The California Budget Crisis: Factors Leading to the Current Budget Deficit and a Discussion of Certain Proposed Solutions

Abstract - We describe California’s current budget deficit, the Governor’s proposed solution, the underlying causes of the deficit, and actions the federal government might consider to aid the states in this time of history-making deficits. Included in the discussion are details of the California General Fund, state revenues and expenditures, as well as the role capital gains income played in the current budget crisis. The views expressed in this paper are those of the authors and do not necessarily represent those of the California Franchise Tax Board or the State of California.

INTRODUCTION

State governments are experiencing unprecedented budget deficits and the State of California is not different. The amount most commonly tied to California’s deficit is 38 billion dollars. Using a current services approach, as used by the California Legislative Analyst’s Office (LAO’s), the forecast deficit is 29.5 to 30 billion dollars, almost 40 percent of general fund expenditures for current services.

The total 30 billion dollar deficit projected by the LOA is not attributable to just one fiscal year, as detailed in Figure 2. Figure 2 reflects the LAO projection of a ten billion dollar deficit in the fiscal year ending June 2003, and the budget year 2003–04 is projected to come in with a deficit of 19.5 billion dollars. Thus, the total projected deficit of 30 billion dollars. The fact that state deficit amounts generally tend to be two–year numbers is something to keep in mind. Indeed, the way that the budget is calculated tends to magnify any imbalance. A better than expected current year tends to be followed by an even better following year and vice versa.

DEFICIT SOLUTION PROPOSED BY GOVERNOR

In Governor Davis’ May revise of the budget, the Governor proposed the following remedies for the current projected deficit:
• Borrowing—the largest piece of this is a 10.7 billion dollar revenue bond that is to be secured with revenue from a new one-half percent sales tax increase. The bond and the tax would both have a term of five years.

• Expenditure reductions.
• New revenues.
• Restoration of the reserve.
• Total budget impact of 30 billion dollars.

These proposals are reflected in Figure 3.

As detailed in Figure 4, 50 percent of the 10.8 billion dollar proposed expenditure cuts are to education. Another 25 percent is for health and human services, largely Medicaid. The remaining 25 percent is spread between local assistance, state employee compensation and other expenditures.

As for revenue increases, of the budgeted 7.1 billion dollar proposed increase, a projected 3.1 billion dollars is attributable to an increased vehicle license fee. A reduction in the vehicle license fee a few years ago included language to repeal the reduction in the event of a budget deficit.
Administration officials in the Governor’s office approved the reduction repeal on June 20, 2003, a move that is sure to initiate legal challenges based on various legal arguments.

The sales tax increase shown in Figure 5, reflects the one-half percent increase to pay–off the revenue bond, mentioned previously. The income tax increase is the imposition of a 10.3 percent tax rate for high–income taxpayers.

WHAT CAUSED THE DEFICIT

Now let’s explore the reasons this deficit arose. Figure 6 reflects expenditure and revenues over time. As you can see, revenues keep pace with expenditures, just as the constitutionally balanced budget requirement dictates. In the late 1990’s, however, revenues greatly increased and expenditures kept pace. As in the private sector, when the bauble came, few in government saw it as a bauble. Most thought the increasing revenues were the start of a new era. Then in 2001–02, the bauble burst, but expenditures had their own momentum, thus creating our current imbalance.

The remainder of the discussion will focus on revenue, the reason why the decrease in revenue was so large, expenditures, and finally, suggestions on ways that the federal government could assist states with their current budget deficits.
Figure 5. Revenue Increases ($7.1 Billion)

Figure 6. State Revenues and Expenditures In Millions
The California Budget Crisis

As Figure 7 demonstrates, more than 50 percent of the state’s General Fund revenue is from the personal income tax (PIT), which is very similar to the federal individual income tax. Sales tax accounts for 35 percent, the corporate tax for 10 percent, and other revenue sources for 4 percent. From this information, it is very apparent that the General Fund is very reliant on PIT, which was not true in earlier years.

In 1980–81, the PIT made up 35 percent of California’s General Fund. By 2000–01, it grew to 58 percent, before falling to 51 percent in 2002–03. At the same time, the share of the General Fund attributable to the corporate income tax had decreased from 14 percent to 10 percent. Likewise, the share attributable to sales tax had also decreased from 38 to 35 percent. We will now examine each revenue source, in turn.
PERSONAL INCOME TAX (PIT)

From 1994–05 through 2000–01, the growth in PIT revenues was dramatic, evidenced by double-digit growth each year as depicted in the preceding chart. In 2001–02, the bottom fell out as PIT revenues decreased by 25.5 percent. Let’s examine the factors behind this decrease.

As most people already know, the decrease was due, in most part, to the loss of revenue from capital gains. The exceptional growth in PIT revenues in the late 1990s was almost entirely the result of the growth in capital gains. When the bauble burst, it took PIT revenues with it. As Figure 10 shows, the decline in capital gain income from 2000 to 2001 was over 50

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**Figure 9.** Personal Income Tax Revenue Fiscal Year Total vs. % Change

**Figure 10.** Income from Capital Gains and Option Income* In Billions

*This chart combines capital gains reported on Schedule D and option income combined with wages.
percent, more than 100 billion dollars. This decline explains almost the entire decline in California’s PIT revenues.

Since capital gains and option income tend to be earned by the wealthiest tax-payers, the share of PIT borne by the wealthiest taxpayers fell dramatically in 2001, to a level below that in 1999.

Indeed, of the 9 billion dollar reduction in tax liabilities in 2001, 7.5 billion dollars is attributable to the top 1 percent of taxpayers. The remaining 99 percent incurred the remaining 1.5 billion dollar decrease.

The other significant point this table reflects is how concentrated the California PIT is. In 2001, even after the large reduction, still 39 percent of the tax was paid by the top one percent of taxpayers.

Figure 12 takes a close look at the PIT distributions of adjusted gross income (AGI) and tax. In 2001, the top 1 percent, those with incomes over $350,000, controlled almost 20 percent of AGI. This segment of the population paid almost 40 percent of the tax. The bottom 40 percent paid less than 1 percent of the tax. The bottom

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**Figure 11.** Shares of PIT Tax Paid by Top One Percent of Taxpayers

![Figure 11](image1)

**Figure 12.** PIT Distributions of AGI and Tax (2001)

<table>
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<th>Lower AGI</th>
<th>AGI</th>
<th>Tax</th>
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<tr>
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</table>
60 percent, taxpayers with income below $40,841, paid less than 5 percent of the tax.

The reason for this distribution is a combination of a progressive tax structure with rates going from 1 percent to 9.3 percent, no exclusion or other preference such as a lower tax rate for capital gains, and significant exemption credits, especially for children.

It should be noted that incomes at the highest level tend to be more volatile, especially capital gains, and the tax system tends to be more volatile than a more proportional system.

SALES TAX

Figure 13 demonstrates the tendency of sales tax revenue to diminish over time. The light gray line shows the tax in nominal terms. The black line is deflated by gross state product, which is more telling. It shows that outside of tax rate increases, such as the one in 1991–92 and the one proposed by the Governor for 2002–03, the tax is declining in its relation to gross state product. The reason for this decline is that it is levied on tangible goods, while our economy is steadily moving towards services. This results in a decline in the proportion of consumption that is subject to taxation. Indeed, the increase in sales tax rates tends to increase the distortion between taxable and nontaxable goods.

CORPORATION TAX

Moving on to the corporation tax, we see a similar reduction over time, but the reasons for the decline are more complex.

One reason for the decline in corporate tax is a gradual shift to pass-through entities.

Figure 15 shows that in 1988, 88 percent of positive income reported by all three corporation types was for C corporations. By 2001, that proportion had dropped to 61 percent. The S corporation income share more than doubled from 1988 to 2001. The rise of the income share reported by LLCs was even more striking, more than doubling from 1998 to 2001. So one part of the answer is that income continues to be reported, but that the taxation of that income has shifted from the corporation sector to the individual income tax sector.

Another part of the answer is the amount of credits claimed by corporations, which have risen dramatically in California since 1988.
As Figure 16 reflects, credits reduced the corporate tax by over 15 percent in 2000. The two largest credits are a 6 percent Manufacturer’s Investment Credit and a Research and Development Credit, similar to the federal credit.

Of course, there have been volumes written about tax shelters and a general increase in aggressiveness in tax reporting, both at the federal and state levels. It is estimated that as much as one-half billion dollars in revenue has been lost to the State of California in each of the past four years due to abusive tax shelters. Keep in mind that, in general, tax positions taken by taxpayers at the federal level tend to flow through to the state level. Additionally, as companies adopt more aggressive positions in how they source income to states in an effort to reduce their tax, states absorb a double impact. In summation, the overall “pie” is shrinking and states
are getting smaller slices, as well. It has been estimated that the overall impact of strategies used by taxpayers to reduce their California tax liability may exceed one billion dollars.

EXPENDITURES

Figure 17 tracks state expenditures deflated by gross state product over time and we see that expenditures have held fairly steady in the 1980s and most of the 1990s. Then, in the late 1990s, they began to trend up. The main reason for this was that capital gains, which are not in gross state product, along with our reliance on the PIT, drove up revenues. Expenditures followed. The momentum continued, even after the bauble burst.

Figure 18 details where increases in expenditures occurred:

From 1998–99 to 2002–03, expenditures grew by 46 percent, or 36.8 billion dollars. Almost half of that amount went to education, primarily K–12. Another 22 percent went to health and human
services, primarily Medicaid and other social programs, such as Medicare. Transportation, business, and housing absorbed 8 percent of the expenditure increases. These along with Corrections (prison system) accounted for 75 percent of the increase. Some may say these increases were excessive, but going behind the number the increases seem to be justified.

With respect to education, California went from the 40th out of 50 states in per pupil expenditures to 33rd in 2001, still below average. A large portion of the Medicaid increase was due to a rise in medical costs. Even with the increase, California’s benefits continue to be below the average of the ten states with the largest populations. In regard to the increase in transportation spending, additional infrastructure was certainly overdue and needed, as those familiar with California’s commute times can will agree.

That having been said, California’s budget imbalance requires that spending be reduced and/or revenues increased. The governor’s solution incorporates both revenue increases and expenditure reductions. But, because borrowing plays such a heavy role in the proposal, it is certainly a temporary fix. The LAO is estimating an ongoing structural deficit of eight billion dollars per year, so further corrections will have to be made.

WAYS THE FEDERAL GOVERNMENT CAN HELP

We conclude this discussion by addressing some of the ideas that the federal government might consider in an effort to assist states in this time of unprecedented budget deficits.

Things the federal government can do to assist states:

- One–time grants.
- Increase economic growth.
- Increase enforcement funding for the Internal Revenue Service (IRS).
- Combat tax shelters.
- Reduce health costs born by states.
- Implement tax incentives through credits and tax rate reductions, not deductions and exclusions.

One–time grants to the states may be warranted considering that states are experiencing the largest fiscal problem since World War II. Of course, the Jobs and Growth Tax Relief Reconciliation Act of 2003 is providing 20 billion dollars of assistance to the states. California’s share of this will
be slightly over two billion dollars. The LAO’s projected 30 billion dollar California deficit is a composite of two years deficits but the solution must be achieved in one year, absent any repayment of loans involved in the solution. Keeping this one–year requirement in mind, the federal government may consider additional one–time grants as a viable part of any final solution.

Certainly, increases in economic growth would tend to increase state revenues, and reduce deficits. To the extent that the federal government is successful in increasing economic growth, state governments will benefit.

An increase in funding to the IRS would also aid states during this time of fiscal crisis. For instance, California receives audit referrals from the IRS. These referrals are called Revenue Agent Reports (RARs). These referrals dropped dramatically after 1998–99. Taking the average of the four years prior to this drop–off and not adjusting for inflation or economic growth, it appears that California lost nearly 500 million dollars for the most recent four years. Also, this is the direct drop–off. There is an additional unknown reduction from reduced compliance enforcement, because some taxpayers believe the risk of being audited has significantly decreased. An increase in funding to the IRS would also likely be used to combat abusive tax shelters, which as mentioned previously, are estimated to have cost the State of California as much as one–half billion dollars in revenue for each of the past four years.

If the federal government absorbed more health care costs that are now borne by the states, this would also be an aid in reducing state deficits. There are many different policies that might be used to implement this strategy, such as the current proposal for the federal government to pay for prescription drug coverage under Medicare.

The implementation of federal tax incentives through credits and tax rate reductions in lieu of deductions and exclusions would also put less strain on state revenues. The enactment of federal deductions and exclusions does impact state revenues, even when states do not conform to the deduction or exclusion. This impact occurs when taxpayers fail to adjust for the federal deduction or exemption when figuring their state taxes. The imposition of federal tax rate reductions or credits do not have this same impact on states due to the nature of the tax computation.