in California is unusual in at least a few aspects. States as a whole saw no negative growth rates in real expenditures during the early 1990s and also did not enjoy the consistent 5 percent plus growth rates in the remainder of the 1990s that California did. Expectations for FYs 2005-06 and 2006-07 also point toward higher growth rates in real expenditures in California than in the states as a whole.

California chooses to increase its spending at a higher (lower) rate than all states during boom (bust) years in the State’s economy. Later I will argue this is driven in large part by the highly pro-cyclical sources of revenue that it primarily relies on.

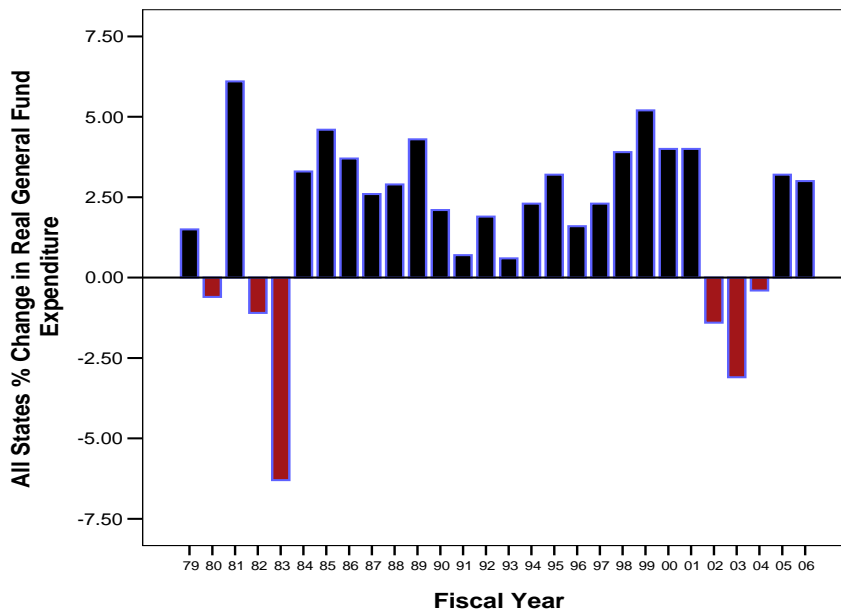
The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 3. CALIFORNIA % CHANGE IN REAL GENERAL FUND EXPENDITURE



Data Source: California Department of Finance (2006).

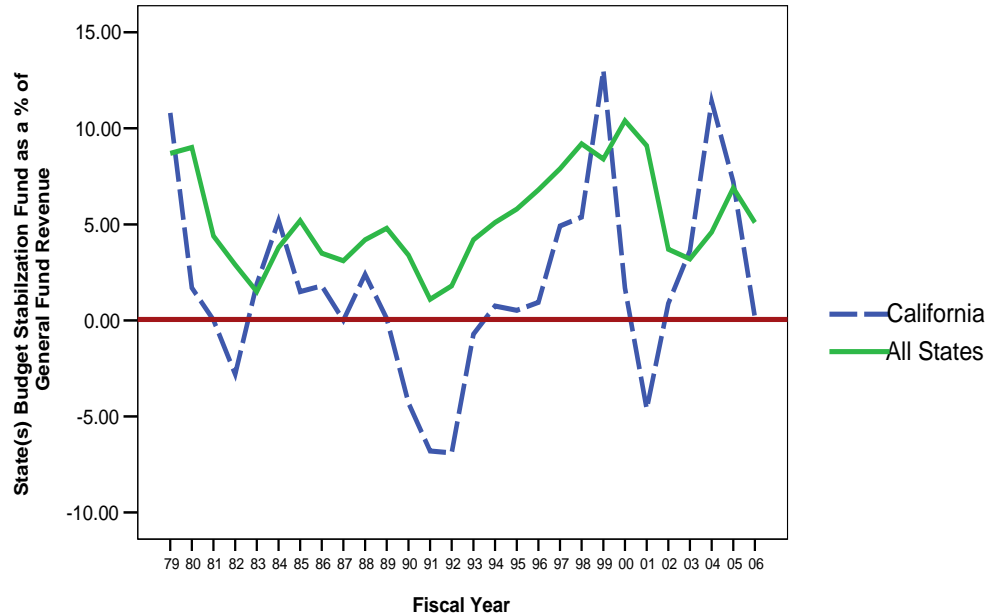
FIGURE 4. ALL STATES % CHANGE IN REAL GENERAL FUND EXPENDITURES



Data Source: National Association of State Budget Officers (2005), Table 2, p. 3.

The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 5. STATE(S) BUDGET STABILIZATION FUND AS A % OF GENERAL FUND REVENUE



Data Sources: California Department of Finance (2006); and NASBO (2005), Table 9, p. 14.

Figure 5 shows for a given fiscal year the ratio of the budget stabilization fund to general fund expenditures for both California (dashed line) and aggregated for all states (solid line). When these measures fall below the middle line, the yearly operating budget has gone negative enough that the budget stabilization fund cannot cover it and it also turns negative. Notice that deficits of this magnitude are not all that unusual in California, while they have never occurred in the aggregate measure calculated for all states.

The fiscal yo-yo that California’s state budget has experienced in this decade is not all that different than what was observed in the State from the late 1970s to early 1990s. It appears that the only thing that spares California’s state budgets from an operating deficit large enough to cause the budget stabilization fund to turn negative (as occurred in FYs 1982-83, 1991-92 thru 1992-93, and 2000-01) is a persistent period of growth in the State’s economy (as occurred between 1994 and 2000).

The “Roller Coaster” of California State Budgeting After Proposition 13

The remainder of this paper turns to an examination of explanations for the past and expected future budget outcomes for the State of California. The State merits this examination for two reasons: (1) its relative size within the United States (the gross domestic product of California is nearly 14 percent of that of the nation, New York’s GDP – the next closest – is 60 percent of California’s) and (2) as a warning to other states that if they adopt California-style fiscal reform, and experience similar economic and demographic changes, they too are more likely to experience, as shown in Figure 5, the “Californication” of their state’s budget cycles.³ The explanation first examined is the fiscal restrictions imbedded in California’s 1879 state constitution and the interconnected chain of additional restrictions placed in California’s constitution after, and to a large part because of, the passage of Proposition 13.

³ My apologies to the Red Hot Chili Peppers for stealing the title of their album.

The “Roller Coaster” of California State Budgeting After Proposition 13

III. Fiscal Restrictions in California’s Constitution

The only states that require a super-majority for the annual passage of a state budget are Arkansas, California, and Rhode Island. The two-thirds supermajority requirement in California dates back to the populist constitution it adopted in 1879. Since the passage of Proposition 13 in 1978, a two-thirds majority has also been required in the State for any “changes in state taxes enacted for the purpose of increasing revenues;” however, legislative actions that decrease state tax revenues can be enacted with only a simple majority (California Budget Project, 2004). In 2006 there were 11 states that required a two-thirds majority to pass any form of tax increase. In the spring of 2006 the political composition of the California Senate was 63 percent Democrat, while the California Assembly was 75 percent Democrat. Thus, Democrats must gain the support of some Republicans to annually pass the state budget and/or to raise state taxes. California’s Constitution also requires that all state general obligation bonds receive support from two-thirds of both houses of the legislature and majority support from voters. Interesting to note is that it was not until FY 2004-05, and the passage of Proposition 58 which accompanied the unprecedented voter-approval of \$15 billion in state deficit reduction bonds (Proposition 57), that California’s Constitution required its Legislature to send its Governor a budget where general fund appropriation for the next fiscal year matched estimated general fund revenues and transfers from a budget stabilization account.

Table 1 describes the California ballot measures, passed since Proposition 13, that are noted by the LAO (2004, pp. 14-15) as having major state-local fiscal implications. They are offered here as evidence of further factors that have placed the State’s annual operating budget in the roller coaster situation earlier illustrated in Figures 3 and 5. With the exception of the Gann Amendment, an argument can be made that each of the constitutional amendments listed in Table 1 have served in some way to make it more difficult for California to balance its annual operating budget.

Further restrictions on the power of local entities to levy taxes for the provision of local services (Props 62 and 218) make it more likely that state revenue be used to fund previously locally funded services. Requiring the state to devote a

The “Roller Coaster” of California State Budgeting After Proposition 13

TABLE 1. CALIFORNIA PROPOSITIONS WITH MAJOR STATE-LOCAL FISCAL IMPLICATIONS

Measure/ Election	Provisions
Proposition 4 (Gann Amendment) November 1979	Limits spending by state and local governments to prior-year amount adjusted for population growth and per-capita income. If exceeded, state must return surplus to taxpayers in two years. Only reached in 1987. Weakened over the years through the exemption of certain appropriations. Many believe that it is not now a meaningful constraint.
Proposition 62 November 1986	New local general taxes require two-thirds approval of governing body and a majority of local voters.
Proposition 218 November 1996	Further limits authority of local governments to impose taxes, assessments and fees. Two-thirds of voters must approve any new local non-general taxes.
Proposition 98 November 1988	Guarantees a minimum level of state general fund revenues be devoted to funding K-14 public education. Guaranteed amount is calculated based upon greater of three tests: (1) % received equal to % received in FY 86-87 (approx. 40%), (2) as much as received previous year adjusted for enrollment, or (3) same as “(2)” except growth factor is equal to growth in per-capita general fund revenues plus ½%. Intended to act as a floor, in practice worked as a ceiling typical equal to 40 – 45% of state’s general fund revenue going to K-14.
Proposition 99 November 1988	Imposes an additional \$0.25 tax on cigarette pack and limits revenue to health-related uses.
Proposition 172 November 1993	Increases state general sales tax by 0.5% and dedicates revenue to public safety programs.
Proposition 10 November 1998	Imposes an additional \$0.25 tax on cigarette pack and limits revenue to childhood development programs.
Proposition 42 March 2002	Selective sales taxes collected on gasoline are permanently earmarked for transportation uses only.
Proposition 49 November 2002	Increases state grants to public K-12 schools for before and after school programs. No additional funding source prescribed. Currently close to \$0.5 billion of state spending devoted to it.

Table 1 continues next page...

The “Roller Coaster” of California State Budgeting After Proposition 13

TABLE 1 (CONTINUED). CALIFORNIA PROPOSITIONS WITH MAJOR STATE-LOCAL FISCAL IMPLICATIONS

Measure / Election	Provisions
Proposition 63 November 2004	Imposes a 1% additional tax on personal income earned in the state over \$1 million. Revenue is used to fund mental health services. Expected to raise \$0.8 billion in FY 2006-07.
Proposition 1A November 2004	After the passage of Proposition 13, local property taxes were paid to California counties and the state had the constitutional right to distribute those revenues to cities and school districts in the county, and the county government in a manner they chose. During times of statewide fiscal stress, this often resulted in the state reducing payments to counties and cities and shifting them to school districts to meet constitutionally-imposed Proposition 98 funding requirements. This constitutional amendment freezes the current allocation in a county in place unless the Governor declares a fiscal emergency and agrees to repay imposed transfers after three years. Also requires the State to fully fund local mandates.

minimum amount of general fund expenditure to K-14 education (Prop 98) reduces what is available for other needed state expenditures. Raising state taxes, but then directing them to only one category of expenditure (as in Props 99, 172, 10, 42, 49, and 63) makes it difficult to exercise the budget flexibility needed to reallocate existing revenues when spending priorities change. And finally, California’s Constitution now prohibits the State from shifting property tax revenue from the county and city governments in a county to the school districts in the county (Prop 1A). In times of statewide fiscal stress, this restriction increases the likelihood that the State will have to spend beyond its means to meet its mandated Prop 98 public school funding obligations.

California allocates a significant portion of its state budget to local assistance. In FY 2001-02 the State devoted 40.4 percent of all state expenditure to intergovernmental expenditure to local governments.⁴ A comparable figure, calculated for all states in the United States was 28.4 percent. This development is a result of the *Serrano v. Priest* school finance decisions (that declared the difference in

⁴ Data to calculate drawn from Census of Local Governments (2002).

The “Roller Coaster” of California State Budgeting After Proposition 13

base revenue limits per pupil in California’s public schools need be less than \$350 per student in 2005 dollars), Proposition 13, and the propositions described in Table 1. California’s continuing assumption of state responsibility for funding things that are provided locally, and were once funded locally, is a clear reason for the difficulty observed in balancing the State’s operating budget. The next section looks to the State’s revenue reliance for another.

The “Roller Coaster” of California State Budgeting After Proposition 13

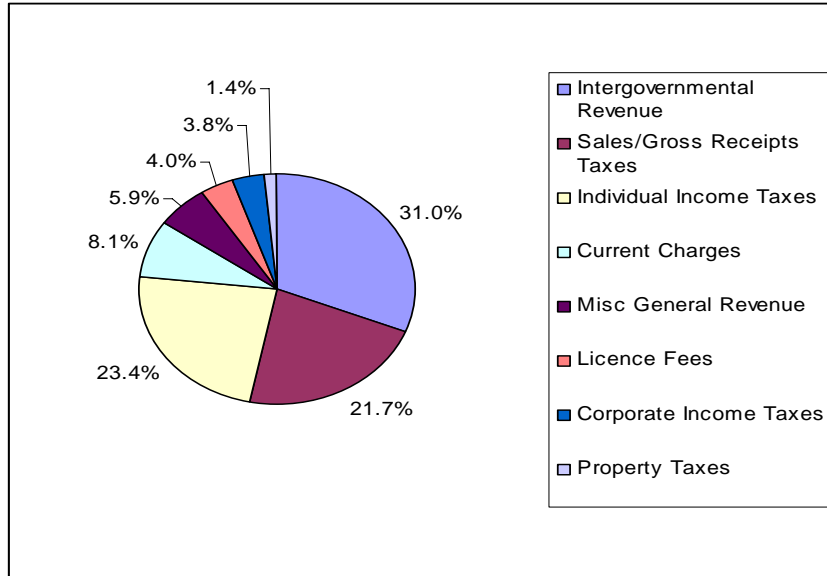
IV. State Revenue Reliance

In comparison to other states, there are important differences in the way that California raises revenue. Some of these differences can be pointed to as reasons the State has experienced wider fluctuating and less predictable revenue streams. As shown in Figures 6 and 7, California relies on individual income taxes, sales/gross receipts taxes, and corporate income taxes to a greater extent than all states. While these two sources accounted for about 19 percent of all aggregate state revenue in FY 2001-02, they accounted for nearly 26 percent of all California’s revenue. This is a concern because these forms of tax revenue exhibit greater instability over the business cycle. The structure of California’s individual income tax makes this instability particular acute.

California’s individual (personal) income tax is one of the most progressive in the country. In 2005, a single person (married couple) making over \$41,476 (\$82,952) in taxable income owed 9.3 percent of every additional taxable dollar to the State. As reported by the LAO (2004, p. 26), taxpayers with taxable incomes over a half-million dollars account for only a half percent of all California’s income tax returns, but a whopping 30 percent of income tax liabilities. Furthermore, the State draws about half of its personal income tax revenue from households reporting above \$200,000 in taxable income. These high income tax payers are more likely to record stock options and capital gains as part of their taxable income. As Figure 8 shows, since the realization of these components of taxable income fluctuate widely over the business cycle, so does the revenue California collects from all taxes. During the last recession, California tax revenue declined from \$76 billion in 2000-01 to \$63 billion in the following fiscal year. This 17 percent loss in general fund tax revenue was almost entirely composed of a loss in personal income tax revenue due to a reduction in realized stock options and capital gains. Even in FY 2004-05, almost three years after the last recession officially ended, income tax revenues from these two volatile sources were still \$2 billion less than their peak in FY 2000-01.

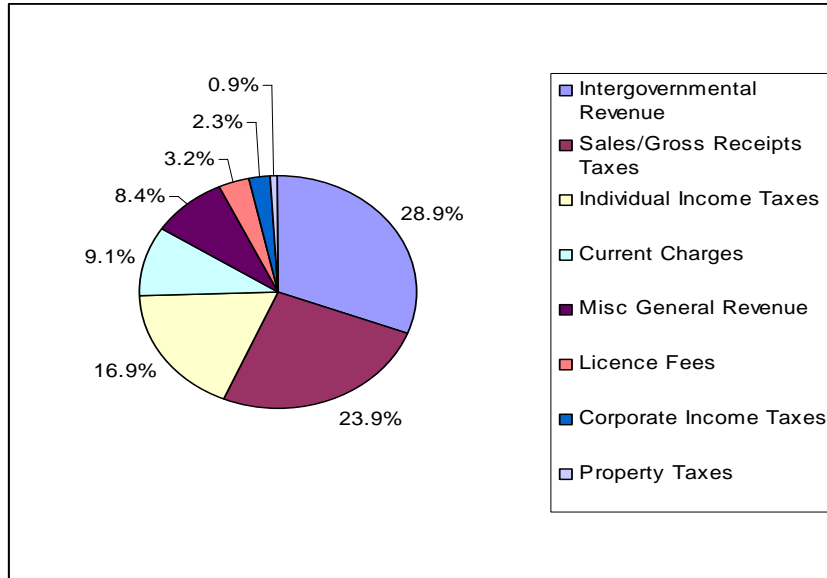
The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 6. GENERAL FUND REVENUE RELIANCE FOR STATE OF CALIFORNIA, FY 2001-02



Data Source: Census of Governments (2002).

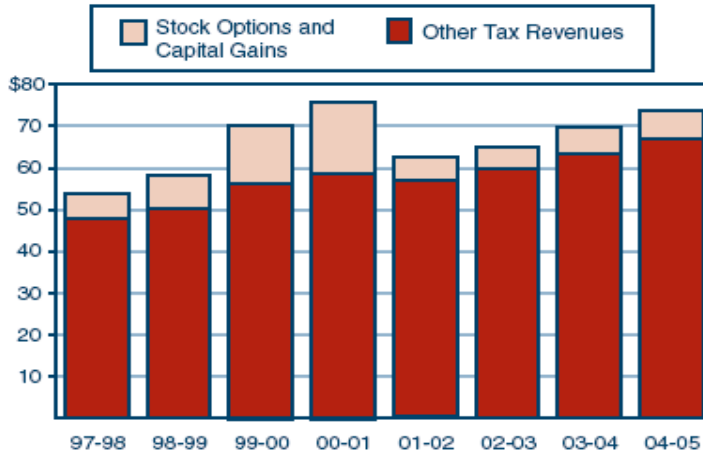
FIGURE 7. GENERAL FUND REVENUE RELIANCE FOR ALL STATES, FY 2001-02



Data Source: Census of Governments (2002).

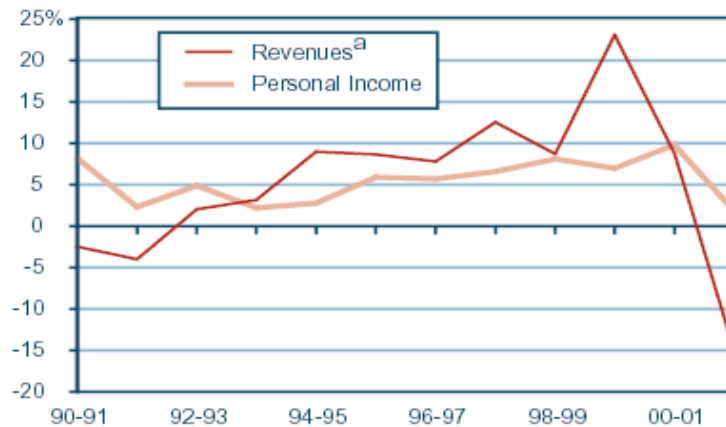
The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 8. CALIFORNIA TAX REVENUE (BILLIONS \$\$) BY FISCAL YEAR



Source: LAO (2004), *Cal Facts: California’s Economy and Budget in Perspective* Table 8); available at http://www.lao.ca.gov/2004/cal_facts/2004_calfacts_toc.htm.

FIGURE 9. CALIFORNIA GROWTH IN GENERAL FUND REVENUE AND PERSONAL INCOME (BILLIONS \$\$)



^a Excluding effects of law changes.

Source: LAO (2002), *Cal Facts: California’s Economy and Budget in Perspective* Table 3); http://www.lao.ca.gov/2002/cal_facts/budget.html.

The “Roller Coaster” of California State Budgeting After Proposition 13

The variability of tax revenue from stock options and capital gains, as a driver of California’s yearly operating deficits, finds further support through the observed relationship between the changes in State revenue and personal income drawn in Figure 9. Notice that growth in State revenue tracks above growth in personal income from FYs 1933-04 to 2000-01. It is only when the growth in personal income is on a general downward trend, and stock options and capital gains less likely to be realized, that growth in revenues falls below growth in personal income (i.e., before FY 1993-94 and after FY 2000-01). Referring back to Figure 5, these are also the same periods when California exhibited negative values for its budget stabilization fund.

The historical instability observed in the State of California’s fiscal situation may have also been related to variations in previous spending patterns. In addition, projected demographic trends could make the State’s future fiscal instability even worse. I turn to a review of these issues next.

The “Roller Coaster” of California State Budgeting After Proposition 13

V. Previous Spending and Future Demographics

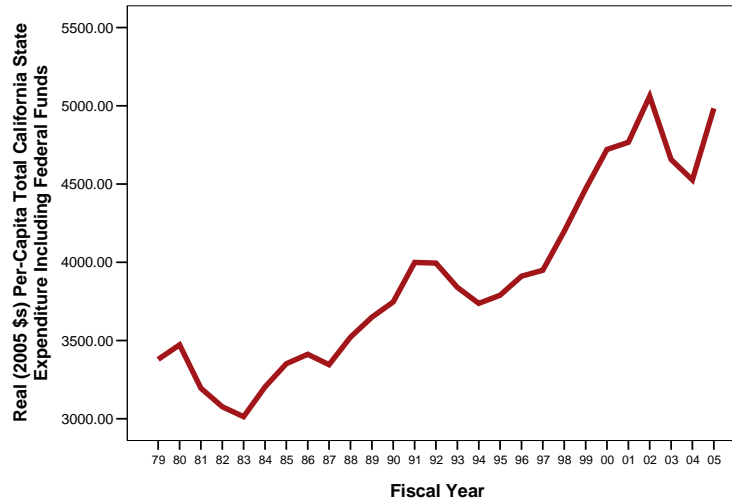
Has the fiscal instability in California’s state budget been caused at all by upward spending pressure upon the state since Proposition 13? Earlier there was some evidence of this offered in Figure 3 where the percentage change in California’s real general fund expenditure rose in most years, and at a rate that was higher than that calculated for all states as a whole. Though, one could argue that these trends may have been caused by population increases in the State being greater than the rest of the country. Figure 10 dismisses the idea that real spending growth in California has only been due to population increases. With a few dips after the recessions of the early 1980s, 90s, and 2000’s, real (2005 \$) per-capita spending in the State has risen sharply from about \$3,500 in 1979 to nearly \$5,000 in 2005 (comparable figures for all states are \$2,190 in 1979 and \$4,897 in 2002).

As detailed in Figure 11, California currently spends 62 percent of its general fund budget on K-12 and higher education, and corrections. Most observers consider this portion of the budget untouchable due to the Proposition 98 funding guarantee for primary and secondary public education, the State’s historical commitment to its “Master Plan” of offering an accessible higher education to all, and public attitudes that support correctional spending. Of the remaining 38 percent of general fund expenditures, 31 percent is devoted to health and human service spending. As noted in Fisher (2006, p.12), for states as whole in FY 2001-02, education and correction expenditures made up 36 percent of general expenditure, while health and human service spending accounted for 27 percent. California’s expenditure patterns and commitments are quite different than observed for all states as a whole. This difference could lend itself to further fiscal instability given the demographic and related income trends predicted for California.

Throughout the period under observation, the haves and the have-nots in California have been growing farther apart than in the rest of the United States. Figure 12 demonstrates this occurrence well. Notice that the percentage change in family income for the bottom 10th percentile grew at a much slower rate than for the top 10th percentile. Though this divergence has occurred throughout the United States, the figure shows that it was more pronounced in California.

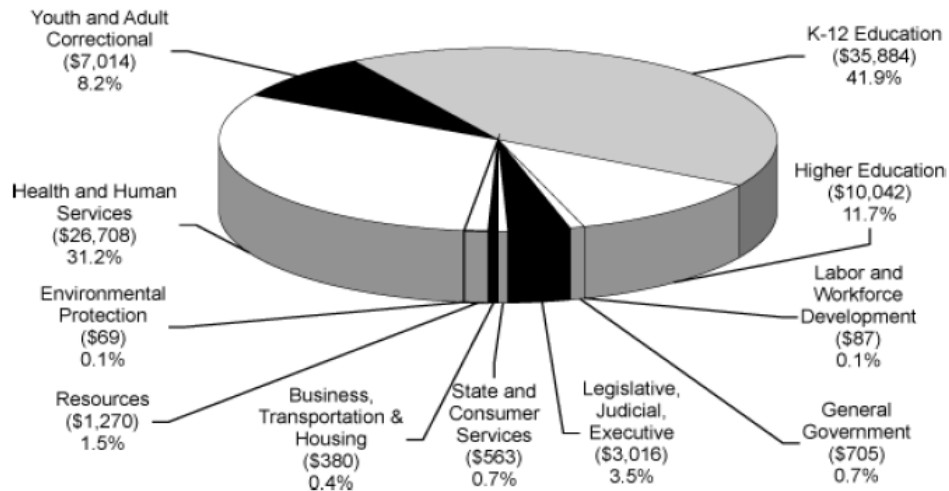
The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 10. REAL (2005 \$) PER-CAPITA TOTAL CALIFORNIA STATE EXPENDITURE



Data Source: California Department of Finance (2006).

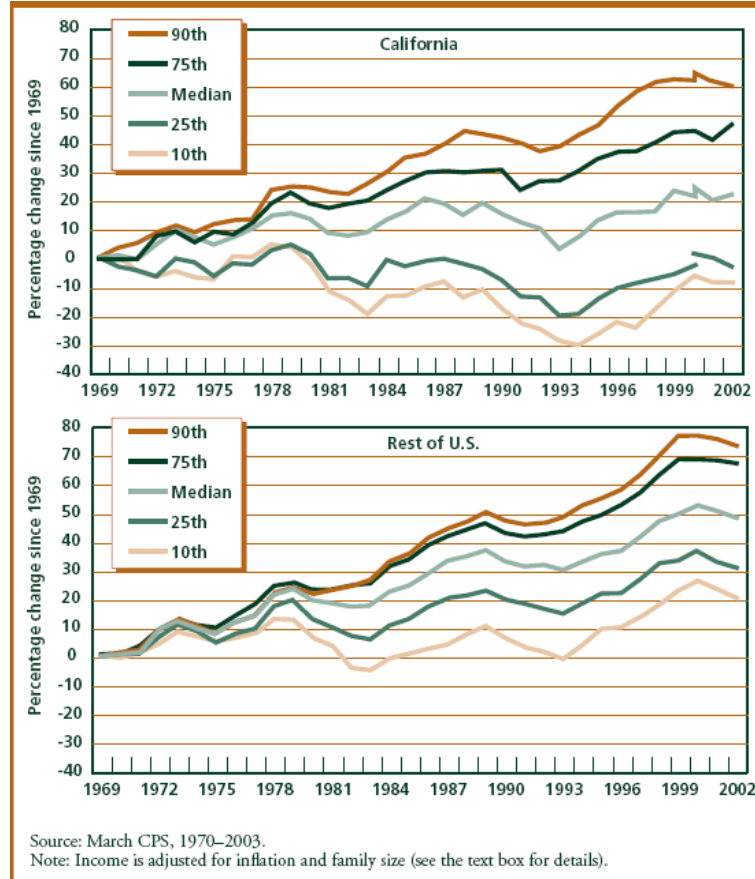
FIGURE 11. FY 2005-06 CALIFORNIA GENERAL FUND EXPENDITURES (MILLIONS \$)



Source: Public Policy Institute of California (January 2005), *Just the Facts: California's State Budget*; http://www.ppic.org/content/pubs/jtf/JTF_BudgetJTF.pdf.

The “Roller Coaster” of California State Budgeting After Proposition 13

FIGURE 12. FAMILY INCOME CHANGE RELATIVE TO 1969



Source: Reed (2004), Figure 1, p. 5,

A likely cause of the greater divergence in income growth in California is the large increase in the number of foreign-born residents that the State has experienced in the last three decades. According to PPIC (2002), the State’s foreign-born population totaled 1.8 million (7.6 percent of its total) in 1970, but by 2000 it had reached 8.9 million (26.1 percent of its total). In 2002, the poverty rate among California’s immigrants was 18 percent, while native-born residents experienced a significantly lower rate of 12 percent poverty. Much of this divergence in poverty incidence is traceable to differences in educational achievement that exist between immigrants and the native born. The rate of non-completion of high school among California’s immigrants over age 25 was 42 percent in 2002 (as compared to only 12

The “Roller Coaster” of California State Budgeting After Proposition 13

percent for the native born), while only 23 percent of these immigrants had completed college (as compared to 29 percent for the native born).

Thus, some of the State of California’s fiscal instability can be attributed to budgetary commitments that are different than other states and a growing underclass that has pushed the percentage of general fund expenditures devoted to health and human service activity to 36 percent as compared to the 27 percent that all states devote. Projections indicate that these fiscal pressures are unlikely to abate. The next section describes other possible future occurrences that, if they occur, are likely to put present even further challenges to the State’s fiscal situation.

The “Roller Coaster” of California State Budgeting After Proposition 13

VI. Other Concerns on the Horizon

State budget analyses for the United States as a whole (Eckl, 2005), and for California in particular (LAO, 2006), contain caveats of further concerns on the horizon that could make existing warnings of doom for state budgets even worse. Here I report upon the ones mentioned specifically for California.

In California, as in most states, budget analysts worry over the continuing demands placed upon the statewide primary and secondary public education by the growing accountability movement and the Federal “No Child-Left-Behind” Act. Regarding this policy concern, California faces the additional demands of a larger and more difficult to educate immigrant population and the State Legislature’s requirement that in 2006 high school seniors pass an exit exam in order to receive a high school diploma (than in 2005 nearly a quarter failed). In addition, if the nationwide movement for greater adequacy in K-12 public school funding catches hold in the State, required expenditure in this area could rise by as much as one-third (Conley, 2006). This is a fiscal catastrophe in the making for a state that devotes over 40 percent of its annual general fund budget to K-12 education spending.

Eckl (2005, p. 25) points to Medicaid (or Medi-Cal as it is called in California) as the fastest growing single category of state spending. Across all states it is budgeted to grow over 8 percent in the next fiscal year. In California, Medi-Cal spending from the State’s general fund is expected to total \$12.9 billion in the current fiscal year. This is just over 14 percent of total general fund expenditure. But this is only 38 percent of public expenditure on medical services for California’s low-income residents, the remaining portions come from the federal government (55 percent) and other state and local revenue sources (7 percent). As noted by the California Health Care Foundation (2006), Medi-Cal expenditures in the State over the last decade increased by nearly 75 percent due to enrollment growth and rising costs per beneficiary. In the future, this category of spending poses even greater fiscal concerns to California for a few reasons: the increasing number of beneficiaries using it, the high percentage of funding it receives from the federal government, and President Bush’s plan to reduce federal spending on Medicaid grants to states as part of his deficit reduction plans.

The “Roller Coaster” of California State Budgeting After Proposition 13

Related to Medi-Cal spending, rising health care costs in general could also spell trouble for balancing California’s future operating budgets. According to (Benson, 2006), the State currently pays about \$1 billion a year to cover health care premiums for current retirees. But analysts at the LAO estimate that this will not be enough to cover future unfunded liabilities that will fall somewhere between \$40 and \$70 billion. Subsequently, the LAO has suggested that the State begin putting aside an additional \$1 billion a year to meet these obligations. In a related development, the LAO (2006) estimates that the state funded retirement systems for public employees (PERS) and public K-14 teachers (STRS) face future unfunded liabilities of about \$24 billion. There have been some increases to the contribution rates made by public employers to account for this, but not nearly enough. If the State contribution to STRS were adjusted up enough to cover its projected future shortfall, the added annual costs would be an additional \$1 billion. California Assemblyman Keith Richman called these developments a potential “bombshell for state and local finance” (Benson, 2006). The California Legislature and Governor are likely to face increasing pressure to deal with these bombshells because the Government Accounting Standards Board, through ruling 45, has just required that all state governments (and local governments with expenditures greater than \$100 million) begin better tracking and reporting to the public on the actuarial amount of funding required to meet the future projected health care and pension costs of its retirees.

The LAO’s (2006) analysis of the most recent California budget notes two other possible developments that would alter their budget forecast if they came to fruition. The first is the outcome of three different court cases that the State is currently appealing. If all three are ultimately lost, the liability to California’s general fund could be as high as \$1.5 billion. Of likely greater concern for the potential size of the of the State’s structural operating deficit is whether the California economy and the tax revenues it generates continues to expand at the moderate pace that the budget forecast assumes. The risks of this not happening are tied to a rise in energy costs and/or a pronounced slowdown in California’s real estate and construction markets. The LAO estimates that such a deceleration of the State’s economy could result in as much as a \$4 billion reduction in annual state revenue.

The “Roller Coaster” of California State Budgeting After Proposition 13

Though, as shown earlier, such a change is not unusual when the State enters an economic downturn.

Before examining suggestions that have been put forth to improve California’s budget situation, the next section considers the current opinions of the State’s citizens on the issue.

