Structural Budget Gap Begs for Reform

Policymakers are struggling to find ways to close California's persistent structural budget gap. A structural deficit exists when the state's taxes, fees and other revenue sources are insufficient to fund existing service levels adjusted for population growth and inflation.

The Legislative Analyst estimates the gap at $15 billion and states that the spending cuts, deferrals, etc. in the Governor's proposed budget would not eliminate it but merely reduce it to $5-7 billion per year. Only some combination of ongoing spending cuts or revenue increases can close a structural gap.

Where did the gap come from? One major element is the heavy dependence of California's budget on the personal income tax. Taxes on capital gains and stock options ballooned to $17.6 billion in 2000-01 and then fell to $6.2 billion in 2003-04.

Another large factor is the substantial tax cuts of the 1990s. Tax cuts enacted since 1998-99 alone have reduced annual state revenues by approximately $5.6 billion.

The economic downturn and demographic factors have also played a part. Revenues have gone down, but population has gone up, especially in groups needing government services.

State income taxes are deductible on federal income tax forms. That means that when the rate in California was decreased to 9.3 percent, more income was taxed at the federal level. Restoring the 10 and 11 percent tax rates in California would add revenue for the needs within the state while reducing the amount of Californians' income going to the federal government. On average, the higher state taxes paid by top-bracket earners would be more than offset by recent federal tax cuts.

Sales tax revenue has declined over the years as a share of personal income because of a shift from consuming goods to purchasing services, and of increased Internet and mail-order sales. The California Budget Project estimates that if the same share of personal income went to taxable goods as in the late 1970s, revenues would be $10.2 billion higher. Taxing some services could help fill the structural budget gap.

California is one of only three states that routinely require a 2/3 vote to pass the state budget. This empowers the minority disproportionately, whereas a majority vote requirement would actually place responsibility on legislators, making them take ownership of the budget and the process. Perhaps less negotiation about "pork barrel" budget items would take place.

The hidden budget—tax expenditures —also plays a part. Never comparing the choices within the budget to the "off budget" credits, exemptions, and deductions makes it difficult to make decisions about the revenues and programs most important to managing our state. And while raising taxes requires a 2/3 vote in the legislature, granting a tax break that lowers someone's taxes takes only a simple majority.

The $15 billion bond to cover California's existing debt is giving the governor and legislature some breathing room. It has given them time to address structural impediments to a balanced budget. We need to consider what size budget is necessary when we have more people living longer, when there are more children in our schools and when we want our citizens to be healthy.