The State Budget Outlook . . .
Is the Glass Half Full or Half Empty?

Everyone agrees that state revenues are up substantially, and that this year's budget will not require the kind of painful slashing of programs and massive borrowing that took place during the last few years. On the other hand, few would claim that there are no remaining problems or hard choices to be made. A recent report from the California Budget Project (CPB) also asks whether the Governor's proposed budget will prepare California for the future.

The proposed budget assumes that combined revenues from 2004-05 and 2005-06 will be $5.5 billion higher than expected, and that the trend will continue in 2006-07. Corporate taxes have been significantly higher, and personal income and sales tax revenues have also been up somewhat. The budget proposes increased spending for schools, a rollback of college fees and funding of after-school programs mandated by Proposition 49. It also would repay $920 million on some loans from transportation funds and add an additional payment of $460 million to the money owing this year for repayment of the deficit financing bonds.

There are, however, several threats to the revenue projections that could jeopardize these proposals. One is uncertainty about the final results of revenues collected from a tax amnesty program under which some companies chose not to participate in the program but nevertheless paid "protective claim" payments to cover the possibility that they might later be assessed high penalties. It is expected that a large portion of those payments will eventually have to be refunded.

There are also several court actions that could cause budget problems. They include one in which a court has blocked issuance of a bond to cover some of the state's pension obligations, another in which a court has ruled that a contested increase in a cost-of-living adjustment should be paid, and the recent court-ordered takeover of administration of the state prison medical system, which is likely to raise its costs considerably.

The proposed budget does not take into account reductions in money that will be coming to California as a result of the domestic spending reductions in the federal budget, most of which will affect low-income people. It also does not include funding for any possible increases to salaries or benefits for state workers although most of the state employees' collective bargaining agreements will soon be up for negotiation.

The Governor's budget contains some cuts that are likely to get a chilly reception from the Legislature. It significantly reduces spending for both child care and employment services in the CalWORKs program, and would not pass along a federally-funded cost-of-living adjustment for the aged and disabled in the SSI/SSP program.

The CBP report suggests that California's demographic trends are on a collision course with our system of finance. The state continues to grow at a rapid pace, with the population likely to increase by about 10 million people by 2020, and it is expected to be a more challenging population with greater needs for services. The number of people over 65 is expected to increase by about 71 percent, straining such programs as Medi-Cal and other supportive services. In the next few years 61 percent of our school-age population is expected to be Latino or black, with a significant portion English language learners, groups that will need better educational resources if they are to flourish.

At the same time, the gap not only between the rich and the poor but also between upper and middle income families is growing. The median income has edged down, and the percentage of families below the poverty level has moved up. Our economy is also losing jobs in sectors of the economy with higher average pay, and expanding in sectors with lower average pay.

California's revenue structure is ill-equipped to meet these demographic and economic challenges. Tax cuts enacted between 1993 and 2005, including reduction in the Vehicle License Fee, a corporate tax rate reduction, and an array of other tax breaks and credits, will reduce current revenues by about $9.9 billion. The phase-out of the federal estate tax in 2006-07 will cost the state about another $1.1 billion. California's structural deficit—the gap between income, given our revenue structure, and spending to maintain services at their current level— is expected to remain, even if there are no major setbacks to the economy as a whole.

It should come as no surprise, then, that the Budget Project answers its own question by concluding that the Governor's proposed budget fails to address the challenges raised by demographic and economic changes and does not begin to prepare for California for the future.