Policy Brief
periodic analyses of issues before the Legislature

LAO

The State's Budget Problem

INTRODUCTION

As the Legislature reconvenes for the start of the 1991-92 session, the state is confronted with perhaps its most difficult budget problem ever. There are different, but interrelated, aspects to the state's fiscal problem:

- *Current Year.* The state is only five months into 1990-91, yet it now appears the state could end the fiscal year in deficit. This slide in the state's fiscal fortunes is due principally to a cyclical downturn in the economy, which could cause a decline in estimated current-year revenues of about $1.5 billion.
- *Budget Year.* For 1991-92 the state faces a multi-billion-dollar gap between revenues and spending. This budget gap is due both to the short-term cyclical downturn in the economy and a longer-run, *structural* budgetary imbalance between expenditures and revenues.
- *Beyond the Budget Year.* Even if the state's economy rebounds completely by the end of 1991-92 and the reserve is restored, the state is likely to face a considerable budget gap in subsequent years due to its structural budgetary imbalance. Compounding the difficulty, the Legislature and administration must deal with a wide array of legal and practical issues in addressing this structural problem.

The purpose of this policy brief is to outline for the Legislature the nature, magnitude, and causes of the budget problem. In addition, we offer some general strategies for dealing with the budgetary gap. While the exact extent of the current- and budget-year shortfalls cannot be determined at this time, we can identify the general magnitude of the problem to assist the Legislature as it begins its fiscal deliberations.

CURRENT-YEAR PROBLEM

It was just over four months ago that the Legislature and administration acted to address a $3.6 billion budget gap between 1990-91 revenues and expenditures (including the restoration of a $1.3 billion, 3-percent reserve). The state bridged this gap by cutting spending by $2.7 billion and raising $900 million in new revenues. Yet now, in early December, the state's fiscal situation has taken yet another turn for the worse. Barring significant corrective action and assuming the current consensus view of economists about the California economy, we estimate that the state will end 1990-91 with a deficit.

What's Happened Since Enactment of the Budget?

There have been three main factors behind the deterioration of the current-year fiscal situation (see Figure 1):

- *Prior-Year Adjustments.* The state started the current year expecting a year-end 1989-90 General Fund surplus (that is, uncommitted monies) of $241 million. Based on the Controller's preliminary *1989-90 Annual Report*, however, the state ended last year with a small deficit ($52 million). This has the effect of reducing the 1990-91 budget's projected year-end reserve of $1.3 billion by about $300 million.
- *Fall-Off in Revenues.* Since July, both the national and California economies have weakened considerably. Based on these trends, California forecasters have revised downward their estimates of such indicators as personal income growth, taxable sales, and corporate profits. This translates into much slower growth in state revenues. Based on the current consensus view of economists, 1990-91 General Fund revenues would be about $1.1 billion lower than the level projected in July. However, more recent economic data showing additional weaknesses, and actual revenue collections, suggest that the 1990-91 revenue shortfall could be larger. If these recent trends continue, the revenue reduction would turn out to be about $1.5 billion.
- *Increased Expenditures.* At the same time that estimates of revenues have been going down, current-year spending projections have been going up. The exact amount of these increases are unknown, but our preliminary estimates suggest that they would be about $300 million.

Figure 1

Estimated 1990-91 General Fund Balance

(in billions)

	June 30, 1991 GF Balance
Estimated, July 1990	**$1.3**
Changes since July 1990:	
• Reduction in prior-year fund balance	-0.3
• Decrease in estimated current-year revenues	-1.5
• Increase in estimated current-year expenditures	-0.3
Estimated, December 1990	**-$0.8**

The Outcome: Deficit Likely Absent Corrective Action

As Figure 1 indicates, absent corrective action the net effect of these factors is that the state is likely to end the current year with a deficit of about $800 million. Of course, an even bigger problem would emerge if California's economy experienced an outright recession rather than the "sluggish" growth that has been forecast.

Similarly, there are some significant downside risks on the expenditure side that could add to the state's current-year problems. Figure 2 summarizes the major spending threats that could exacerbate the 1990-91 fiscal situation.

Can the State End the Year in Deficit?

As described above, it appears probable that—absent intervention by the Legislature and administration—the state will end this fiscal year in the red. This invites the question: Can the state legally run a deficit?

There is no specific legal provision requiring the state to finish each fiscal year in the black. What the State

Figure 2

Threats to the General Fund

1990-91

- ***Kinlaw v. State of California***

  A lawsuit currently under review by the California Supreme Court could result in a reimbursable mandate related to health services to medically indigent adults. State costs could increase by up to $775 million on an annual basis, and additional amounts of over $2 billion could be required to provide reimbursement for prior-year costs.

- ***Implementation of OBRA 87***

  Current-year costs for Medi-Cal long-term care rates may be up to $150 million higher if the federal government or a court requires the Department of Health Services (DHS) to implement the nursing home reform provisions of the federal Omnibus Budget Reconciliation Act of 1987 (OBRA 87).

- ***AB 75 "Hold Harmless" Provisions***

  As a result of action taken in the 1990 Budget Act, we estimate that state funding for the Medically Indigent Services program is a *minimum* of $62 million below the level required by legislation implementing Proposition 99.

- ***Vehicle Impact Fee***

  There is considerable uncertainty as to whether $50 million in receipts from the "vehicle impact fee" imposed by Ch 453/90 (AB 1109, Katz) may be spent for General Fund purposes.

- ***Implementation of OBRA 90***

  The recent federal budget agreement makes a number of significant changes in laws governing Medicare and Medicaid. These changes will increase state Medi-Cal costs by an unknown amount.

Constitution *does* require is that, when the Governor *submits* the budget plan each January, the plan be balanced.

Although it is the exception, the state has, in fact, ended the fiscal year in the red before. In 1982-83, for instance, the state finished the year with a $590 million deficit. The state also had small deficits in 1987-88 and 1989-90.

Whether the state *should* end years in a deficit position is a different question, however. It's generally both prudent and advisable to avoid deficits, for several reasons. First, "rolling over" a deficit into the next fiscal year can make a bad budget year considerably worse (as may be the case with 1990-91 and 1991-92). Second, running a deficit can damage the credit worthiness of the state, potentially resulting in higher interest costs. Third, deficits can adversely affect the public's confidence in the fiscal integrity of the state.

What Should the Legislature Do?

There are basically two ways for the Legislature to address the projected current-year deficit:

Eliminate the Deficit This Year. If the Legislature decides it wants to eliminate the deficit by June 30, 1991, then it must act fairly quickly to reduce expenditures and/or increase revenues. For instance, a quick way to raise a significant amount of money would be to extend the temporary 1/4-cent sales tax (imposed for earthquake relief and set to expire January 1, 1991) for several months. Extending it six months (through the end of the current year) would raise about $300 million. To keep the sales tax in place, the Legislature and the Governor would have to act in December.

Similarly, there are expenditure options that could be considered. For instance, the Governor's November proposal to address the current-year shortfall (see Figure 3) includes two major expenditure reduction options: (1) suspension of Proposition 98 and (2) a reduction in the state's renters' tax credit. These proposals, however, were rejected by the Legislature during deliberations on the 1990-91 budget.

The larger the deficit problem, however, the more difficult it will be to fully eliminate it in the remaining months of the fiscal year, even if action is taken quickly. This is because there are relatively few options available to achieve significant expenditure savings or revenue gains within a short time period. For instance, it is difficult to achieve significant expenditure savings because of such factors as contractual agreements and other types of commitments, and the time lags involved in making changes like employee layoffs.

Take a Longer-Term Perspective. Alternatively, the Legislature could decide it is not feasible to completely eliminate the current-year deficit during the remainder of the fiscal year. In this case, the current-year solution would be an integral part of any budget-year solution. Even here, however, it would be prudent for the Legislature to begin its fiscal planning in cooperation with the administration as early as possible. This is because the 1991-92 budget problem is even more serious than the situation faced earlier this year in enacting the 1990-91 budget. To assist the Legislature in its fiscal planning, we summarize later in this brief the basic strategies available to it for addressing this problem.

THE BUDGET YEAR...AND BEYOND

In August of this year, we did a preliminary review of the state's fiscal picture for 1991-92. Despite our assumption

Figure 3

The Governor's Plan to Increase the 1990-91 General Fund Balance

Proposal	Legislation Needed	Impact on 1990-91 Fund Balance	Comments
Suspend Prop. 98 funding guarantee	Yes	Up to $526 million	Specifically rejected by Legislature during budget deliberations
Capture state school savings from higher property tax growth	Yes	$75 million	Figure reflects *estimated* savings only
Reduce renters' credit	Yes	$200 million	Comparable reductions rejected by Legislature during budget deliberations
Increase tidelands oil revenue transfer	Yes	$119 million	Reflects increased funds available due to rise in oil prices paid to state
Hiring freeze and 1% reduction	No	Less than $20 million	Implemented through an executive order

that the economy would grow at a relatively "normal" rate, we estimated that baseline expenditures would, nevertheless, exceed revenues by over $1 billion. This shortfall reflects the state's underlying *structural budget problem: spending for current programs is growing at a rate in excess of current revenues.*

Since that time, the economic outlook has changed significantly. The weakened economy has not only dropped forecasters' revenue estimates for 1990-91, but also for 1991-92. As a result of these two concurrent problems—a longer-term structural imbalance and a shorter-term cyclical imbalance—the state faces a potentially huge budget gap in 1991-92. Figure 4 illustrates the nature of the components of the gap for 1991-92 and the following two years. The imbalance shown for 1991-92 would have been considerably larger had it not been for 1990-91 budget actions which reduced expenditures and augmented revenues. Although the economy is assumed to strengthen by 1992, the cyclical imbalance still remains a factor because of the time it takes to return to "normal" revenue levels.

What's the Magnitude of the Budget-Year Problem?

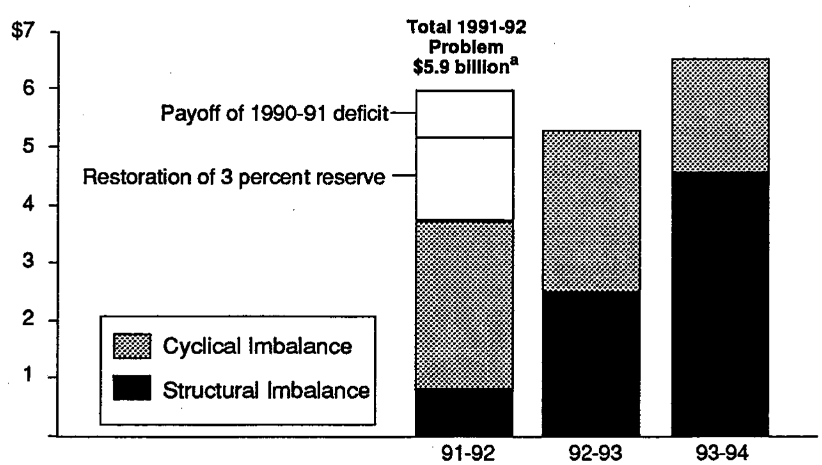
Although there is a great deal of uncertainty surrounding any estimates of a future fiscal-year condition, we have attempted to illustrate the magnitude of the state's problem by updating our projection of 1991-92 revenues and expenditures. Figure 5 summarizes our calculations. It indicates that estimated spending (including the restoration of a 3-percent reserve) will exceed available revenues (given current economic forecasts) by $5.9 billion. (This estimate includes the payoff of the projected current-year deficit of $800 million.)

The economic downturn contributes to the budgetary shortfall in several ways. First, the downturn's impact on 1990-91 revenues is principally responsible for the elimination of the reserve and the projected deficit at the end of the current year. Second, it affects budget-year revenues in a couple of ways: (a) the growth in 1991-92 revenues takes place on a much lower *base* and, more importantly, (b) revenue

Figure 4

Components of the State Budget Problem

(in billions)



[a] 1991-92 data reflect the second-year effects of 1990-91 budget actions. These actions reduced expenditures and augmented revenues, thereby making the 1991-92 projected budget imbalance less than it otherwise would have been.

Figure 5

Projection of the 1991-92 General Fund Condition

(In billions)

Revenues		**$43.5**
Spending Requirements:		
Baseline Expenditures	$47.2	
Pay Off 1990-91 Deficit[a]	0.8	
Restore 3% Reserve	1.4	
Subtotal		**49.4**
Projected Shortfall		**$5.9**

a Assumes no action is taken to reduce the projected 1990-91 deficit.

growth will be at a considerably lower *rate* than otherwise. Based on the current consensus economic forecast, we estimate that 1991-92 revenues will grow at 5 percent --significantly below the 8 percent average over the past decade. (Every 1 percent drop in revenues equals about $450 million.)

In addition to the short-term problems caused by the cyclical downturn in the economy, the state's 1991-92 budget gap also has a large component caused by its longer-term structural problem.

The Structural Budget Problem

Even if the economy were *not* experiencing a slowdown, the state would face a considerable imbalance between revenues and expenditures in 1991-92. We estimate that expenditures for current programs will grow at a rate of about 11 percent in the budget year. This is significantly faster than the growth in revenues during an "average" year. However, our review of the state's major spending programs indicates that this discrepancy is likely to exist for the next several years.

What's driving spending at these higher rates? There are several factors:

Demographic. Demographic forces have been causing many programs to expand at an unusually rapid pace. For example, enrollments in K-12 schools are growing almost twice as fast as the state's general population. Since spending on K-12 education takes over 40 percent of the state's General Fund budget, this type of caseload growth absorbs a lot of the new revenue growth each year. Similarly, the state's increased use of bonds in recent years to meet the capital outlay needs of a rapidly growing population (especially for schools and prisons) has resulted in a significant increase in debt-service costs.

Programmatic. Policy choices by both the state and the federal government are also responsible for rapid growth in some programs. For instance, statutory and administrative decisions in the criminal justice area have been responsible for dramatic growth in the Department of Corrections' budget (average annual growth of over 16 percent during the last five years).

In addition, federal requirements over the years have had the cumulative effect of adding substantially to the growth rates of many program areas (such as Medi-Cal).

Societal. In some cases, state programs have been growing rapidly due, in large part, to changes in the way people behave, including the extent to which they use state programs. For example, the child welfare services program has been growing at an average rate of 15 percent over the past five years, principally due to increased caseloads. Presumably, these higher caseloads are the result of increased incidence of child abuse and neglect and/or a greater tendency for people to report abuse and neglect. Societal and behavioral changes also have contributed to rapid growth in other program areas, such as corrections.

For these reasons, we estimate that--absent corrective action--total spending on current state programs will continue to grow at a significantly faster rate than "normal" revenue growth. More specifically, we estimate that for the next several years, baseline expenditures will grow in the 10 percent to 11 percent range. Among the key program areas driving these increases will be K-12 education, corrections, Medi-Cal, welfare, and debt service.

Legal and Practical Concerns

Not only does the state face a longer-run structural imbalance, but there are many legal provisions which, to varying degrees, affect the Legislature's and administration's ability to address the imbalance. For example, there are *constitutional* provisions which can only be changed by a vote of the people. One such provision is Proposition 98, which restricts the Legislature's ability to allocate funding among programs. (The provisions of Proposition 98, however, can be suspended through the passage of an urgency measure other than the Budget Act.) In addition, there are *statutory* provisions (such as COLAs and eligibility requirements), which automatically drive spending unless specifically modified by the Legislature. Similarly, on the revenue side, there are various statutory and constitutional provisions defining the state's revenue structure that would have to be modified to change the level of revenues.

In addition to these legal issues, there are other factors that must be considered in addressing the state's budget gap. For instance, in considering revenue increases, the Legislature must take account of the public's concerns regarding increased tax burdens. Similarly, on the expenditure side, it's difficult to achieve substantial savings in major program areas (such as health, education and welfare programs) without serious service-loss consequences. It was the conflict involving these fundamental factors and their impact on state priorities that rendered the current-year budget deliberations earlier this year so intractable for so long.

What Can the State Do?

Given the probable magnitude of the 1991-92 budget gap, the Legislature and administration clearly will have to take significant steps. Because the problem has manifested itself fairly early, there is time before the start of the fiscal year to consider state priorities and options for achieving them.

The "Trigger." Barring legislative action to the contrary, part of the budgetary gap will be closed by the automatic spending reduction mechanism provided by Ch 455/90 (SB 1783, Beverly). This mechanism, known as the "trigger," authorizes the Department of Finance to reduce spending by up to 4 percent when projected revenues fall below projected baseline (or "work-load") expenditures by a specified percentage. Generally, constitutionally protected spending (primarily Proposition 98 funding and debt service) is exempt, while cuts in certain health and welfare programs are limited to the lesser of 4 percent or the applicable statutory COLA for each program.

We estimate that the trigger mechanism would result in spending reductions totalling about $1 billion in 1991-92. These across-the-board cuts would be implemented by the administration, without legislative input or direction as to the exact nature of the reductions.

Other Approaches. Even with the trigger operating, however, the state will have to take other significant actions to get the 1991-92 budget in balance. In beginning that task, we suggest that the Legislature and administration take a broad-based perspective on the various strategies available to them. Figure 6 summarizes the general alternative approaches that we have identified.

As the figure indicates, there are both strategies which increase revenues and those which reduce expenditures. We will discuss these strategies further in our 1991-92 *Perspectives and Issues*, offering specific criteria for applying the various strategies and examples of where each one might be applicable.

CONCLUSION

As discussed above, the recent fall-off in state revenues due to the deteriorating economy has two dramatic impacts on the state's fiscal condition. First, absent corrective action it will result in a deficit in the General Fund's 1990-91 end-of-the-year balance. Second, it has magnified an already significant budgetary problem in 1991-92 caused by the structural imbalance between expenditures and "normal" revenues.

In addressing these budgetary shortfalls, it's important to keep the two components of the budgetary gap—the cyclical and structural elements—distinct. This is because each can be approached in a somewhat different manner. For instance, the state may want to deal with the cyclical revenue imbalance in one way (such as temporary tax increases or one-time spending cuts and deferrals) and the structural budget problem in another way (such as permanent revenue increases and/or base expenditure reductions).

In any case, both the Legislature and the administration will need to begin their fiscal planning and priority setting earlier than usual in order to address the serious budgetary problems confronting the state.

Figure 6

Strategies for Addressing the Structural Budget Problem

INCREASING REVENUES

Increase in Tax Base

1. Eliminate tax expenditures
2. Expand areas of taxation

Increase in General Tax Rates

Improved Effectiveness of Tax System

REDUCING EXPENDITURES

Service Reductions

1. Eliminate programs
2. Restrict coverage
3. Reduce eligibility

Improved Efficiencies

1. Use least-cost management methods
2. Consider consolidations and restructurings
3. Privatize

Funding Shifts

1. To fees (paid by program users)
2. To private sector