March 9, 2015

Hon. Mark Leno, Chair
Joint Legislative Budget Committee
Room 5100, State Capitol
Sacramento, California 95814

Dear Senator Leno:

At the January 22 hearing of the Senate Committee on Budget and Fiscal Review, you asked us about the trend of state spending since the beginning of the recession. This letter provides additional information concerning that trend, as a follow up to that discussion.

Pre-Recession Budget Outlooks Assumed Much Higher Spending

According to the National Bureau of Economic Research, the last recession began in December 2007 and ended in June 2009, at which time the current economic expansion began. Our office's last state budget outlook prepared prior to the start of the national recession was the November 2007 *Fiscal Outlook*.

November 2007 Outlook: $136 Billion of General Fund Spending in 2012-13. As with our current fiscal outlooks, the November 2007 publication included a main scenario that assumed continuing economic growth and a continuation of then-existing spending and tax policies. Such a scenario assumed annual growth in state spending on schools and many other programs, as well as annual cost-of-living adjustments for state worker pay and some other programs. Under these conditions, the November 2007 *Fiscal Outlook* assumed that 2007-08 General Fund spending would be $104.2 billion and would grow at an average annual rate of 5.4 percent per year, thereby reaching $135.6 billion in 2012-13. This assumed spending trend roughly matched the assumed trend for General Fund revenues at the time, with revenues projected to grow from $99 billion in 2007-08 to $133 billion in 2012-13.

Our November 2007 publication anticipated annual budgetary shortfalls throughout the period. This means that at the time, it was thought that tax increases or other budgetary changes would be necessary to support the assumed future levels of spending. Reductions in spending commitments, by contrast, would have reduced the $135.6 billion of assumed 2012-13 spending. As discussed below, spending reductions of this type did occur during the recession.

Actual 2012-13 General Fund Spending: $97 Billion. According to the administration's final update of 2012-13 spending, the state General Fund actually spent $96.6 billion in that fiscal year. This is $39 billion (29 percent) less than the amount that our November 2007 *Fiscal Outlook* assumed the General Fund would spend in 2012-13. State spending declined in nominal terms during the recession: with 2012-13 General Fund spending falling $6.4 billion (6.2 percent) below 2007-08 levels, unadjusted for inflation.

The $39 billion lower spending amount in 2012-13 was spread across a variety of programs throughout the budget, including $10 billion less in General Fund spending on Proposition 98, over $4 billion less in spending on prisons and parole, several billion dollars less in General Fund spending on Medi-Cal, over $3 billion less on spending for universities and financial aid, about $2 billion less on spending for the courts, billions less in General Fund spending for a variety of health and social services programs, and other differences.

Recession Battered California Budget. As you know, the primary reason for the drop in General Fund spending over this period was the recession. The recession battered California's tax revenues, requiring adoption of spending cuts, tax increases, and other measures to balance the state budget. By 2009-10, for example, the state ended up collecting $87 billion in General Fund revenues and spending $87.2 billion from the General Fund—$29.9 billion (25.5 percent) less spending than we assumed for that fiscal year in November 2007. In 2009 alone, the Legislature and the prior Governor approved about $60 billion of actions to attempt to keep the budget in balance and address pronounced cash shortfalls that threatened the state government's solvency.

2015-16 Budget Proposal: General Fund Spending of $113 Billion. Due to growth in the economy and stock prices, as well as the approval of temporary Proposition 30 tax increases by voters in 2012, General Fund spending has climbed since 2012-13. The Governor's 2015-16 budget plan proposes $113 billion of General Fund spending in 2015-16. This amount would be $10.3 billion (10 percent) above 2007-08 General Fund spending levels, unadjusted for inflation.

General Fund Responsibilities Quite Different Today

General Fund Today Not Easily Comparable to That of 2007. The General Fund has different responsibilities today than it did in 2007 and, therefore, the level of General Fund spending today is not easily comparable to that discussed in our November 2007 *Fiscal Outlook*. In several key areas of public services, the state has shifted funding responsibilities from the General Fund to (1) other state and local government accounts or (2) individuals and families. Because of these shifts, current General Fund spending arguably is understated relative to what might have been expected prior to the recession.

Challenges in Quantifying General Fund Changes. It is difficult to develop a comprehensive list of the changes that California made in General Fund responsibilities during the recession due to the complexity of the state budget. It is especially difficult to quantify all of the identified shifts due to the interrelationship of the state's budget formulas and the difficulty in knowing how one change, if not adopted, might have affected other budgetary decisions.

Major Shifts of Responsibilities. In the proposed 2015-16 budget plan, the ongoing shifts of General Fund responsibilities to other state or local or private accounts include, but are not limited to, the following:

- 2011 local realignment shift of certain programs to local governments ($7.2 billion, now paid from state special funds).
- Medi-Cal hospital fees and managed care organization tax ($2 billion, now paid from state special funds).
- Increased reliance on tuition and fees paid by families to cover higher education costs. (While it is impossible to know what levels tuition and fees would be at now if the

recession had not occurred, net tuition and fees for the higher education segments—excluding tuition paid from Cal Grant awards—now are $1.7 billion higher than they were in 2007-08.)

- Use of weight fee and other transportation revenues to pay a portion of transportation-related debt service ($1.2 billion, now paid from state special funds).
- Funding of K-14 education from former redevelopment agency taxes (about $1 billion, paid to school districts as local property taxes that generally reduces state General Fund spending requirements).
- Funding of California Work Opportunity and Responsibility to Kids (CalWORKs) program base grant costs from 1991 realignment funds ($0.7 billion, now paid from state special funds).
- Funding of CalWORKs grant increases from 1991 realignment funds ($0.3 billion, now paid from state special funds).
- Use of State Responsibility Area Fire Prevention Fund fee to cover portion of California Department of Forestry and Fire Protection costs ($0.07 billion, now paid from state special funds).

(In addition to the items listed above, note that the final payoff of the early-2000s deficit financing bonds, known as economic recovery bonds, and the related end of the "triple flip" financing mechanism relieves the General Fund of over $1.2 billion of costs in 2015-16, with additional savings anticipated in 2016-17. The expiration of the triple flip, however, was already spelled out in state law at the beginning of the recession.)

"Adjusted" General Fund Spending Approaching $130 Billion for 2015-16. In a hypothetical world in which none of the shifts above occurred and the General Fund still paid for all of these expenses, General Fund spending in 2015-16 might be somewhere between $125 billion and $130 billion, much higher than the $113 billion reflected in the Governor's recent spending proposal. This adjusted level of spending is still somewhat below the later years' spending levels indicated in our November 2007 *Fiscal Outlook*. Put another way, assuming that the economy continued expanding uninterrupted from 2007 through today, our November 2007 outlook presumably would have anticipated 2015-16 spending at well above this $130 billion adjusted spending level.

Comparing current spending levels with assumptions from years ago is very difficult, as described earlier. The main lesson we take from the comparisons discussed above is an obvious one: that the state budget went through many changes during the years of the recession and the early years of the economic recovery.

Helpful to Consider Special Fund Expenditures. Other comparisons of budgetary trends exist, and in some cases, these comparisons may be more meaningful. We discuss some such comparisons in the next sections of this letter. As described above, the state has decided to shift General Fund expenditure responsibilities to state special funds, some of which provide funding to local entities. Accordingly, the comparisons below consider General Fund and special funds' expenditures *combined* to get a sense of overall state spending trends.

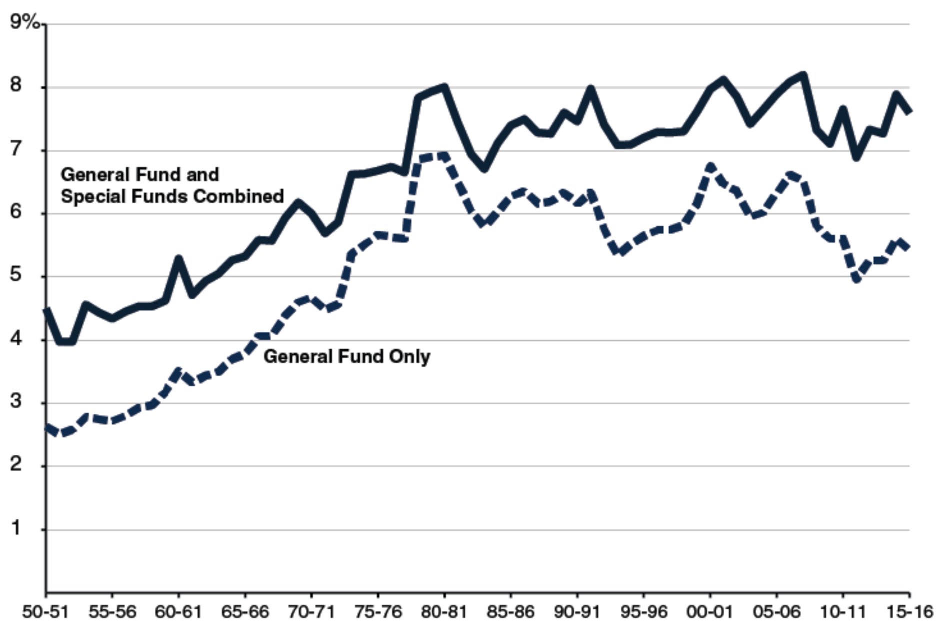
State Spending Compared to the Economy

Personal Income a Key Measure of California Economy. The economic statistic known as personal income is a broad measure of economic activity in California. Personal income tends to grow faster during economic expansions and grow more slowly during recessions. Personal income also tends to grow faster during periods of faster population growth. It measures wages and salaries and various other types of income (excluding capital gains, among other types). One way to look at state spending is to consider it as a percentage of the state's personal income, as shown in Figure 1.

Figure 1

General/Special Fund Spending Has Averaged 7.5 Percent of Personal Income Since 1978

Spending as Percent of California Personal Income



Note: For 2014-15 and 2015-16, spending reflects amounts in *2015-16 Governor's Budget*. 2014-2016 personal income amounts are LAO projections.

As Share of Economy, 2015-16 Spending Below 2007-08 Levels. As shown in Figure 1, spending from the General Fund and state special funds combined is at an estimated 7.6 percent of statewide personal income in the Governor's 2015-16 budget proposal. This is slightly above the 7.5 percent average by this measure since 1978, the year that Proposition 13 passed. (Spending as a percentage of statewide personal income grew steadily during the decades prior to 1978.) Compared to personal income, General and special fund spending peaked at 8.2 percent in 2007-08 and fell to 6.9 percent in 2011-12 before climbing again to an estimated 7.9 percent in the current fiscal year, 2014-15. At an estimated 7.6 percent of personal income in the 2015-16 gubernatorial budget proposal, General and special fund spending would be below the level it was in 2007-08 according to this measure.

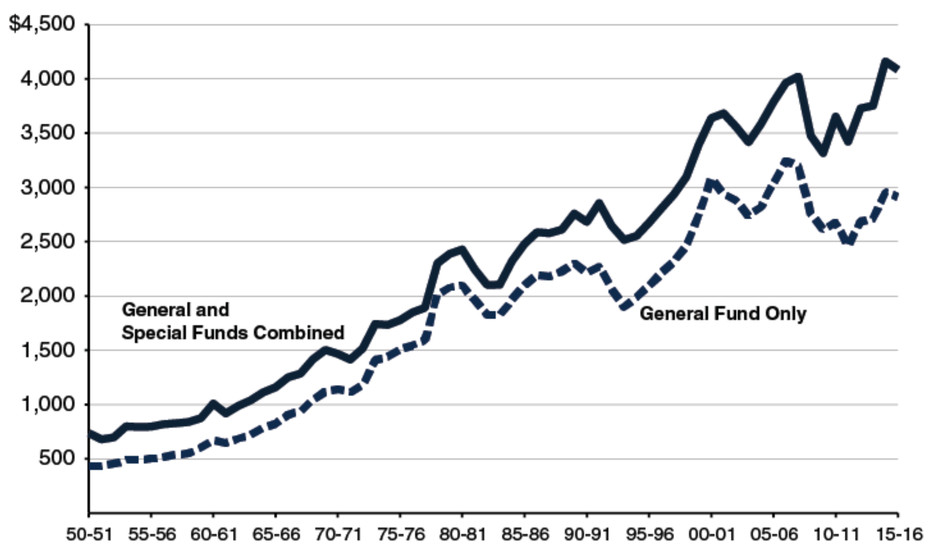
Per Capita State Spending Adjusted for Inflation

Spending Has Climbed, Due in Part to Low Inflation. Figure 2 displays per capita inflation-adjusted state spending in 2015-16 dollars, using the implicit price deflator for U.S. gross domestic product (GDP). (The “GDP deflator” is a commonly used measure in considering inflation that reflects growth in prices of new, final goods and services in the economy.) Since 1990, this inflation measure has grown at an average annual rate of 2.1 percent, which is a far slower inflation rate than in prior decades. Largely due to this persistently low level of inflation, per capita inflation-adjusted spending has grown markedly in recent decades, as Figure 2 illustrates. In 2015-16 dollars, per capita General Fund and special fund spending reached $4,024 in 2007-08 before falling to $3,317 in 2009-10. Since then, this measure has climbed to $4,161 in 2014-15 and is estimated to be $4,083 under the Governor’s proposed 2015-16 budget. At this level, General Fund and special fund spending would be above the level it was in 2007-08 according to this measure.

Figure 2

Per Capita Inflation-Adjusted Spending Has Climbed Over Time

Spending in 2015-16 Dollars, U.S. Gross Domestic Product Deflator



Note: For 2014-15 and 2015-16, spending reflects amounts in *2015-16 Governor's Budget*. Reflects Department of Finance (DOF) population estimates and projections, as well as DOF gross domestic product deflator estimates for 2014-15 and 2015-16.

There are other measures of inflation that can be used in this sort of calculation. For example, using the inflation measure that considers prices for goods and services purchased by state and local governments in the U.S., per capita inflation-adjusted spending peaked (in 2015-16 dollars) at $4,299 in 2001-02 and stood at $4,146 in 2007-08 before falling to $3,381 in 2009-10. Since then, General and special fund spending has climbed to $4,178 during the current fiscal year and is estimated to be $4,083 under the Governor’s proposed 2015-16 budget. At this level, General Fund and special fund spending would be below the level it was in 2007-08 according to this measure.

Using the California consumer price index, a measure of the prices of consumer goods in the Los Angeles and San Francisco areas, provides yet another perspective. In 2015-16 dollars, under this inflation measure, per capita General and special fund spending reached $4,072 in 2007-08 before falling to $3,360 in 2009-10. It climbed to reach $4,174 in the current fiscal year and is estimated to be $4,083 in 2015-16 under the Governor's budget plan. At this level, General Fund and special fund spending would be just above the level it was in 2007-08 according to this measure.

Trends in Major Program Areas

Discussed in Several Recent LAO Reports. One may also consider spending trends for specific programs. We have examined trends in program spending in several recent reports as part of our 2015-16 budget analysis series. The trends in spending since the recession vary significantly by program. Such trends are discussed in our recent reports concerning the Governor's 2015-16 budget proposals for:

- Human services (beginning on page 8).
- Health (beginning on page 7).
- Proposition 98 education programs (beginning on page 8).
- Higher education (beginning on page 8).
- Criminal justice (page 5).

Conclusion

Considering Spending Trends Over Time. The recession significantly affected virtually every aspect of California's state budget and led to major changes in the responsibilities and funding of the state's General Fund. Whether spending is greater now than before the recession can vary by program and by the measure one uses to examine spending trends over time. Looking ahead, we note that our office's November 2014 *Fiscal Outlook*, in its main scenario that assumes uninterrupted economic growth, assumes state General Fund spending will grow to $124 billion in 2019-20. There is, however, a significant likelihood that General Fund spending in 2019-20 under current state policies will have to be less than this amount if economic growth is interrupted during the next few years.

For more information, please contact Jason Sisney (916-319-8361, Jason.Sisney@lao.ca.gov) or Ryan Miller (916-319-8307, Ryan.Miller@lao.ca.gov) of my staff.

Sincerely,

Mac Taylor
Legislative Analyst

cc: Members, Senate Committee on Budget and Fiscal Review
Ms. Keely Bosler, Department of Finance