Introduction

This budget proposes the difficult but necessary steps needed to bring the state's chronic structural deficit under control, not only for this fiscal year but permanently. This is accomplished by (1) imposing strict spending restraint in the current and budget years while protecting and preserving essential state services and (2) proposing a Constitutional Amendment to reform the budget process so that state government has the tools needed to avoid spending more than it has in the future.

Origin of the Structural Deficit

For the last three decades the state's budget has swung in and out of balance. The enactment of Proposition 13 in 1978 dramatically reduced local property tax revenues, resulting in equally dramatic increases in the state's fiscal obligations to programs formerly financed mainly by local government, such as schools, social services, health and mental health care and law enforcement. This set off a round of recalibrations of the state budget during periods of strong economic growth punctuated by several recessions. By 1998, however, the state's fiscal house appeared to be in good order. Long-term projections showed spending in line with revenue for years to come.

Between 1998-99 and 1999-2000, however, revenues jumped 23 percent due to a stock market and dot-com boom that drove unprecedented increases in stock option and capital gains income. These were magnified from a state revenue perspective because the state's income tax system relies disproportionately on the very high-end earners most likely to receive such gains. In 2005, California taxpayers with incomes over $119,000, who constituted 10 percent of all taxpayers, paid 78.3 percent of the personal income tax.

The structural deficit was created when the state added new, permanent spending increases that relied on these one-time revenue gains. In addition to major new commitments, costs in many state programs have been driven up by spending formulas, caseload and population growth, wage and provider rate increases and court orders. Figure INT-01 displays the major components of General Fund spending growth since 1998. Specifically, it compares the General Fund workload budget for 2008-09 to actual spending in 1998-99. The workload budget is what it would cost the state to operate government in 2008-09 in the absence of any changes in law or policy to restrain spending growth.

Figure INT-01

Major General Fund Spending Growth Since 1998-99

(Dollars in Millions)

	1998-99 Actual	2008-09 Workload Budget	Average Annual Percentage Growth
Proposition 98--K-14 Education	($24,672)	($44,418)	(6.1%)
Base Program	$24,672	$38,271	4.5%
VLF Tax Cut Impact	0	6,147	NA
Medi-Cal	7,471	14,798	7.1%
In-Home Support Services	530	1,758	12.7%
Developmental Services	714	3,002	15.5%
Healthy Families	16	432	39.4%
Other Health and Human Services	7,332	11,864	4.9%
Corrections and Rehabilitation	4,547	10,503	8.7%
Debt Service, Lease Payments, and Revenue Anticipation Notes Interest Costs	1,974	4,890	9.5%
Proposition 42	0	1,485	NA
Courts	907	2,467	10.5%
Higher Education (excluding Community Colleges)	5,142	7,001	3.1%
Contribution to State Teachers Retirement System	293	1,279	15.9%
Proposition 58 Transfers to Retire Economic Recovery Bonds	0	1,509	NA
Health and Dental Benefits for Retirees	310	1,263	15.1%
Other	3,918	5,092	2.7%
Total	**$57,827**	**$111,761**	**6.8%**

The Fiscal Crisis of 2003-04 and the Workout Plan of 2004-05

When the revenue boom of 2000 turned to bust in the recession of 2001, the higher rates of state spending enacted during the boom years resulted in one of the worst deficits in the state's history. In response, the budget of 2003-04 borrowed money to cover the deficit of the prior year and closed the budget gap with over $5 billion in one-time solutions, leaving the state facing a $14 billion budget gap in the subsequent year.

The Governor's Budget for 2004-05 proposed a workout plan for the state's budget by proposing to refinance the borrowing begun in the previous year and restrain spending growth, thus buying time for normal revenue growth to catch up with spending demands and bring the state back to long-term fiscal balance. Had this plan been fully implemented, the state would not have a structural deficit today.

However, the plan was never fully implemented. Shortly after the workout plan was proposed, state General Fund revenues experienced another unanticipated growth spurt. The unanticipated revenues built a large reserve, which made it possible to balance the budgets for 2005-06 and 2006-07 without making major program reductions. Given the improved revenue picture and the difficulty of the choices that would have had to have been made to restrain spending growth rates in the long term, the Legislature declined to enact the statutory changes necessary to slow overall spending. In other words, the most important element of the workout plan – spending restraint – was never put in place.

While revenue growth slowed somewhat in 2006-07, spending continued to grow. This was not because of any major new commitment, but because not enough had been done to change the underlying statutory programs that were driving spending increases. While 2005-06 and 2006-07 budgets were enacted with a prudent reserve, the structural deficit remained. Our projections in both of those years showed that the deficit would re-emerge in 2007-08.

Reforming the Budget Process, the Budget Stabilization Act

The state's budget history shows that there are two shortcomings in the budget process that have led to recurring budget deficits. First, the state tends to spend all the money it takes in during years of high revenue growth or when it has a large available reserve. Thus, high-growth years lead to unsustainable levels of spending for the long run.

Second, the state has not been able to slow spending growth fast enough to bring it back in line with a realistic projection of future revenues.

In order to address these two problems and restore the state to long-term balance, the Governor's Budget proposes the Budget Stabilization Act, a Constitutional Amendment to reform the state budget process. The reform would prevent over-budgeting based on extraordinary revenue gains and give the state the tools it needs to quickly reduce spending when necessary to avoid a deficit.

Avoiding Over-Budgeting Based on Extraordinary Revenue Gains

In order to prevent reliance on unsustainably high revenue gains, the Budget Stabilization Act will require that excess revenues – revenues above a reasonable, long-term average rate of growth—be deposited in the Revenue Stabilization Fund. In years of below-average rates of revenue growth, monies will be transferred from the Revenue Stabilization Fund back into the General Fund in an amount not to exceed the shortfall. When the Revenue Stabilization Fund exceeds an amount equivalent to 10 percent of General Fund revenues in a given year, the excess will be available for one-time spending for schools (in proportion to the Proposition 98 share of total General Fund revenues) and providing one-time tax rebates, investing in one-time infrastructure projects, or paying off debt.

The Act allows transfers from the Revenue Stabilization Fund back into the General Fund only in years when revenue grows at a rate less than the long-term average. Transfers would NOT be allowed simply to avoid deficits, not even in emergencies. The state already has mechanisms for addressing emergencies, including the ability to temporarily raise taxes with a two-thirds vote of the Legislature.

Giving the State the Tools to Quickly Reduce Spending When Necessary

To ensure that the state quickly reduces spending to sustainable levels, the Budget Stabilization Act will provide for automatic reductions. These reductions will be triggered whenever the Governor projects that the state will be in deficit. The Governor will be required to estimate the year-end balance in the General Fund three times each year – in November, January and May. When this estimate shows a likely General Fund deficit of one percent or less, the Governor will reduce appropriations, on an annualized basis, by 2 percent and when it shows a deficit of greater than one percent of appropriations will be reduced by 5 percent. Given the difficulty of achieving actual savings during the fiscal year, the reductions will be pro-rated for the amount of time remaining in the year.

The Act will also require the Legislature and the Governor to enact statutory changes in all state entitlement programs that allow for reductions in service levels or rates of payment sufficient to achieve the targeted reductions of 2 and 5 percent. In order to ensure that a full year of savings is achieved by these program reductions, they will remain in effect, once triggered by a projected deficit in a particular year, not only for the remainder of that year, but until the Legislature takes a subsequent action, either in the next Budget Act or in separate legislation to restore the prior levels of service. In the event that the Legislature fails to enact a schedule of program reductions in a given program, or if the reductions authorized by the Legislature are insufficient to achieve the required annualized savings goals, the Governor will be authorized to waive any state law or regulation necessary to achieve the full amounts of the reductions.

Not all state appropriations could be reduced under the Act. For example, debt service will not be subject to reduction. To ensure that reductions are not inconsistent with the United States or California Constitutions, the Governor will be required to exempt appropriations from reduction if the reduction would be constitutionally unenforceable.

The Budget Stabilization Act will not change any vote threshold. Tax increases, urgency measures and most General Fund appropriations will still have to be enacted by two-thirds majorities in both houses of the Legislature.

The State Faces a $14.5 Billion Deficit in 2008-09

The Budget Act of 2007 projected a reserve of $4.1 billion, the largest planned reserve in the state's history. It also showed that the deficit would re-emerge next year with spending exceeding revenues by $6.1 billion.

Since those projections were made, the budget situation has deteriorated dramatically. Figure INT-02 displays the major changes that have resulted in a projected shortfall of $14.5 billion by the end of 2008-09, in the absence of any changes to state law or policy to reduce spending.

Figure INT-02

$14.5 Billion General Fund Deficit

Workload Budget [1/]

(Dollars in Billions)

	2007-08	2008-09
2007 Budget Act Reserve	**$4.1**	
Changes in Beginning Balance/ Carryover from 2007-08	-0.5	**-$3.3**
2007-08 Operating Deficit		**-$6.7** [2/]
Major Revenues Decrease/Increase (-/+)	-4.2	4.6
Other Revenues	-0.7	-1.4
Expenditure Increases:		
Proposition 98	-0.6	-2.3
All Others	-1.4	-5.4
2008-09 Operating Deficit		**-$11.2**
2008-09 Governor's Budget Workload Budget Deficit	**-$3.3**	**-$14.5**
Operating Deficit	**-$6.7** [2/]	

[1/] Workload budget reflects the projected costs of state government if no corrective actions are taken.

[2/] The operating deficit for 2007-08 reflects spending more in that year than the revenues collected that year. This operating deficit carries forward into 2008-09 and is increased by projected spending increases partially offset by revenue increases.

Achieving Balance in 2007-08 and 2008-09

If the Budget Stabilization Act had been in effect since 1998, the state would not have developed a structural budget deficit. It is possible, even likely, that there would be some deficit in years such as this one. However, in that event the Act would have triggered automatic reductions in spending early in the year. Because such mid-year reductions do not usually achieve a full year's worth of savings, under the provisions of the Act, they would remain in effect into the subsequent year, or until superseded by a new budget or other statutory change enacted by the Legislature.

The Budget proposes a very similar approach to achieving balance this year and next. Specifically, the Budget proposes numerous statutory changes to reduce spending to take effect by March 1, 2008. In order to achieve this ambitious timeline and to avoid a

Proposition 58

Proposition 58 was approved by the voters in 2004. It requires the Legislature to enact a balanced budget and it authorizes the Governor to declare a fiscal emergency and call a special session of the Legislature to address it when a significant budget shortfall looms. The Governor declared such an emergency this year. The measures he is proposing to address the emergency are described below. Under the Proposition, the Legislature has 45 days to act on these measures or they are prevented from acting on other bills or adjourning.

current-year cash shortfall, the Governor has declared a fiscal emergency and called a special session pursuant to Proposition 58 (see textbox for background).

In addition to the ten-percent reductions, the budget also proposes to sell the $3.3 billion of authorized Economic Recovery Bonds (ERB's) and to suspend the pre-payment of ERBs scheduled for 2008-09. Figure INT-03 summarizes the major changes proposed to balance the budget.

Figure INT-03

How We Closed the Budget Gap

(Dollars in Millions)

	2007-08	2008-09
Workload Reserve	-$3,318	-$14,479
Impact of 2007-08 Solutions on 2008-09 Beginning Reserve		4,190
10-Percent Reductions	217	9,132
Sell Economic Recovery Bonds	3,313	
Proposition 58 Suspension		1,509
Reduce Proposition 98 Overappropriation	400	
Other Special Session Reductions	200	96
Accrual of June Personal Income Tax and Corporate Tax		2,001
Franchise Tax Board and Board of Equalization collection and enforcement enhancements	60	329
Reserve at Governor's Budget	**$872**	**$2,778**