ATTACHMENT 1

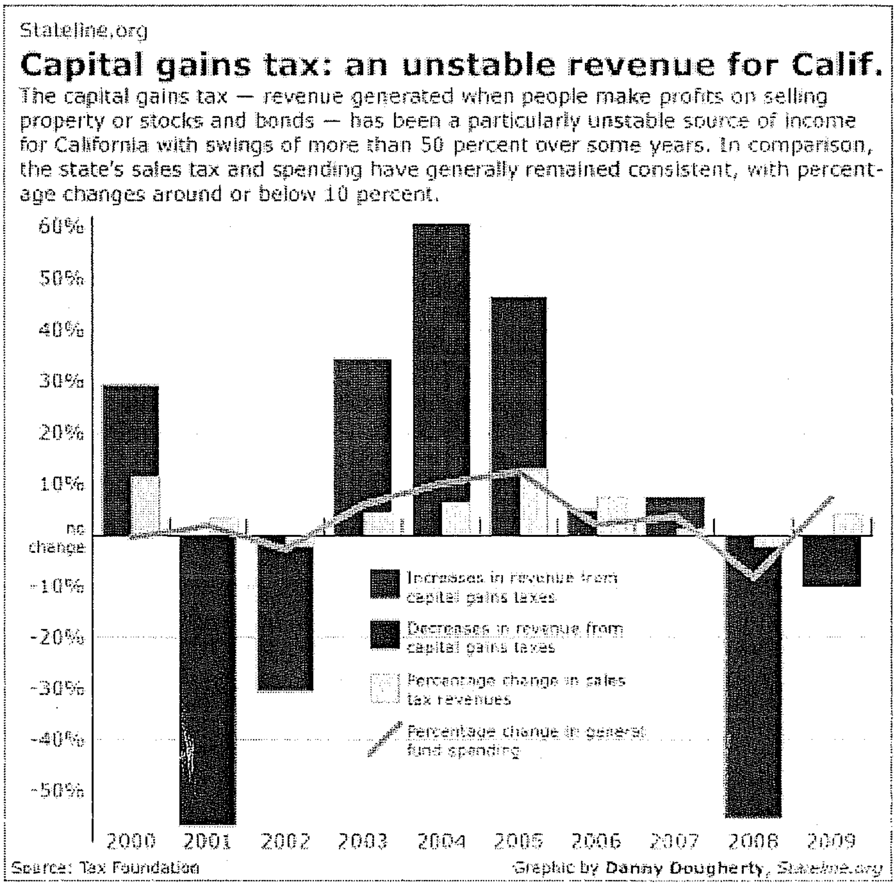
TOP STORY

FRIDAY, MAY 15, 2009

The path to California's fiscal crisis

By Pamela M. Prah, Stateline.org Staff Writer

California has always been a trendsetter. What happens in California often pops up elsewhere. Which raises this question: Are the perpetual billion-dollar deficits that haunt California state government unique to the Golden State or the harbinger of what other states can expect?



The answer, analysts say, is that although most states are experiencing some of the same financial stress, California's woes are its own. At the same time, other states can take a cue from California's troubles.

The state's financial hole is so deep that voters will decide on May 19 six questions the Legislature put on the ballot as part of budget deal in February with Gov. Arnold Schwarzenegger (R) that closed a $34 billion deficit. But with revenues plummeting, the state might still be short $15.4 billion even with the deal — and $21 billion if voters reject the package. Schwarzenegger has threatened to lay off 5,000 state workers and 1,700 firefighters, shorten the school year by five days and release 38,000 prisoners if the ballot measures fail.

Like most other states, California is being hammered by the recession, but experts say the depth and intensity of the current downturn makes the situation there particularly tenuous. "Many other states do face the same kind of problems California faces, but California's problems are just so much more bigger and more complicated," said Sujit CanagaRetna, senior fiscal analyst for the Council of State Governments.

One reason California's fiscal ordeal stands out is because of the state's size — it's the eighth-largest economy in the world. Threatening that economy is a mix of volatile tax revenues, voter-mandated spending and political factors that hamper effective budgeting.

CALIFORNIANS WEIGH BUDGET MEASURES

Californians once again are poised to decide how their state handles its money.

This isn't the first time Schwarzenegger has used the ballot box to try to fix the budget. Voters in 2005 resoundingly rejected by 62 percent to 38 percent a measure that would have imposed a state spending cap and allowed the governor to make budget cuts without legislative approval.

The ballot measures voters will decide on May 19 are:

Spending limit and tax hike — Proposition 1A would increase size of state "rainy day" fund from 5 percent to 12.5 percent of the general fund, set spending caps and extend the temporary 1-cent sales tax increase for two years.

New education payment plan — Proposition 1B would provide $9.3 billion in supplemental payments to local school districts and community colleges.

Borrow from the state lottery — Proposition 1C would allow the state to borrow $5 billion from future lottery profits to help balance the current state budget.

Redirect children's services funding — Proposition 1D would temporarily shift up to $608 million from tobacco taxes reserved for programs for young children to the general fund to balance the budget.

Redirect mental health funding — Proposition 1E would for two years move $230 million in each year set aside for adult mental health programs to the general fund to balance the budget.

Ban pay raises for state officials — Proposition 1F would prevent elected members of the Legislature and statewide constitutional officers, including the governor, from receiving pay raises in years when the state is running a deficit.

All of the measures except the pay-raise ban are unpopular, according to a Field Poll last month. Voters also have given Schwarzenegger and the Legislature their lowest-ever approval ratings, in a May 1 Field Poll.

Rather than having a steady flow of money from several sources as many states do, California experiences wild swings in revenue because of its dependence on a small group of people: its wealthiest taxpayers.

The top 1 percent of the richest taxpayers typically pay about half of all personal income taxes in California. More than 55 percent of the state revenue last year came from personal income taxes, followed by the sales tax with 27 percent.

As long as times are good, this arrangement works because as people splurge on big-ticket items and make profits, they send large infusions of tax revenue to the state. But when the economy takes a tumble and people tighten their belts and corporations' profits fall, the state's primary source of revenue takes a precipitous drop.

"California is unique in that it so dependent on such a small portion of the population," said Mark Baldassare, president of the Public Policy Institute of California, a nonprofit in San Francisco that does independent research on the state's economic, social and political issues.

The capital gains tax — revenue generated when people make profits on selling property or stocks and bonds — is particularly volatile. In 2000, for example, when Silicon Valley and the rest of the state was enjoying the "dot.com" boom, state revenues derived from capital gains went up nearly 30 percent. A year later, when the technology bubble burst, capital gains plummeted by more than 55 percent. "California is in a class in itself the way it relies so heavily on capital gains," Joseph D. Henchman, director of state projects at the Tax Foundation, a nonpartisan Washington D.C., research group.

The same boom-bust cycle happened with the rise and fall of the once hot housing market. All revenues related to the housing sector, including direct revenue sources like real estate transaction fees, income taxes from construction workers and indirect revenue sources like sales tax revenues from home improvement stores like Home Depot or Lowe's have dwindled.

And the red ink keeps coming. Last month, the state fell short of expected revenue by more than $1.8 billion in personal and corporate income taxes. The bleak revenue picture means the state might need to borrow up to $17 billion, and even more, if voters reject the ballot measures, the Legislature's chief budget analyst warned May 7.

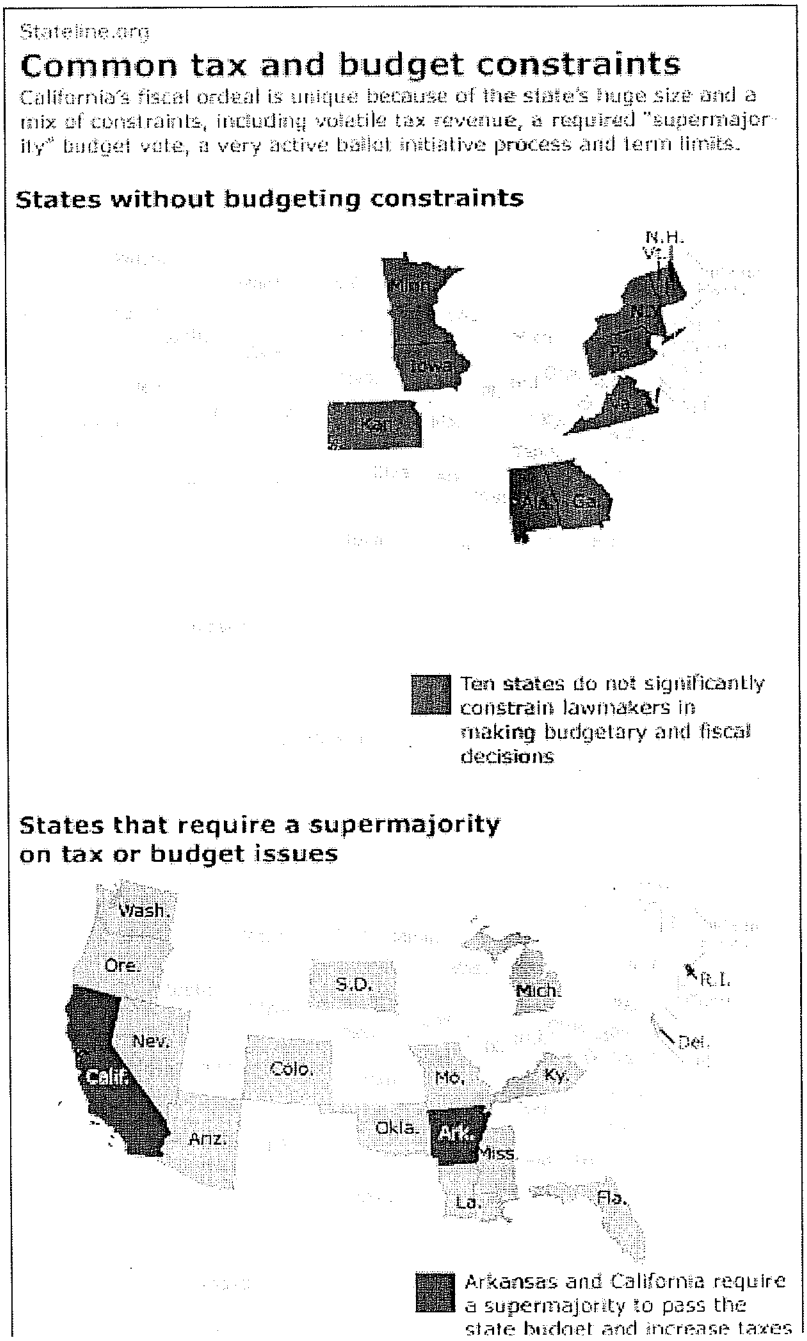
"California has gotten itself into a deficit crisis of unprecedented proportions because it relied on an overly progressive income tax system that produced volatile one-time revenues and overspent those funds on ongoing programs," state Republican Sen. Dave Cox, vice-chair of the Senate Appropriations Committee, said in a statement last month.

Obviously, politics plays a huge role in the current budget morass: the Republican governor and Democrats who control the Legislature can't agree on how much to tax and how much to spend. But the problems go deeper. Schwarzenegger came to office in 2003 when voters ousted Gov. Gray Davis, a Democrat, in an unprecedented statewide recall election. Davis was unpopular, in part, because of his poor handling of the spiraling budget deficits with his fellow Democrats in the statehouse.

Other factors contribute to California's chronic budget woes as well. Some of them are:

"Supermajority" vote — California is one of 16 states that have adopted legislative "supermajority" requirements that make it more difficult for legislators to raise taxes or modernize their tax code because they need more than a simple majority of lawmakers to approve such a move, with most, including California, requiring a two-thirds vote.

But California also is one of only three states that require a supermajority to pass the budget (Arkansas and Rhode Island are the others), again requiring two-thirds, according to the Public Policy Institute of California.



Active citizen initiative process — California's budget has to take into consideration an array of citizens' ballot measures, including the famed Proposition 13 in 1978 that cut property taxes and kicked off a nationwide property tax revolt. At the same time, other ballot measures have locked in a certain amount of money for particular programs. A 1988 measure, for example, guarantees at least 40 percent of the general fund goes to education.

Term limits — Among the nearly dozen states that cap the length of legislators' terms, California is among the strictest. Assembly members are limited to six years in office and senators to eight, and after they serve, they are banned from that chamber for life. This often means that by the time elected officials are experienced in the budget process, they have to leave office.

Irregular cash flow — The state generally disburses most of its dollars in the first half of the fiscal year (between July and December), but it collects most of the money in the second half of the fiscal year (between January and June). That means the state routinely runs monthly cash flow deficits through the first half of the fiscal year and has surpluses through much of the second half, the state's nonpartisan Legislative Analyst's Office said in its May report.

In most years, it's easy for the state to borrow funds to cover these temporary deficits. But the combination of last fall's weak revenues and the tightening of the credit market forced the state to consider borrowing from the federal government to meet cash-flow needs. Instead, the state halted funding for thousands of infrastructure projects to conserve resources.

Depleted rainy-day fund — Currently, the state can set aside up to 5 percent of the general fund, but often doesn't. Proponents of a ballot measure that would increase that level to 12.5 percent say a higher threshold could have ensured that the state had enough money to fill some of the deficits, rather than make cuts to programs or resort to layoffs.

An adequate rainy day fund also makes it easier for states to borrow money for financing both long-term and short-term projects. California's credit rating fell earlier this year to the lowest in the country.

Antiquated tax system — Like most other states, California has a tax system that hasn't kept up with the times. The U.S. economy has shifted from producing goods, like cars and appliances, which most states have taxed since the 1930s, to producing services, which most states do not tax. Consumers also are buying more online and often avoiding paying state sale taxes.

A 2007 Federation of Tax Administrators survey showed that California taxes 21 services out of the 168 that were included in the survey.

Not only are states collecting less revenue under an antiquated system, the demands put on states are actually increasing, especially on the health-care front. Simply put, the tax structure doesn't generate enough revenue to cover all the services that the state offers.

For many of these reasons, California was one of the bottom two states in the Government Performance Project (GPP)'s money grades last year, with a D+. Like *Stateline.org*, GPP is a project of the Pew Center on the States.

Are there lessons for other states?

Scott Pattison, executive director of the National Association of State Budget Officers, said other states can learn from California's mistakes by making sure they have flexibility in their financial management systems and "avoid walling things off" so that cash reserves can be tapped during a downturn.

He also said states "need to get out of this culture of silos where everyone is trying to protect themselves and stand up and do what is right for the entire state in the long term, rather than everyone protecting their own slice of the pie."

California's panoply of problems may make its budget crisis stand out, but some experts say similar budget nightmares are likely to hit other states during the years ahead.

"When the budgetary choices become more politically painful, there's a danger that other states will descend into California-style gridlock," said Robert B. Ward, director of fiscal studies at the Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York.

After states weather this recession, they will still have billion-dollar headaches. The year after a recession is over is always the hardest for states because Medicaid rolls and other public safety net programs have swelled, creating an ongoing difficulty for budgets. The National Governors Association has estimated the states' budget gaps could top $230 billion through 2010.

A longer-term problem is the burden of health care and pension benefits for retiring state workers that are expected to total $2.73 trillion over 30 years, according to a study from the Pew Center on the States.

Ward of Rockefeller expects states will be forced to make more unplanned spending cuts and painful tax and fee increases, reshape programs to emphasize revenue rather than effectiveness and shift more of the costs to the next generation. "California, here we come?" he asks.

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