The California Budget Crisis – Causes and Recommendations

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By William D. Fletcher

INTRODUCTION

California needs the equivalent of a readable annual report that lets everyone who is interested see how well the state is doing and where it's headed. Hopefully, this report is a step in that direction. The closest overview available is the State Controller’s Office annual report and reports published by the LAO (Legislative Analyst’s Office).

This report is not trying to make a political statement or promote a specific agenda. The objective is to present the facts and any logical conclusions supported by the facts. The author is a social moderate and a fiscal conservative who is in favor of a social safety net, progressive taxation, and good pay and benefits for public employees. However, we should only promise what we can deliver longer-term. And, we should pay our way now and not burden future generations with excessive debts and unfunded obligations.

California is the “golden state” and should be the leading state in the nation. The state has the largest population and GDP by far. If California were an independent country, it would be the ninth largest economy in the world, slightly smaller that Italy but significantly larger than countries such as Spain, Russia, and India. California is the gateway to the Pacific, the fastest growing region in the world. The state has rich agriculture and other natural resources and is a leader in attracting high-tech investments. The state has an excellent university system, a terrific climate, is the entertainment capital of the world, and is a major tourist destination.

However, our finances are not in order. When analyzing California’s finances, there is a lot of data, but not much information. What is missing – or at least not easily accessible includes:

- Trend analysis, where are we headed?
- A long-term forecast
- Productivity, performance, or competitiveness measurements
- Comparisons to other states
- Total debt, underfunded liabilities, and other obligations

While there are several think tanks analyzing California’s finances, they are largely focused on the micro view, single topics or issues, or complex, in-depth analysis.
WHERE ARE WE HEADED?

Where you might think the state is heading depends upon whether you are an optimist or somewhat pessimistic. This diagram is a simple model of the dynamics driving California’s economy. Will higher taxes and a poor business climate retard the state’s growth, keep unemployment high, and increase entitlement spending? Will our debts and underfunded liabilities lead to a financial crisis?

The economist Herb Stein stated “if something can’t go on forever, it will stop.” We just don’t know when or how. Hopefully, this report will give some insights as to how it could end and what needs to be done.
This is an attempt to get an overview of the state’s public finances. The state budget only captures about 40 percent of the public spending in the state. In addition to the state government, there are:

- 984 school districts
- 4,772 special districts such as for power generation, flood control, and water conservation
- 57 counties
- 481 incorporated cities

Each of these entities has the ability to raise and spend money from taxes, fees, and other sources and incur debts that must be paid by taxpayers. The state’s finances are complicated and hard to understand. These other government entities are even less visible. Because the numbers on this chart come from several sources, it’s not possible to balance revenues and expenses. However, the numbers do give an idea of the relative size of these organizations. Federal payments are only payments that go to state and local government organizations. The largest single federal grant is for Medicaid. Federal spending that goes directly to citizens and organizations such as Medicare and Social Security payments, student loans, pay and benefits for military personnel and federal government employees in the state are not included.
This is another overview of the state’s finances. Most discussion is over the General Fund. The General Fund is that portion of the budget over which the Governor and the legislature have the most control. However, the General Fund is only about 64 percent of the state’s spending and about 27 percent of the total. Proposition 98 directs that about 40 percent of General Fund spending has to go to K through 12 education. Recently, in a process referred to as “realignment” about $6 billion of annual spending has been shifted from the General Fund to Special Funds. This is cost shifting and not a reduction in spending.

<table>
<thead>
<tr>
<th>Funds</th>
<th>2012-13 budget ($billions)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal funds (2012-13 budget)</td>
<td>82.9</td>
<td>No longer boosted by Recovery Act funds. About 85% is for local assistance and 12% for state operations.</td>
</tr>
<tr>
<td>General fund</td>
<td>91.3</td>
<td>Revenues are from income tax (62%), sales tax (22%) and corporation tax (10%). About 72% is spent on transfers and 28% on specific programs.</td>
</tr>
<tr>
<td>Special funds</td>
<td>39.4</td>
<td>Fee-supported funds. State statutes specify how funds must be deposited and spent. Motor vehicle fees are about 30% of special fund revenue.</td>
</tr>
<tr>
<td>Bond funds</td>
<td>11.7</td>
<td>Programs funded by issuing long term bonds. Funds are earmarked for specific projects or purposes. Bond interest payments included in General Fund.</td>
</tr>
<tr>
<td>Total state</td>
<td>142.4</td>
<td>State controls most property tax money and redirects it toward K-12 education.</td>
</tr>
<tr>
<td>Local funds to counties, cities, school districts, and special districts (2010 actuals)</td>
<td>112.9</td>
<td>A portion of the sales tax, fees, etc.</td>
</tr>
<tr>
<td>Total funds</td>
<td>338.2</td>
<td>Approximate total. All data not from the same year.</td>
</tr>
</tbody>
</table>
How are we doing? The state has run deficits since the 2000-01 fiscal year. When times were good and tax revenues were increasing, we spent it all and more. When times were tough and tax revenues were down, we ran bigger deficits.

During good times, pay and benefits were increased and budgets grew making it harder to control or reduce spending during slowdowns and recessions. The state should have a rainy day fund to set aside some money during boom times to cover deficits during lean times. There is legislation to this effect but it has not been effective in setting aside any funds.

Note that in 1999, Governor Gray Davis signed SB400 giving state workers significantly enhanced pensions and granting some retroactive pension increases to retirees. The assumption was that the high investment returns earned by the state’s pension funds would pay for this generosity, $600 million/year at the time, and no additional pension contributions would be required. Unfortunately, this was about a year before the Tech Bubble burst and investment returns fell to earth.

These generous retiree pension and healthcare benefits are taking a larger share of the state’s budget and causing big problems for many cities and counties.
In about 1990, the state’s revenues depended on personal income taxes, corporate income taxes, and sales taxes for more or less equal shares of revenue. Since then, the state has increasingly become dependent upon the very volatile income tax for most state revenue. High-income taxpayers (top 10 percent) pay about 80 percent of these income taxes. A significant portion of their income is dependent upon capital gains and other investment income that is very dependent upon changes in the economy. The wealthiest citizens should pay a high share of income taxes. However, this volatility needs to be taken into account when preparing the state’s budgets. Don’t spend it all during good times because it won’t be there in bad times.
This volatility has had a big impact on the state’s spending on education and Health & Human Services since the Real Estate Bubble burst in the 2007-08 fiscal year. Spending has been flat to down since the Housing Bubble collapsed. However, this was after substantial spending increases over the previous ten years.
Since the Housing Bubble burst in 2008, General Fund spending was reduced but more than made up for by federal stimulus funds so that total spending has been essentially flat. There hasn’t been any significant reduction in state employment during this period. Locally, about 30,000 teachers lost their jobs, or about ten percent of the state’s teachers. There have also been cuts in public safety and other employees at the county and city level.
Due to the passage of Propositions 30 and 39, the state will have additional revenue starting this fiscal year. In addition, the Governor and the legislature have agreed on a number of budget cuts. The state’s economy is improving slowly, but steadily. All are good signs. According to the state’s Legislative Analyst’s Office, there is a good chance that the state will balance its budget this fiscal year, 2012-13, and over the next five years. This will depend upon the Governor and the legislature where the Democrats have a super majority in both houses, having the discipline to control spending. Five months into the current fiscal year, the state has a $2.7 billion deficit according to the Controller’s Office. It will be necessary to wait a few months to see if Propositions 30 and 39 and the improving economy close this gap.

We should probably dismiss the possible effects of going over the “fiscal cliff.” Even if congress and the President let the country go over the edge, they will eventually take actions to soften or eliminate its effects. A potentially bigger concern is implementation of the Affordable Care Act, a.k.a. Obamacare. California has committed to fully implement this program. The ACA is scheduled to be fully implemented in 2014, about a year from now. The ACA’s cost is hard to estimate. For example:

- How many new enrollees will sign up?
- What will be the cost per enrollee?
- Will more employers drop company-provided health insurance in favor of the public option?
- How much of the cost will be covered by the federal government?
- Will cost control measures yield intended results?
Medicaid is already one of the largest expense items in California’s state budget, second only to K-12 education.

Today, California has about 11.0 million enrolled in Medi-Cal, the state’s Medicaid program. There are an estimated 7.1 million uninsured in the state, and it is estimated that about 5.0 million of these uninsured will become eligible for benefits under the ACA.

### How much do we owe?

<table>
<thead>
<tr>
<th>($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General obligation bonds:</td>
</tr>
<tr>
<td>- State</td>
</tr>
<tr>
<td>- Local*</td>
</tr>
<tr>
<td>Trust Fund loans</td>
</tr>
<tr>
<td>Budget gap for 2012-13</td>
</tr>
<tr>
<td>Unfunded pension obligations</td>
</tr>
<tr>
<td>Unfunded healthcare obligations</td>
</tr>
<tr>
<td>Total debt**</td>
</tr>
</tbody>
</table>

*school districts (6.8), special districts (80.6), county governments (22.1), and city governments (68.1)

Where’s the balance sheet? What are the state’s total liabilities, including underfunded benefits and entitlements? There isn’t an accurate overview of the state’s total liabilities. Most debt is at the local level and does not show up in the state’s financial statements. The Controller’s Office does attempt to summarize the finances of the counties, cities, school districts, and special districts in annual reports. These reports list revenue, spending and debts but do not comment on any potential problems or required actions.

There are problems at the county and city level with the bankruptcies of Vallejo, San Bernadino, Mammoth Lakes and Stockton. Are these exceptional situations or an indication of a much wider developing problem?
The next two charts summarize 2012-13 revenue and spending from the General and Special Funds as reported in the Governor’s Budget Summary for the enacted budget.

General Fund and Special Funds forecast revenues are $11.9 billion more than was raised in 2011-12, a 9.8 percent increase over last year. This includes the additional revenue anticipated by the approval of Propositions 30 and 39.
General Fund and Special Funds spending for this fiscal year, 2012-13, is forecast to be about $7.1 billion greater than last year. Bond Fund spending is forecast to be about $1.0 billion less than last year. We can see that K-12 education and Health and Human Services make up the two largest spending categories by far.

Bond fund spending is from bonds issued by the state, not from current income. The interest and principle payments on these bonds is an expense under the General and Special Funds.
Demographic trends are not favorable. Retirees, people over 65 years old, are the fastest growing segment of the state’s population by far. As people enter retirement, their earnings and taxes paid go down, and their demands on the state’s services go up, especially for healthcare. For a very long time, California had about five wage earners for every person of retirement age. This ratio is expected to decline to 3.6 wage earners per retiree in 2020, about eight years from now, and to less than 3.0 wage earners per retiree in 2030.

This demographic trend will put a lot of pressure on the state’s finances as retirees pay fewer taxes but require more state services.

California is also losing population through net migration to other states as reported in a recent study by the Manhattan Institute. Since 1990, California has lost about 3.4 million residents to other states. California’s population growth is due to internal growth (births minus deaths) and foreign immigration. Domestically, California has more residents leaving for other states, than those who are choosing to move to California.

The states that are receiving the most former California residents are Texas, Arizona, Nevada, Oregon, and Washington, in that order.

Who cares? Isn’t it a good idea to have lower growth? There will be less demand on the environment, infrastructure, school systems, etc. Unfortunately, there will be fewer taxpayers to pay for the state’s
aging population, infrastructure improvements, public employee retirement benefits, and other essential state expenditures. It’s much easier to balance the budget and fund the future if the state has a growing population and economy.

In 1960, New York was the largest state with a population of 16.8 million. California was a close second. Since 1960, over 50 years, New York’s population has only increased about 17 percent to 19.6 million while California’s population has grown 240 percent and Texas’ population has grown 270 percent. Will California’s growth rate stagnate like New York’s going forward? If so, it will be harder to balance the budget and pay for essential services.

Another ominous trend is the growing share of the state’s budget being consumed by retiree pensions and healthcare for state employees. There will be increasing crowding out of other essential spending. Controlling pension and retiree healthcare obligations is essential for the future of California’s finances.

STATE-BY-STATE COMPARISONS

How does California compare to other states?

Initially, the plan was to compare California to Texas, the next largest state. New York and Florida were added to give comparisons of the four largest states and states that have some similarities and
important differences in how they are managed. Findings are grouped under several headings: governance, the economy, taxation, finances, K-12 education, higher education, social policies, and the prison system.

Tables for each of these headings summarize the comparisons of these four states. This report will highlight what’s most significant in each table.

What is Texas doing right?

One statistic that is overwhelming is Texas’ job growth. For over 20 years, Texas has led the nation in the creation of new jobs.

The Texas jobs machine

Two of the other largest states, California and New York, are laggards. Florida was doing well until the Housing Bubble collapsed. Some people dismiss Texas’ job growth as jobs for “hamburger flippers.” This isn’t true. Texas has growing high-tech, energy, and service industries and there is no reason to believe that jobs created in Texas are lower quality than those created in other states. Fast growing Austin, Houston, Dallas, and San Antonio all have abundant high-tech, and high paying service and professional jobs.
A recent study of job growth by major city showed Texas having four cities in the top 10. Austin and Houston are the top two cities in the nation for job growth. California had one city, San Jose, barely make the top ten and three cities in the bottom ten: Oakland, Sacramento, and Riverside.
California is by far the largest state by population and GDP with almost 38 million residents. California is almost fifty percent larger than Texas, and is twice the size of New York and Florida. Two states are heavily Democratic, California and New York, and two are largely Republican, Texas and Florida. California and New York have high sales and personal and corporate income taxes while Texas and Florida don’t have any personal income tax. California and Texas are both border states with identical percentages of their populations made up of Hispanics.

<table>
<thead>
<tr>
<th>Party affiliation</th>
<th>CALIFORNIA</th>
<th>TEXAS</th>
<th>NEW YORK</th>
<th>FLORIDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Heavily Democratic</td>
<td>Heavily Republican</td>
<td>Democratic</td>
<td>Republican</td>
<td></td>
</tr>
<tr>
<td>Public sector unions</td>
<td>Very strong</td>
<td>Weak</td>
<td>Very strong</td>
<td>Weak</td>
</tr>
<tr>
<td>Tax policy</td>
<td>High sales and income taxes</td>
<td>No income tax</td>
<td>High sales and income taxes</td>
<td>No income tax</td>
</tr>
<tr>
<td>Hispanic (%)</td>
<td>38</td>
<td>38</td>
<td>18</td>
<td>23</td>
</tr>
<tr>
<td>Black (%)</td>
<td>6.7</td>
<td>11</td>
<td>15.7</td>
<td>14</td>
</tr>
</tbody>
</table>
In comparing the governments in each state, it’s interesting to note that Texas and Florida have part-time legislatures. The Texas legislature meets every other year for 90 days and the Florida legislature meets every year for 60 days. The governors of these states can call special sessions of the legislature if needed to deal with a specific issue.

In Texas’ part-time legislature about seventy five percent of the legislators are employed in businesses, farming, or medicine and nineteen percent work as attorneys in private practice. They have day jobs. In California, the legislature is essentially in continuous session and only about eighteen percent of the legislators worked in business or medicine before being elected to the legislature. Most were in government, worked as attorneys, or were community organizers.

Does the Texas legislature’s composition and part-time nature have any relationship to the state’s lower taxes, balanced budgets, or job growth?
California has the largest economy by far as measured by GDP. As stated earlier, California’s economy would be slightly smaller than Italy’s if California were a separate country, and larger than the economies of Spain, Russia, or India.

In looking at job growth for approximately the last ten years, California had a net loss of almost 500,000 jobs at a time when Texas added about 1.3 million jobs. If we adjust for California’s larger population, Texas jobs growth equals about 1.9 million equivalent jobs in California. Think about how much better off the people of California would be today if California had approached Texas’ rate of job creation. There would have been more tax revenue, lower unemployment, and lower spending on entitlements.

A big part of the problem is California’s business climate that includes high taxes as well as burdensome regulations and other deterrents to business formation and job growth. Recent surveys show that California ranks very low as a place to do business, dead last in a recent CNBC survey. On the other hand, Texas ranked first in two leading surveys.

It’s not the policy of the governor or legislature to be anti-business. However, it is perhaps the unintended consequence of other actions that raise the cost and complexity of doing business in California. Improving the state’s business climate and promoting job growth has to be the cornerstone of the state’s economic policies.
California’s tax burden is significantly higher than Texas or Florida, but lower than New York’s. These statistics are from earlier in the year and do not reflect the higher taxes associated with Propositions 30 and 39.

California’s maximum personal income tax rate is 13.3 percent following voter approval of Proposition 30. California now has the highest income tax rate of all the states. It remains to be seen if this tax increase raises as much revenue as anticipated. It also remains to be seen if this rate increase leads to more high income taxpayers changing their residences and making other changes to reduce their California income tax bill. California’s corporate income tax rate is also the highest of the other three states in the comparison, and is among the highest in the U.S.

It’s interesting to note that California collects more property tax revenue per resident and per home when compared to Texas or Florida even though these states don’t have state personal income taxes as a source of income. The higher cost of housing in California offsets the lower property tax rate dictated by Proposition 13. New York’s property taxes are the highest of these states.

<table>
<thead>
<tr>
<th>TAXATION</th>
<th>CALIFORNIA</th>
<th>TEXAS</th>
<th>NEW YORK</th>
<th>FLORIDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax burden ($ per capita)</td>
<td>4,910 6th</td>
<td>3,197 39th</td>
<td>6,157 3rd</td>
<td>3,897 21st</td>
</tr>
<tr>
<td>Tax burden (% state income)</td>
<td>11.8 5th</td>
<td>7.9 48th</td>
<td>13.2 1st</td>
<td>9.0 37th</td>
</tr>
<tr>
<td>Personal income tax maximum rate (%)</td>
<td>13.3</td>
<td>0.0</td>
<td>8.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Corporate income tax rate (%)</td>
<td>8.84</td>
<td>1.0%</td>
<td>7.1</td>
<td>5.5</td>
</tr>
<tr>
<td>Sales tax rate (%)</td>
<td>8.11</td>
<td>8.14</td>
<td>8.48</td>
<td>6.62</td>
</tr>
<tr>
<td>Property taxes ($ per capita)</td>
<td>1,465</td>
<td>1,475</td>
<td>2,136</td>
<td>1,589</td>
</tr>
<tr>
<td>Property tax ($ per home)</td>
<td>2,631</td>
<td>2,141</td>
<td>3,736</td>
<td>1,691</td>
</tr>
</tbody>
</table>

Chart 19
Sources of state and local income

<table>
<thead>
<tr>
<th>State</th>
<th>Income</th>
<th>Property</th>
<th>Sales</th>
<th>Corporate</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. average</td>
<td>21.3</td>
<td>33.4</td>
<td>22.9</td>
<td>3.6</td>
<td>18.9</td>
</tr>
<tr>
<td>California</td>
<td>26.2</td>
<td>31.8</td>
<td>22.0</td>
<td>5.6</td>
<td>14.4</td>
</tr>
<tr>
<td>Texas</td>
<td>0.0</td>
<td>42.0</td>
<td>30.8</td>
<td>0.0</td>
<td>27.2</td>
</tr>
<tr>
<td>New York</td>
<td>32.8</td>
<td>30.4</td>
<td>16.6</td>
<td>7.7</td>
<td>12.4</td>
</tr>
<tr>
<td>Florida</td>
<td>0.0</td>
<td>43.1</td>
<td>30.0</td>
<td>2.7</td>
<td>24.2</td>
</tr>
</tbody>
</table>

Chart 20

This chart shows how each state’s revenues are allocated. Florida and Texas don’t have personal income taxes and rely more heavily on property taxes and sales taxes. Texas doesn’t have a corporate income tax but does have a gross receipts tax that’s applied to businesses in the state.

FINANCES

<table>
<thead>
<tr>
<th>Surplus/Deficit</th>
<th>CALIFORNIA</th>
<th>TEXAS</th>
<th>NEW YORK</th>
<th>FLORIDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax increases and budget cuts may balance the budget</td>
<td>Growing economy leading to budget surplus</td>
<td>Deficit projected</td>
<td>Balanced budget</td>
<td></td>
</tr>
<tr>
<td>Rainy day fund</td>
<td>Empty</td>
<td>$7.0 billion surplus</td>
<td>Don’t know</td>
<td>Don’t know</td>
</tr>
<tr>
<td>State and local debt ($ per capita)</td>
<td>10,159 8th</td>
<td>9,297 14th</td>
<td>15,240 1st</td>
<td>7,917 22nd</td>
</tr>
<tr>
<td>Unfunded pensions ($ billions)</td>
<td>398.4 50th</td>
<td>180 47th</td>
<td>182 48th</td>
<td>98.5 44th</td>
</tr>
<tr>
<td>Bond rating (lowest in U.S.)</td>
<td>A-</td>
<td>AA+</td>
<td>AA</td>
<td>AAA</td>
</tr>
</tbody>
</table>

Chart 21
As stated earlier, California has run deficits for over ten years. Texas has been able to take actions to close its deficits and has about $7.0 billion in a rainy day fund. California is expected to balance its budget this fiscal year, 2012-13, but has a year-to-date deficit of $2.7 billion as of the end of November. All four states have high debt burdens and large unfunded obligations for public employee pensions and retiree healthcare. This is a national problem at the state level.

Another concern is that California has the lowest or next to lowest bond rating in the U.S. and has to pay an interest rate premium estimated to be 0.66 percent on its debt. If the state’s budget is balanced this year, and spending is controlled, this low bond rating should improve.

<table>
<thead>
<tr>
<th>K-12 EDUCATION</th>
<th>CALIFORNIA</th>
<th>TEXAS</th>
<th>NEW YORK</th>
<th>FLORIDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per pupil spending ($ per year)</td>
<td>9,600 31st</td>
<td>8,500 44th</td>
<td>18,100 4th</td>
<td>8,700 39th</td>
</tr>
<tr>
<td>Average teacher salary (highest in U.S.)</td>
<td>64,424</td>
<td>46,179 29th</td>
<td>62,332 4th</td>
<td>46,930 27th</td>
</tr>
<tr>
<td>Teachers</td>
<td>300,544</td>
<td>321,729</td>
<td>207,315</td>
<td>172,417</td>
</tr>
<tr>
<td>Teachers per 10,000 residents</td>
<td>84</td>
<td>127</td>
<td>112</td>
<td>81</td>
</tr>
<tr>
<td>Student/teacher ratio (almost highest)</td>
<td>21.1</td>
<td>15</td>
<td>13.3</td>
<td>17.9</td>
</tr>
<tr>
<td>High school graduation rate</td>
<td>68</td>
<td>67</td>
<td>70</td>
<td>59</td>
</tr>
<tr>
<td>8th Grade math (score and rank)</td>
<td>273 46th</td>
<td>290 10th</td>
<td>280 35th</td>
<td>278 40th</td>
</tr>
<tr>
<td>8th Grade reading (score and rank)</td>
<td>255 48th</td>
<td>261 36th</td>
<td>266 25th</td>
<td>262 34th</td>
</tr>
</tbody>
</table>

California’s per pupil spending for K through 12th grade education has been declining due to budget pressures. On a per pupil basis, California still spends more than Texas and Florida but only about half of what New York spends. California does have the highest paid teachers in the U.S. Results as measured by 8th grade math and reading tests, a common national metric, show that California is one of the poorest performing states. New York doesn’t do much better even though they spend twice as much per pupil as California, Texas, or Florida. Studies have shown that per pupil spending does not correlate closely with improved educational outcomes. California needs school reform as well as increased spending on K-12 education.
It’s widely known that state funding for higher education in California has been reduced, costs are up, and tuition and fees have increased to close the gap. One striking fact is that there are now as many administrative personnel as there are faculty in both the University of California and California State University systems. For example, the California State University system has 12,019 faculty positions, whereas there are 12,183 administrative positions, and the University of California system has 8,669 faculty positions, and 8,822 administrative positions. Is this a sign of a growing bureaucracy and unnecessary cost increases? Could we deliver quality education for less if we really tried?

<table>
<thead>
<tr>
<th>HIGHER EDUCATION</th>
<th>CALIFORNIA</th>
<th>TEXAS</th>
<th>NEW YORK</th>
<th>FLORIDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enrollment</td>
<td>1,738,013</td>
<td>943,694</td>
<td>578,411</td>
<td>648,766</td>
</tr>
<tr>
<td>Appropriations ($millions)</td>
<td>6,631</td>
<td>7,904</td>
<td>8,082</td>
<td>5,810</td>
</tr>
<tr>
<td>Five year change (%)</td>
<td>-12.3</td>
<td>-4.8</td>
<td>-0.9</td>
<td>-26</td>
</tr>
<tr>
<td>Higher education employees</td>
<td>143,157</td>
<td>110,581</td>
<td>50,865</td>
<td>56564</td>
</tr>
<tr>
<td>1st</td>
<td>2nd</td>
<td>10th</td>
<td>6th</td>
<td></td>
</tr>
<tr>
<td>Monthly pay ($)</td>
<td>5,255</td>
<td>4,438</td>
<td>4,501</td>
<td>4,442</td>
</tr>
<tr>
<td>1st</td>
<td>6th</td>
<td>3rd</td>
<td>4th</td>
<td></td>
</tr>
</tbody>
</table>

Chart 23
An often-quoted statistic is that California has about twelve percent of the U.S. population but about thirty three percent of those on public assistance. This is due to California’s more relaxed eligibility requirements for TANF, Temporary Assistance for Needy Families. California didn’t adopt the national guidelines established under President Clinton’s welfare reform legislation. If California followed national guidelines, the state would have about 870,000 fewer people receiving benefits.

California also has the highest percentage of its population on Medicaid of any state, about 30 percent. This is partly due to the fact that more children are enrolled. However, California’s Medicaid reimbursement rate is the lowest in the U.S. California’s reimbursement rate is about half the Medicare rate, compared to a national average of about seventy percent. If you are a California resident dependent upon Medicaid, can you find a doctor who will accept you as a patient?
California’s prison system is very expensive both relative to other states and relative to other state expenditures. California spends almost as much on its prison system, $8.9 billion, as on its university system, $10 billion. California’s cost per inmate is twice that of Texas and Florida.

### Chart 25

<table>
<thead>
<tr>
<th>PRISON SYSTEM</th>
<th>CALIFORNIA</th>
<th>TEXAS</th>
<th>NEW YORK</th>
<th>FLORIDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual cost ($ billions)</td>
<td>7.9</td>
<td>3.3</td>
<td>3.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Incarceration rate (per 100,000)</td>
<td>471</td>
<td>689</td>
<td>322</td>
<td>535</td>
</tr>
<tr>
<td>Prison population</td>
<td>167,276</td>
<td>154,576</td>
<td>59,237</td>
<td>101,324</td>
</tr>
<tr>
<td>Cost/inmate ($)</td>
<td>47,421</td>
<td>21,390</td>
<td>60,076</td>
<td>20,553</td>
</tr>
</tbody>
</table>

Have we passed a tipping point?

**Before**

- Corrective actions can lead to higher economic growth, increasing tax revenues, and manageable growth in pensions, health care, and welfare spending
- Debt stabilizes and grows at manageable levels

**After**

- Politically acceptable corrective actions aren’t sufficient to avoid a crisis
- External forces such as the bond market (Greece), bankruptcy (Stockton), or voters (Prop. 13) force a resolution
- Or, California goes into a steady, irreversible decline (Detroit)

HOW DOES IT END?
Has California passed a tipping point? Is it still possible to make reasonable changes to stimulate growth of the economy, control spending, reform entitlements, and improve California’s debt ratings? Or, have we reached a point where external forces will dictate solutions to the state’s problems such as a bankruptcy court, reluctant lenders, or voters through the initiative process?

What’s the end game?

**Rosy Scenario**
- State’s economy improves steadily, slowly
- State budget is balanced, Democrats control spending
- Job growth reduces social costs
- No pension crisis
- Cities and counties avoid bankruptcy
- Some meaningful school reforms
- Reasonable investments in infrastructure are made
- High Speed Rail is a success!

**Not so rosy scenario**
- Economic growth not enough to raise revenue and reduce unemployment significantly
- State continues to lose businesses and taxpayers
- Chronic budget deficits due to spending increases and slow revenue growth
- Pension costs and social benefits crowd out other essential spending
- Pension crisis results from generous benefits and lower than anticipated investment returns
- Some major city and county bankruptcies
- No improvements in schools and infrastructure

There isn’t enough information to make a specific forecast. Instead, two future scenarios have been defined, one rosy or optimistic, and one that’s not so rosy. These scenarios are to illustrate the possible outcomes facing the state. The reader can choose one of these scenarios or something in between.

We should be cautiously optimistic but recognize that there is the potential for a bad outcome. It would probably show up as continuing deficits at the state level, and more bankruptcies at the county and city level. Growth of the economy, job creation, and business formation could also stagnate, along with the number of high income taxpayers. There is also the potential for a pension and retiree health care crisis if underfunded pension funds continue to earn less than the assumed 7.50 percent per year and retiree benefits absorb an increasing share of tax revenues. If we increased K-12 funding, how much would actually make it to the classroom?

**RECOMMENDATIONS**

What needs to be done? Specific actions are for the Governor and legislature to work out. This report will focus on the three big issues that need to be addressed:
1. Improve the state's business climate and get the economy growing faster.
2. Control spending and balance the budget.
3. Reform state employee retirement programs to reduce costs and avoid a crisis.

**Grow the economy:**

As James Carville famously said “it’s the economy, stupid.” California must improve its business climate to grow the economy faster because:

Growing the economy is the best way by far to increase the state’s tax revenues.

Growing the economy is the only way to reduce unemployment and create the new jobs needed for the state’s high school and college graduates.

Growing the economy also reduces entitlement spending and the number of people who depend upon government programs.

**Balance the budget:**

California must also balance its budget and start paying down debt to improve its bond rating. Propositions 30 and 39 plus steady but slow growth of California’s economy will increase tax revenues, at least short-term. However, spending increases can easily overwhelm any increase in revenue. Today, the Democratic Party controls the state’s government. All state-wide political offices are held by Democrats. In addition to a Democratic governor, Democrats have a super majority in both houses of the state legislature. They have complete control of the state’s finances. It will be a big test of the Governor and the legislature to show the self-discipline needed to keep the budget in balance, and deal with other financial problems such as the state’s bond rating and needed entitlement reforms.

The voter-approved tax increases in Propositions 30 and 39 should increase revenue. However, it remains to be seen if this revenue equals what is anticipated from these tax increases. It also remains to be seen if California’s even higher taxes will, over time, further discourage new business formation and cause high income taxpayers to move their residences to other states and take other actions to decrease their taxable income.

**Reform retirement programs:**

The state needs to reform state employee pension and retiree healthcare benefits. Pension and healthcare benefits are already crowding out other state spending and forcing some cities into bankruptcy. These benefits shouldn’t be blamed totally for these bankruptcies but they are a major contributor. Pension plans at the state and local level still assume that their investment returns will be the 7.50 percent/year needed to adequately fund future benefits. Actual results for the past 10 years are much lower and pension plans are underfunded. If there isn’t a dramatic and permanent increase in investment returns, then the state is digging a big hole in the form of underfunded pension plans. Retiree healthcare benefits are less expensive than pensions but are significant. Also, most healthcare benefits are not funded and are paid out of current income.
If the state has to eventually admit that pension funds’ investment returns are less than current assumptions, then there will be a very big hole to fill. There is also the issue of fairness. Who should pay for any shortfall? Should current taxpayers be responsible for underfunding that occurred over the past ten or twenty years? Would these generous pension and health care benefits have been awarded in the first place if there was an honest accounting of the cost? Also, how long will voters be willing to support public employee pay and benefits that are more generous than those available in the private sector?

One final thought is that we the voters are responsible for the government we have and are ultimately responsible for California’s success or failure.

* * *

About the author:
William (Bill) Fletcher retired as Senior Vice President at Rockwell International. During most of his time there he was responsible for international operations and business development for Rockwell Automation. Before joining Rockwell, he worked for Bechtel Corporation, McKinsey and Company, Inc., and Combustion Engineering’s Nuclear Power Division, and was an officer and engineer in the U.S. Navy’s nuclear program. His international experience includes expatriate assignments in Hong Kong, Europe, the Middle East, Africa and Canada. In addition to his interest in California’s finances, he is involved in organizations dealing with national security and international relations. The author retains all rights to the text and charts in this report. He can be reached at cafincances@cox.net.

Sources:
The following is a list of the main sources used in preparing this report.

Governor’s Enacted Budget 2012-2013
California State Controller’s Office
California Legislative Analyst’s Office
U.S. Census Bureau
Bureau of Labor Statistics
Bureau of Economic Analysis
State Budget Crisis Task Force
Manhattan Institute
U.S. Energy Information Administration
State Budget Solutions
PEW Center on the States
Tax Foundation
California Tax Reform Association
California Budget Project
Reason Foundation
Stanford Institute for Economic Policy
California Public Policy Center
California Progress Report
California Common Sense
League of California Cities
National Right to Work Foundation
CalWatchDog
CNBC’s America’s Top States for Business 2012
New York Times
Forbes
Wall Street Journal
Orange County Register
Los Angeles Times
USA Today
The Business Journals
The Taxpayers Network
Wikipedia.com
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About.com