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Three: Making California's State Budget More User-Friendly and Transparent: Further Thoughts

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MAKING CALIFORNIA'S STATE BUDGET MORE USER-FRIENDLY AND TRANSPARENT: FURTHER THOUGHTS

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"When a State borrows money to construct some great and permanent improvement, and leaves future generations to pay the debt, she also leaves them the work itself, as some sort of compensation. The violation of principle consists in the PRESENT generation assuming to act for and to bind the next without their consent. But the case is still worse, when a State borrows money to defray the ordinary expenses of her civil administration; because she bequeaths a debt to posterity, without any means to pay it."

Governor Peter Burnett, December 20, 1849

"When I previously proposed to the Legislature that we should set something aside for unforeseen needs, some people said I was taking a defeatist attitude—that I should be thinking in terms of prosperity and not depression — but I am still of the opinion that it is no more defeatist for a State to provide for a possible rainy day than it is for an individual to do so. I am as optimistic as anyone about the economic future of our State, but I think it is elementary prudence to establish a rainy day fund."

Governor Earl Warren, January 6, 1947

"I will recommend an economy-minded budget, and a courageous and fair program to obtain new revenues. I pledge, however, that we will not sacrifice essential services or narrow our vision for California."

Governor Edmund G. "Pat" Brown, January 5, 1959

"For months, some have suggested that the only way out of this difficult situation is to raise taxes. Yet, repeatedly over the past few years, the voters have expressed the strongest of sentiments that the government already collects too many taxes. Therefore, because I believe our first obligation is to listen to the people, we must make every effort to restore fiscal responsibility without a net tax increase. This requires us to establish strong basic priorities."

Governor George Deukmejian, January 3, 1983

Wrestling with fiscal problems is not a new activity for California governors, legislators, and other state officials.[1] Depending on ideology, economic circumstances, and voter preferences, state policy toward taxation and spending has varied. In some administrations, policy has tilted toward government activism and public works; in others, limited government and frugality as an end in itself have been touted.

Even most conservatives today would not go along with the sentiments of California's first governor, cited above, that any borrowing – even for major projects – was to be avoided. Nonetheless, whatever the prevailing political and ideological sentiments, state budgets are a reflection of, and guide to, state policy. They are more than just bland accounts and bookkeeping.

In this chapter, we start with the assumption that budgets and budget documents are critical components of the formulation of public policy. All state and local governments have budgets and these reflect the priorities those governments place on particular activities and projects. Budgets give expression to a government's plans and policies in the service of its constituents. Therefore, budgets that are not informative and accurate will cloud the process of policy determination. Abrupt changes in budgetary practices that may accompany fiscal crises – such as across-the-board spending cuts and job freezes – can inadvertently upset priorities. Below we argue that:

- Recent corporate accounting scandals have both focused attention on private-sector accounting and indirectly created an opportunity for examining public-sector budget practices in California and elsewhere.
- California's state budget presentations remain insufficiently transparent and user-friendly. Legislators and media commentators tend to accept budget information as given without questioning the format or methodology involved.
- California's electricity crisis complicated the state's difficult fiscal situation since emergency state purchases of power were made with funds from the General Fund. In the short term, avoidance of a cash shortage depends importantly on flotation of an electricity bond issue, scheduled for fall 2002. Moreover, accounting methodology pertaining to electricity has been inconsistent from year to year, making budgetary interpretation difficult.
- Although California's economy is large on the world scale, the state does not have the fiscal discretion of an independent nation with its own currency. California cannot create dollars and therefore it cannot run large deficits for indefinite periods, unlike the federal government.
- Uncertainty in economic forecasting means that the budget process should include two elements. There is a need for an adequate "rainy-day" fund to be built up in Good Times in order to smooth out revenue fluctuations. And the state should have a "Plan B" budget in readiness; an alternative spending and revenue agenda in the event of a serious unforeseen decline in revenues.
- Crucial budget decisions in California have been delayed by the two-thirds vote requirement for legislative enactment. The state often fails to enact a budget within its constitutional deadline whenever there is fiscal distress. Even when enacted, the focus of legislative and media attention is on a phantom "reserve" rather than on available cash balances and resources.
- Much of the state's fiscal policy is non-discretionary, in part due to voter initiatives that reflect a lack of trust in elected officials. A more transparent budget process would be a step toward regaining lost public trust.
- California faces a long-term budget problem due to demographic trends that create special demands for educational and health services even apart from the general infrastructure and service needs that accompany population growth. Past tax windfalls from capital gains on stocks and stock options are unlikely to be available in the future to meet these needs.

Corporate Scandals

In the corporate world, there has been a recent outcry regarding accounting irregularities. Major corporations such as Enron and Worldcom have fallen into bankruptcy as accounting irregularities have been disclosed. A major accounting firm, Arthur Andersen, also has fallen from grace. Investors who took substantial hits as stock values tumbled have demanded reforms and Congress has enacted various regulatory changes. Hopefully, these changes will lead to improvements in corporate accounting.

There are several lessons that can be drawn from these private-sector developments. First, the accounting irregularities developed because there were powerful incentives to create them. The stock market rewarded companies that showed seemingly strong results. Stock option plans for executives provided an obvious motivation to undertake activities that boosted stock values – at least for a time. Second, as long as the economic boom lasted, the public, the press, and policy makers went along with questionable practices. Those who expressed doubts were dismissed as anachronistic pessimists who did not grasp the "new economy." Why fix something that did not appear to need fixing? In short, as long as there was no pain, no gain was seen in pushing for better standards of accounting. Third, once pain developed, the process reversed and there was pressure for reform.

Implications for the Public Sector

These lessons have their counterparts for public-sector accounting, including the official budget statements of the State of California, other states and localities, and even the federal government. There can be political pressures to hide problems that might otherwise appear in official data, just as occurred in the private sector. Thus, at the federal level, the budget slipped into deficit during the summer of 2001, and changes in payroll tax accounting were suddenly announced which momentarily stalled the inevitable slide.[2]

If such developments can occur at the federal level, what do they imply for California's state budget? Simply put, the way in which data are presented is determined by individuals – however well intentioned – who respond to incentives. As we noted in our budget chapter in the prior edition of <u>California Policy Options</u>, there are obvious incentives to present the budget in ways that minimize public perceptions of fiscal problems.[3] However, unlike the private sector – as we will note below – there can sometimes be incentives to overstate the problems that do exist. Budget emergencies can at times be useful political tools. In a climate of perceived emergency, it may be easier to obtain legislative support for particular state fiscal policies than when resources are readily available.

In the private sector, improper or misleading accounts can lead to bankruptcy. The consequences for share owners and employees of the firm involved are harsh. But other firms can step in to provide the goods and services that the bankrupt enterprise once supplied. In contrast, governments, unlike most firms, have a monopoly on the services they provide. Bankruptcies and sudden cutbacks of public services are potentially more severe and far-reaching.

What Do the Numbers Mean?

In our prior review of the California budget in last year's edition of <u>California Policy Options</u>, we noted a lack of "transparency" in the method of budgetary presentation. Examples we cited particularly revolved around the use of the words "surplus" and "deficit" in ways that obscured the actual annual balance of revenues and expenditures. Below we present yet another example of such terminological fuzziness. We also note that the electricity crisis of 2000-2001 produced an inconsistency in budgetary presentation across years that seemingly went unnoticed.

$23.6 Billion What?

Because state budgets seem arcane and removed from the day-to-day interests of the average Californian, it is quite understandable that ordinary state residents do not spend much time contemplating these accounts. By and large, the information available is filtered by the media. And media coverage is often uncritical and focused on the personalities involved rather than the accounts themselves.

A simple example is the recent constant repetition of the "fact" that California had a $23.6 billion dollar "deficit" in its General Fund. This number first appeared in conjunction with the Governor's revised budget proposal for fiscal year 2002-03 made in May 2002. A quick search in Nexis/Lexis revealed 544 citations of this figure in news reports, both in California sources and in out-of-state newspapers such as the *New York Times*, between the official announcement in mid-May and August 31, 2002.[4]

Even in opposing the Governor's budget-related actions in the health care area, the *Los Angeles Times* defensively began an editorial with reference to the (rounded up) state deficit: "Faced with a $24 billion state deficit, a budget stalemate and a reelection campaign, it's easy to understand why Gov. Gray Davis doesn't want to…"[5] Since annual general fund expenditures that were proposed in the same budget proposal were about $76.5 billion, a $23.6 billion "deficit" seemed huge. One might have surmised that taxes would have to be raised $23.6 billion/annum to cover it or that expenditures would immediately have to be cut by $23.6 billion (over 30%), or that some combination of the two remedies was required.

A quick scan of the many newspaper articles citing that figure will reveal no definition of what the $23.6 billion number meant. The Legislative Analyst, in reviewing the Governor's proposal, referred to the figure as a "shortfall," rather than a "deficit," but the distinction did not appear in the press. And since the word "shortfall" does not appear in the official glossary of budgetary terminology accompanying the budget, perhaps this ambiguity is understandable. In any event, did the $23.6 billion apply to fiscal 2001-02 year or 2002-03? Was it an annual gap between revenues and expenditures that might have occurred under some scenarios? Or was it an actual gap that was occurring or had already occurred? Newspaper readers would not have had a clue.

Absent even a general definition, the $23.6 billion number as reported in the media carried little information other than that California seemed to have a (big) budget problem. But it was a number that was read and re-read by voters, non-expert legislators, and officials of state and local agencies that depend on the state budget. And, of course, it was read by the financial community that must fund any new issues of state debt.

What exactly did the $23.6 billion figure mean? At the time of the Governor's initial budget proposal in January 2002, there was said to be a "shortfall" of $12.5 billion that needed to be removed.[6] This estimate was said to be the sum of three elements: 1) a current year deficit (i.e., for 2001-02) of $3 billion, 2) a "budget year" imbalance (i.e., for 2002-03) between revenues and expenditures of $9 billion, and 3) a need to add to the "reserve" of $500 million during 2002-03. It is not clear where the $3 billion came from. The deficit reported by the Legislative Analyst in November 2001 (defined as revenue and transfers minus expenditures) was in fact $10.4 billion. However, using the odd terminology that confuses stocks and flows – but is often used in

California budget-speak – subtracting a drawdown from the "reserve" of $6.7 billion from the $10.4 billion (thereby eliminating the reserve), would produce a "deficit" of $3.7 billion.[7] Perhaps $3.7 billion estimated by the Legislative Analyst was the Governor's $3 billion. What about the $9 billion? Note that estimates of revenues and expenditures in the year to come cannot be audited. Presumably, the $9 billion represented an estimate of what might happen in the next fiscal year (2002-03) if nothing were done.[8]

And the $500 million for the reserve? Clearly, this figure was an arbitrary number. It could be argued that the state should have had more in its reserve – precisely because of the budgetary problems it found itself in by 2002. So the January 2002 estimate of the "shortfall" could easily have been said to be more than $12.5 billion at the time, just as it could have been said to be more than $23.6 billion in the following May.

The Governor proposed dealing with the $12.5 billion "shortfall," whatever it may have meant, by spending reductions of $5.2 billion (roughly half in 2001-02 already under way – a mid-course correction). Some of the spending cuts had already been ordered or proposed in mid-November 2001.[9] In addition, there were "fund shifts" of $0.6 billion, federal funding increases of $1 billion (not under the Governor's control), and "loans/accelerations/transfers" of $5.6 billion. The largest item in the last group was "securitization" of tobacco settlement funds of $2.4 billion. In addition, $0.9 billion was to be "saved" by deferring contributions to two state pension funds, a step that might conserve cash but would not prevent the accrual of new pension liabilities.[10] The rest was to be taken as loans from other state funds.

In short, of the $12.5 billion $5.6 was to come from sales of assets (the future flow of tobacco settlement funds) and borrowing. Some of the "fund shifts" were also a form of borrowing.[11] Other shifts were said to be recognition that previously-appropriated funds would not in fact be spent. Reductions in assets, increases in liabilities, and accounting recognition of funds that were not going to be spent do not, of course, improve the actual fiscal condition of the state. Recognizing such unspent funds does not reduce a deficit; recognition simply provides a more accurate estimate of the deficit.

It seemed unlikely that the federal government under Republican George W. Bush would have strong motivation to assist Democratic Governor Gray Davis to the tune of $1 billion. At the time, the Bush administration appeared to be supporting the electoral hopes of Richard Riordan in the Republican gubernatorial primary. Riordan – the former mayor of Los Angeles - was deemed to be the strongest potential rival to Governor Davis.[12]

By May 2002, there was further erosion in the state's revenue base. It was at this point that the earlier $12.5 billion became the much-cited $23.6 billion. The additional $11.1 billion was said to be the combination of a decreased revenue estimate for 2001-02 and 2002-03 combined of $9.5 billion and increased expenditures beyond the January estimate of $1.6 billion. In response, the Governor proposed further spending reductions, more loans, a larger tobacco securitization, and increased taxes. The largest explicit tax increases involved changes in provisions of corporation taxes and increased cigarette taxes. In addition, the state sometimes oddly describes tax reductions as "expenditures," a practice that adds to terminology confusion. The May revised budget proposal thus included a reduced "expenditure" on a vehicle license fee "rollback" by deferring it for a year.

Was there an expenditure reduction? The proposed May-revised budget for 2002-03 called for General Fund expenditures of $76.5 billion relative to an estimated level of $76.9 billion in 2001-02. Although the drop in nominal terms was well within the margin of forecasting error, adjusted for inflation there was a real cut, probably in the 2-4% range. The original plan for 2001-02, adopted in July 2001, called for expenditures of $78.8 billion, marginally below what was estimated to actually be occurring in May 2002. So even with the Governor's proposed mid-course (November 2001/January 2002) spending reductions of $2.4 billion for 2001-02, in fact the actual outcome was about what had been forecast in July 2001. Basically, for 2002-03, the Governor was calling for a modest real spending cut, a reduction nothing like $23.6 billion. And, of course, tax increases of that magnitude were not being proposed.

Electrical Impulses

California's electricity crisis of 2000-2001 was the product of a bipartisan deregulation plan, enacted under a Republican governor and a Democrat-controlled legislature in 1996. We cannot go into the details of what went wrong, except to note that the plan had (at least) three major flaws.[13] These ultimately contributed to an intertwining of the electricity crisis and the state's budgetary distress.

The first flaw was that the deregulation maintained a retail cap on electricity prices while deregulating the wholesale price. In the event that wholesale prices rose substantially for an extended period (as they did), the major utilities were at risk of bankruptcy. Of the three major private utilities, Pacific Gas and Electric (PG&E), Southern California Edison, and San Diego Gas and Electric, the first did declare bankruptcy, the second came close, and the third understood the system well enough to avoid the consequences of the retail cap.

A second flaw was that particularly when the system was running close to capacity, an opportunity for suppliers to manipulate the market – to boost the wholesale price – would develop. There is evidence that such manipulation did occur. What was supposed to be a shift to competition in fact led to price fixing.

The third major flaw was that the deregulation plan had no explicit mechanism for dealing with the issue of reliability. Continuous supply of electricity is a public good. Police, fire, and ambulance dispatching are all examples of critical services that depend on reliable electricity. Everyone benefits from such services even if they are not immediately using them.

In addition, continuous, reliable supply has "option value" for consumers. Even if a private individual or business is not using electricity, the option is always there to do so (or use more). This aspect of service is especially valuable in the case of a product such as electricity that cannot for practical purposes be maintained as an inventory.[14]

Note that even when they are under contract to supply power to a particular consumer, generators of power cannot individually ensure that the power will arrive. They simply put power into the system. Whether the system actually delivers that power depends on the coordination and reliability of all power suppliers collectively. Everyone is responsible, which means that no one is responsible, unless the necessary regulatory and contractual institutions are created.

The upshot of these three flaws was that wholesale prices began to rise and rolling blackouts began to be used to reduce power demand. PG&E went bankrupt. Southern California Edison floundered. And the state developed its own ad hoc public utility to buy power temporarily from wholesalers (who would not sell on credit to bankrupt or near bankrupt utilities).

To purchase that electricity, the state used money from the General Fund channeled through the Department of Water Resources. By the end of fiscal year 2000-01, the cost to the state was roughly $6 billion. Yet these expenditures were not at that time recorded as charges against the General Fund. The rationale for this seemingly-costless electricity was that each dollar spent was balanced by an equal IOU from the utility and its customers. This IOU would someday be paid from the proceeds of a bond sale to be financed by a surcharge on electricity bills.

There is an obvious issue as to whether this balancing of expenses and IOUs was an appropriate budgetary treatment of the state's electricity purchase. The bond sale was originally supposed to occur early in fiscal 2001-02. But its floatation was complicated by the legalities surrounding the PG&E bankruptcy and legislative authorization. A year after the sale was supposed to occur, it still hadn't taken place although it was scheduled for fall 2002.[15] Certainly, a question can be raised about whether a dollar actually spent is fully balanced by a dollar that might materialize if legal and legislative hurdles can be overcome at some future date.

Chart 1 shows the General Fund surplus or deficit using numbers appearing in the Governor's January 2002 budget message, but maintaining the original methodology (non-recognition of electricity purchases). Using that methodology, the General Fund showed a move into deficit (but a relatively small deficit) in 2000-01 followed by a big deficit in 2001-02, when state tax revenue fell off sharply. However, the Governor's January 2002 message abruptly changed the budgetary methodology.

In January 2002, the over $6 billion cost of electricity was suddenly shown as a negative transfer from the General Fund in 2000-01. This negative transfer was to be followed by a positive transfer in 2001-02, when the bond sale was supposed to reimburse the General Fund (but turned out not to do so). The effect was to show the prior year as a period of poor fiscal performance and the current year (2001-02) as being on the road to recovery with a much-reduced deficit. In effect, the revised treatment pushed the deficit of 2001-02 back to 2000-01.

Of course, moving accounting deficits from one year to another does not change the overall financial condition of the state at the end of the period. But being on the seeming road to recovery - rather than at the bottom of a pit - in an election year may have had some appeal.[16] Chart 2 shows the projections of a structural deficit developed by the Legislative Analyst at around the time the new budget was being formulated with the new electricity methodology. Just as the Legislative Analyst was projecting a structural deficit for years to come, the new numbers seemed to suggest that salvation was already at hand.[17]

There did not appear to be any constraint preventing a change in accounting procedures for electricity from one year to the next. And just as the media later accepted the figure $23.6 billion uncritically, so – too – was there an absence of commentary on the shifting treatment of electricity purchases. Official budget documents seemed to be accepted at face value.

Lack of Consistent Standards

It is not surprising that the meaning of state budget information – such as the $23.6 billion "shortfall" or "deficit" - is unclear. There is a Government Accounting Standards Board (GASB) for the public sector, similar to the Financial Accounting Standards Board (FASB) that provides guidelines for corporate accounting. But GASB cannot control budgetary practices of California's state government or those of any other jurisdiction. Government budgets are, after all, political documents and pieces of legislation, which are not subject to outside control. In California as elsewhere, budget definitions and methodology are what the Governor and the Legislature want them to be. A general strengthening of, and support for, GASB standards would be helpful to all state and local governments, even if those governments cannot be legally compelled to comply. Such a step would follow the post-Enron increase in support for FASB with regard to corporate accounting. And nothing prevents the State of California from requiring its own budgets to be presented in compliance with GASB standards. In any event, a more critical evaluation of state budgetary documents by the media would certainly be helpful.

Limits to California's Discretion in Fiscal Affairs

The federal government - as a sovereign entity that issues a major world currency - has a great deal of fiscal discretion. As the governor of Alabama recently noted, "Members of Congress... create programs like they're governors. But they don't have the responsibility of making the financial ends meet that the governors have."[18] And, indeed, the experience of the 1970s and 1980s amply demonstrates that the federal government can run large deficits without encountering difficulties in the financial markets. U.S. Treasury securities are regarded as carrying virtually no risk of default. The Treasury borrows in U.S. dollars and the federal government can issue dollars. Hence, in principle, the promise represented by federal securities can always be honored.

But not all countries have this privileged position. Small countries with histories of high inflation, currency depreciation, and financial instability end up borrowing in respected currencies of other countries such as the U.S. dollar. As Argentina and Mexico - among others - have discovered in recent years, financial markets may become nervous about the ability to pay of a borrowing country, the result being local currency depreciations and banking crises. California boosters like to point to the fact that California, <u>if it were a country</u>, would be perhaps the fifth largest economy in the world. But the fact is that states such as California are potentially what one columnist termed "Our Banana Republics."[19]

Of course, since California has no currency of its own, it cannot have a currency crisis. And its banking system operates largely under federal auspices and regulation and therefore is protected from an Argentine-style meltdown. However, the state's credit standing can be degraded by excessive debt burdens, ultimately leading to higher interest payments and even difficulty in obtaining credit and providing services to Californians.

Three major financial reporting services rate California's General Obligation and other securities. Standard and Poor's downgraded the state's general obligation bonds to from AA to A+ with negative implications in April 2001. That same month, Fitch added a negative outlook watch to its AA rating for such securities. And Moody's dropped its rating from Aa3 to A1 in November 2001.[20] It is unlikely that these ratings will be upgraded until structural problems related to the state budget are seen as being addressed. But further downgrades from current levels remain possible.

It is widely thought that the California constitution mandates that the state's annual budget be balanced. In fact, the constitution simply says that early in each calendar year, the governor should submit a budget and, if proposed revenues fall short of expenditures, there should be an explanation of where the additional revenues will be obtained. This obligation is itself fuzzy since the additional "revenues" could be obtained by running down reserves or by borrowing. There is no language requiring that the Legislature pass a "balanced" budget, whatever that term might mean. The constitution requires that a prudent reserve fund be established, but leaves it to the Legislature to determine what such a level might be.[21]

One clause requires a vote of the people for debt issuance of general obligation debt (see below). But it does not hinder issuance revenue anticipation notes and similar short-term securities. Even revenue anticipation warrants – which borrow in one fiscal year against revenue in the next – can be issued without a vote (and were in June 2002).[22] In short, there is no balanced budget mandate in the state constitution, at least in any precise terminology. That does not mean, however, that California is free to enact unbalanced budgets without limit.

Even were the constitution to mandate that budgets be balanced by some clear-cut definition, a budget is simply a forecast of receipts and expenditures. And forecasts can turn out to be in error. A seemingly-balanced budget might turn out to be unbalanced after the fact. Thus, the ultimate fiscal disciplinarian for the state is not a legal constraint but the national (and international) financial market. As borrowing becomes more and more expensive or difficult, the state will be forced to make fiscal adjustments. And the electorate may respond to such developments in ways that punish those viewed as responsible.

Potential lenders – and rating services – will consider various factors in evaluating the riskiness of California debt. The ultimate question for any lender is "Will I be repaid on time with promised interest?" There is no simple formula that can answer that question. Rather, there are indicators that must be subjectively weighted by prospective lenders.

At the end of calendar year 2001, the State of California owed about $27 billion in general fund supported debt, i.e., debt whose interest and repayment must come from the General Fund. About $21 billion of this total consisted of general obligation securities backed by "the full faith and credit" of the state. The remainder was lease-revenue securities that were backed by the budgets of particular state departments (and which are rated slightly lower for that reason by the rating agencies).

Interest on such obligations as a proportion of expected receipts to the general fund will itself be small. Because interest from state and local securities is generally free of income tax, the return on such securities that will be accepted by lenders is lower than it otherwise would be. If we assume, say, a 4-6% interest rate on the debt, interest payments would be about $1.4 billion per annum, i.e., on the order of 2% of general fund receipts. However, particular security issues, as they mature, can require large lump sums of cash for repayment, if they are not rolled over into new debt. And some debt service goes beyond interest into the repayment of principal on outstanding debt.

During fiscal 2001-02, the state sold over $4.2 billion in new general obligation and lease-revenue securities. In addition, because the timing of expenditures and receipts of the state does not match within the fiscal year, the state issues short-term revenue anticipation notes to provide needed cash. During 2001-02, the state sold $5.7 billion of such securities. It expects to sell $7 billion in the fall of 2002, at currently low short-term interest rates. Finally, various items were put on the ballot for November 2002 that would allow the state to issue over $18 billion general obligation securities for housing programs, educational construction programs, and water projects. Authorization to issue bonds, however, does not require the Treasurer to issue them immediately. Nonetheless, as the state's debt load increases, lenders may become progressively nervous about the default risk.

Even a large debt burden can in principle be paid if the state Legislature and the Governor impose the necessary taxes and/or reduce spending sufficiently. Thus, part of the judgment in determining the riskiness of California debt is an assessment of political will. The fact that difficult state budget decisions were deferred and delayed by legislative stalemate beyond the end of the fiscal year (end of June) for both 2001-02 and 2002-03 is not a positive development. It suggests a lack of political will and could increase lender apprehension.

Uncertainty in Forecasting

As noted, a budget is a plan and plans are sometimes not realized due to unanticipated events. For the state budget, the direction of the economy is an important driver; it affects incomes, sales, and profits and therefore the taxes on those flows. It also affects state expenditures which – other things equal – may rise to deal with needs related to economic distress. Even in "normal" times, economic forecasting cannot be done with precision. External events such as natural disasters and terrorist attacks can affect economic trends and yet are outside the realm of economic forecasting. Actions of Congress are also external to California but can affect the state's budget outlook.[23]

Given the uncertainties surrounding forecasting, it would be useful to prepare contingency plans, particularly for situations in which economic performance falls below expectations. While mid-course corrections can be made by the Legislature in spending and revenue, having a "Plan B" available in advance could help make more intelligent decisions in a timely manner. It would also provide some guidance to agency decision makers.

It is obviously useful to update forecasts frequently as new information becomes available.[24] But like the budget itself, presentation is important if transparency and public understanding are to be fostered. The California Department of Finance publishes a monthly bulletin showing actual and "forecast" revenue for the general fund. Table 1A reproduces data from the July 2002 bulletin which provides data through June 2002.

Although the table shows that some revenue sources were more precisely forecast than others, the bottom line seems to suggest that while actual total revenue fell short of the forecast, the discrepancy was only 1% or $650 million. A 1% forecasting error over the course of a year can hardly be faulted. And generally, the monthly bulletins issued during fiscal 2001-02 showed similarly small forecasting errors, although always a cumulative negative error.

What these published tables do not make clear is that the shortfall, relative to the original forecast when the budget was adopted, was actually much more than 1%. As Table 1B indicates, the end-of-fiscal-year results fell short of the original budget estimate by over $10 billion, or about 14%. The difference between the figures in the bulletins and Table 1B is that the former represents a rolling forecast. As new monthly data came in (and showed repeated revenue shortfalls), the revenue forecast was steadily revised downward. A more informative presentation would provide both the rolling forecast and the original expectation.

Rainy Days

The 14% gap between projected and actual tax revenue in 2001-02 demonstrates that a (large) "rainy-day" fund is essential to cushion the state budget during economic downturns. As our analysis in last year's edition of California Policy Options illustrated, California has tended to underestimate state revenue in Good Times and overestimate it in Bad Times.[25] Since the state does not have the latitude enjoyed by the federal government for deficit spending, it must do what prudent households do to meet emergencies: save during good times. California has had budget crises in the early 1980s, the early 1990s, and the early 2000s, each one coincident with a general recession. So a reasonable expectation is that there will be downturns approximately once a decade.

The recession of the early 1980s was severe both nationally and in California. The recession of the early 1990s was mild nationally but severe in California due to the decline of defense spending and its impact on the state's once great aerospace sector. However, the recession of the early 2000s was not severe and yet a budget crisis developed. Evidently, the rainy-day set-aside that the state had available was not sufficient. Why was that?

As Chart 3 shows, General Fund expenditures reached historically high levels relative to state personal income by the peak of the business cycle of the late 1990s. And as Chart 1 has already demonstrated, regardless of the treatment of state electricity spending, the General Fund was already in deficit at that point. That meant that any economic downturn was bound to turn into a budgetary crisis. But to understand the problem in more depth, it is necessary to examine the institutions of the California state budget and budgetary history in the 1990s.

Enactment of the California State Budget

California operates on an annual budget cycle with fiscal years beginning July 1. The first key event in the fiscal cycle is the presentation of the Governor's proposed budget to the Legislature for the following fiscal year in early January. In May, the Governor returns with a revised budget that takes account of more recent data and projections. The Assembly and the Senate typically produce their own budgets, certainly based on the Governor's revised proposal, but with variations in each house. These two budgets are supposed to be reconciled, passed, and sent to the Governor before the end of the current fiscal year (June 30). The Governor has authority to veto particular expenditures, a process that occurs shortly after the budget is adopted by the Legislature. Various other corrections and adjustments are enacted in the fall.

However, there are no real penalties for not enacting the budget on time. California is one of three states requiring a two-thirds majority vote in the Legislature to pass a budget. Thus, in years such as 2001 and 2002, when there are budgetary problems, budget enactment is often delayed beyond the legal deadlines. California's State Controller, as the result of litigation and legal constraints, continues to pay state employees – except legislative employees – and to fund many programs.[26] The most immediate impact is felt by contractors to the state and certain local government programs whose payments are deferred until a budget is approved.

As time passes without a budget, a larger and larger circle of individuals and institutions become affected. Thus, by mid-August 2002, concerns were being expressed about possible delays in scholarship grants for low-income college students and payments to certain elderly, blind, and disabled individuals who are eligible for renter and homeowner assistance. Some jurors did not receive their meager daily allowances. Of course, news accounts about such unfortunate outcomes of budgetary stalemate put pressure on legislators to enact a budget.

Because legislative approval of the budget requires a two-thirds majority vote, even the current Democratic domination of both the Assembly and the Senate is insufficient to produce a budget, even on a party line vote. In the past, budgets have been enacted by picking off a few needed votes through offering deals to individual Republicans. That process worked in the Senate in 2002, where only one maverick Republican vote was needed.[27] However, passage in summer 2002 proved more difficult in the Assembly due to the coincidence of a greater perceived budget problem facing the state and the reality of a political year.[28] The Assembly did not adopt a budget until the end of August after a threat by the Governor to call a special session if the Legislature adjourned without a budget agreement.

Whenever a budget is finally enacted, it is within the discretion of the Legislature and Governor to modify it in mid-course. Perceived budget "shortfalls" or other developments can lead to such modifications. And, in any event, the actual budget after the fact will be different from the original plan since – as noted - both revenues and expenditures are subject to forecasting uncertainty and error.

Perhaps the best illustration of the uncertainties surrounding budget forecasting is the history of estimates for what the General Fund's "reserve" would be as of June 30, 2002, the end of fiscal 2001-02. The "reserve" in theory is a balance "left over" in the fund and should be the sum of all past revenues and "transfers" into the fund minus all past expenditures. Legislators treat the "reserve" as if it were money in the bank – a demand deposit - although as the history of the electricity debacle makes clear (see above), the money may not be sitting there in cash. You cannot write a check on someone's IOU for electricity without doing some borrowing. In any event, even apart from electricity issues, it is not clear that the reserve corresponds to anything resembling a demand deposit. Thus, use of it as a target is a questionable approach to budgeting.

Despite such questions, Table 2 shows the estimate of what would be in the "reserve" at various points in time as the 2001-02 budget was first planned and then implemented. The estimates over a period of a year and a half varied from +3.4 billion to -$3.7 billion. Given the magnitude of the budget, the most recent estimate on the table is essentially zero. Yet we also know from the short-term borrowing needs of the state that real cash – not a phantom "reserve" - was needed to pay bills in fiscal 2001-02.

Cash Statement

Because the meaning of the reserve is open to question, an alternative view is presented on Chart 4. On an annual basis, the State Controller prepares a report showing the actual receipts to, and disbursements from, the General Fund. As the chart shows, large deficits appeared in fiscal years 2000-01 and 2001-02. Exactly how these figures can be reconciled with the accrual accounting implicit in the official budget data is unclear. Nonetheless, the difficult financial position of the state is evident from the cash statements. In particular, during fiscal 2001-02, the $13.8 billion cash deficit was financed by drawing down other funds and borrowing $7.5 billion against the next fiscal year in revenue anticipation warrants.

The Controller reported having another $10 billion available in "borrowable resources" from other state funds. Even so, if the deficit was to continue at a $14 billion annual rate, the state would exhaust all resources before the end of 2002-03. Of course, as long as the outside credit market is willing to roll over existing loans and lend more money, the drain could continue. And successful floating of the long-delayed electricity bond will help. However, as noted, lenders are likely to become increasingly nervous about state fiscal affairs absent a turnaround in the state's condition.

Structure of the State Budget

The major focus in budgetary deliberations is the General Fund which accounts for about 80% of expenditures in the overall state budget. However, the state has various other funds for special purposes. Revenue in such special funds may be earmarked for particular uses. However, there remains a certain degree of fungibility between the different state funds. In various ways, money can be diverted from special purpose funds into the General Fund. It is possible, for example, simply not to spend monies in a special fund and for the General Fund then to borrow the resulting accrued balance. Some of the largest funds are linked to highways and transportation, beverage container recycling, and various physical and mental health functions. But the special funds run from A to Z (or at least Y), from the Abandoned Watercraft Abatement Fund to the Youth Pilot Program Fund.

Because of the ability to move monies across funds, it is best to present the state budget both in terms of the General Fund and the all-fund total, as shown on Charts 5A and 5B.[29] However, even done his way, the budget presentation can be misleading since some state agencies may generate revenues outside the state budget. The University of California, for example, receives revenues from student fees, contracts for research, hospital services, etc. In certain cases, budget presentations include some of these outside sources of income, leaving it to the reader to determine elsewhere in the documentation what in fact was the state allocation.[30]

As Chart 5A shows, education is the single largest category of general fund expenditure. The prominence of K-12 is due in part to the passage of Proposition 13 in 1978, a ballot initiative that substantially and permanently reduced property tax revenue. In doing so, it cut off a major source of school support and the state stepped in to compensate (partially) for the lost property tax revenue. With that budgetary realignment came a shift in the locus of control of the school systems, with Sacramento playing a larger role than before. As the old saying goes, he who pays the piper calls the tune. However, the voters were not willing to trust the state to spend "enough" on education. Proposition 98, passed by the electorate in 1988, mandated a complex formula determining a minimum share of general fund support that must go to K-14.

Prop 98 also limited the degree to which a downward shift in the General Fund will be "shared" by K-14. Prop 98 combined with Prop 13, which moved the state and local tax base toward income, profit, and sales taxes, and making the revenue base more subject to recessions and booms, an interesting dynamic was created.[31] Booms tend to create budget surpluses; busts create deficits. While this tendency was always present to a degree, reliance on a tax base that is very sensitive to the business cycle - in the face of expenditures that are not - is a potential problem. As noted, that problem can only be handled by maintaining a substantial rainy-day fund to compensate for the business cycle.

There are other elements of the general fund beyond K-14 that are mandated by the federal government or that are determined by forces external to the budgetary process. For example, the cost of corrections is importantly a function of the number of prisoners and, therefore, on the crime rate. With K-14 under a strong mandate and other elements of spending either mandated or determined by outside forces, budgetary discretion is limited. Although "prisons vs. higher education" is an exaggeration of this problem, the notion that an expansion of one element of the budget would have to squeeze another has some validity, particularly when overall revenues are limited.

On a total expenditure basis, K-12 takes about a third of the state budget as shown on Chart 5B. The larger presence of business, transportation, and housing and of resources and environment in total spending reflects the use of special funds and bond funds to finance activities in those areas. Such activities are more susceptible to distinct user fees and taxes.

State Demographic Trends

California government budget priorities, state and local, will inevitably reflect the state's changing demographics. Population projections suggest that by 2010, California will have over 40 million residents, up from about 35½ million in 2002. Net in-migration runs at roughly 200,000 persons per annum from the rest of the U.S. and from abroad. These numbers alone create demands on infrastructure for transportation, water, education, and other services.

Moreover, the composition of California's population growth suggests pressure on public services. The 2000 Census reported that almost 40% of California's residents spoke a language other than English at home and of those about half reported that they spoke English less than "very well." About a fourth of the population was foreign-born and of those over 60% were non-citizens. Over a third of the foreign born had arrived in the 1990s, i.e., recently.

California's income distribution has tended to be more polarized than that of the U.S. as a whole, a characteristic that appears linked to its large immigrant population.[32] The official poverty rate in the state remains above the U.S. average. Even during the boom years 1998-2000, 14% of Californians fell below the poverty line compared to 12% for the U.S.[33] Not surprisingly, gaps in health insurance coverage tend to be larger in California than elsewhere.[34] The state's "Healthy

Families" program – with federal support – has extended wider coverage to children of working poor families. But further outreach is costly and competes with other budget items.

Economists tend to view education as a key instrument, albeit a long-term one, for alleviating poverty and fostering economic advancement. As Chart 6 shows, the K-12 system in California has exhibited dramatic demographic change, especially the rapid growth of Hispanic enrollment. These changes have posed challenges to the school systems of the state. Tensions have arisen around such issues as bilingual education. But more generally, there is widespread concern with education as a political issue, as the electorate's willingness to pass Prop 98 in the 1980s and the growth in per-pupil spending in the 1990s demonstrates. Nonetheless, dissatisfaction with K-12 performance remains a voter concern. And the per-pupil spending gap between California and the U.S. that opened up after Prop 13 was passed has not been closed.

Higher education enrollments in the 1990s in California with its three public systems – the University of California campuses, the California State University system, and the community colleges – remained largely unchanged. However, in the 2000s, enrollments are projected to increase rapidly reflecting the so-called echo of the baby boom. Undergraduate enrollments are projected to rise 29% during 2000-2010. Graduate enrollments are expected to rise by 16%.[35]

The demographic trends in California suggest increased demand for state and local government services. But survey evidence collected during the late 1990s economic boom suggests public reservations about the efficacy with which public money is spent. Over half of respondents to one poll indicated they felt the state wastes "a lot" of its funds.[36] Because of the growth in tax revenue from stock options, capital gains, and income and consumption activities, this skepticism did not have an immediate impact on state fiscal policy. At the peak in 2000-01, taxes on stock options and capital gains provided a startling 22% of General Fund revenue. But the stock market is a volatile source of funds and such revenue windfalls are not likely to recur in the foreseeable future. Now that budgets will be much more constrained, the undercurrent of public skepticism is likely to be more strongly felt. The ultimate unwillingness of the Legislature explicitly to raise taxes in summer 2002 is one indication of that constraint.

Recommendations: Restoring Trust

The issue of trust and public skepticism is important; and it underscores the need for transparency and user-friendliness in budget accounting. We do not here offer solutions for the state's infrastructure and social needs. But we do suggest that fuzzy accounting and elastic budget methodology and definitions contribute to public distrust of politicians and policy makers. California is surely not the only state whose accounting practices could be improved. But thanks to the progressive reforms of a century ago, it is a state in which "direct democracy" plays an important role in governance. When state spending suddenly expanded relative to personal income, voters enacted Prop 13 and other limits on budgetary practices. When they felt education was being shortchanged, they passed Prop 98. But the difficulty with fiscal policy by referendum is that the choices are reduced to yes or no. Elements of compromise, adjustment, and flexibility are lost.

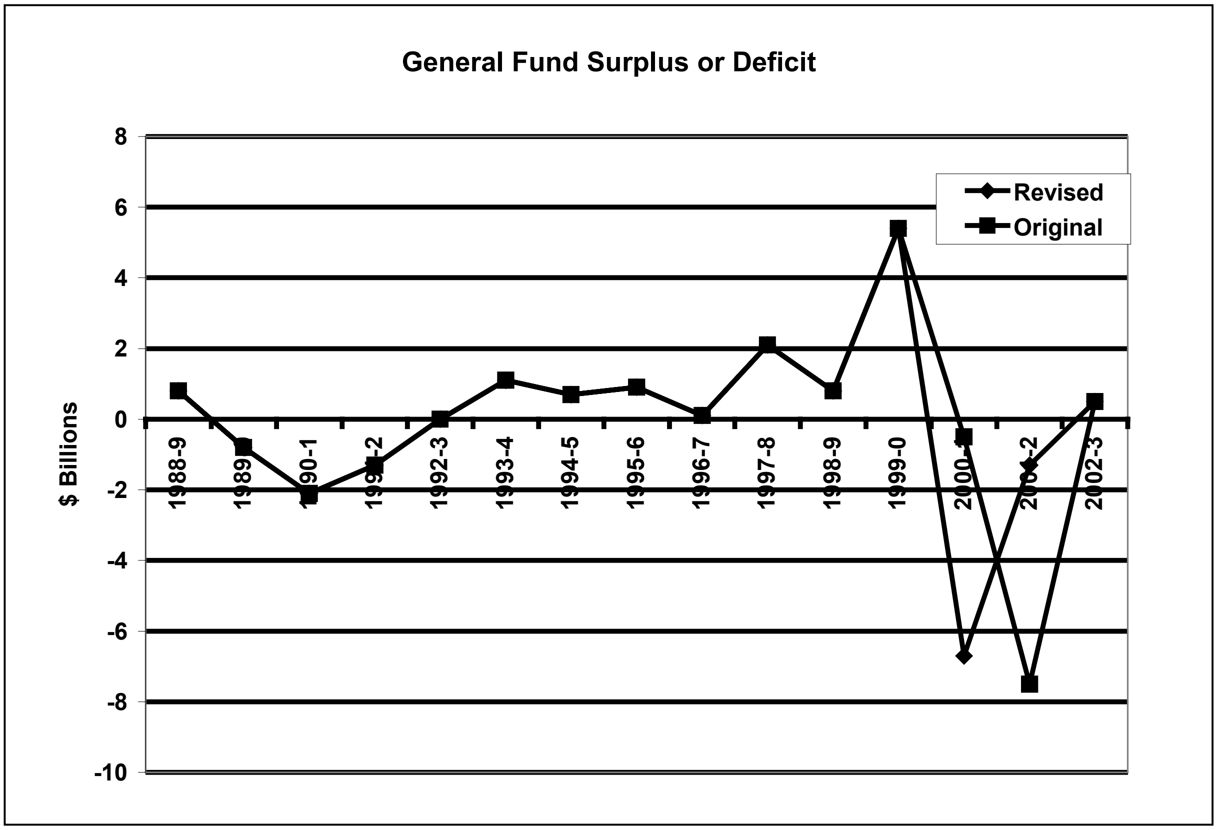
As we noted in the previous edition of California Policy Options, good accounting practices should include not confusing stocks and flows. Words such as surpluses and deficits should refer only to annual flows. If revenues exceed expenditures in a year, then that is a surplus. The opposite is a deficit. Borrowing should not be depicted as revenue. Fuzzy combinations of stocks and flows over multiyear periods, e.g., the $23.6 billion “shortfall,” simply confuse the public. Similarly, comparisons of forecast and actual revenue should make clear when the reported forecasts were made and whether the forecasts have been adjusted as new information became available.

As in corporate accounting, there are reasonable variations in methodology that can be applied. But it is important that the same methodology be used from year to year. Electricity spending, for example, cannot be non-existent in one year and a negative revenue transfer in the next. Of course, methodology can be changed with good reason. But when it is done, accounts should clearly show the changes made and provide a time series under the old rules and the new.

Given the large $13.8 billion cash deficit in fiscal year 2001-02, the need to respond in the short term will be great. Even in passing the budget for 2002-03, the Legislature left it to the Governor to make unspecified cuts that it could not itself itemize. And in the longer term, the state faces fiscal stress – a structural deficit - tied to demographic changes and population increases without the earlier revenue windfall of capital gains taxes on stocks and stock options.

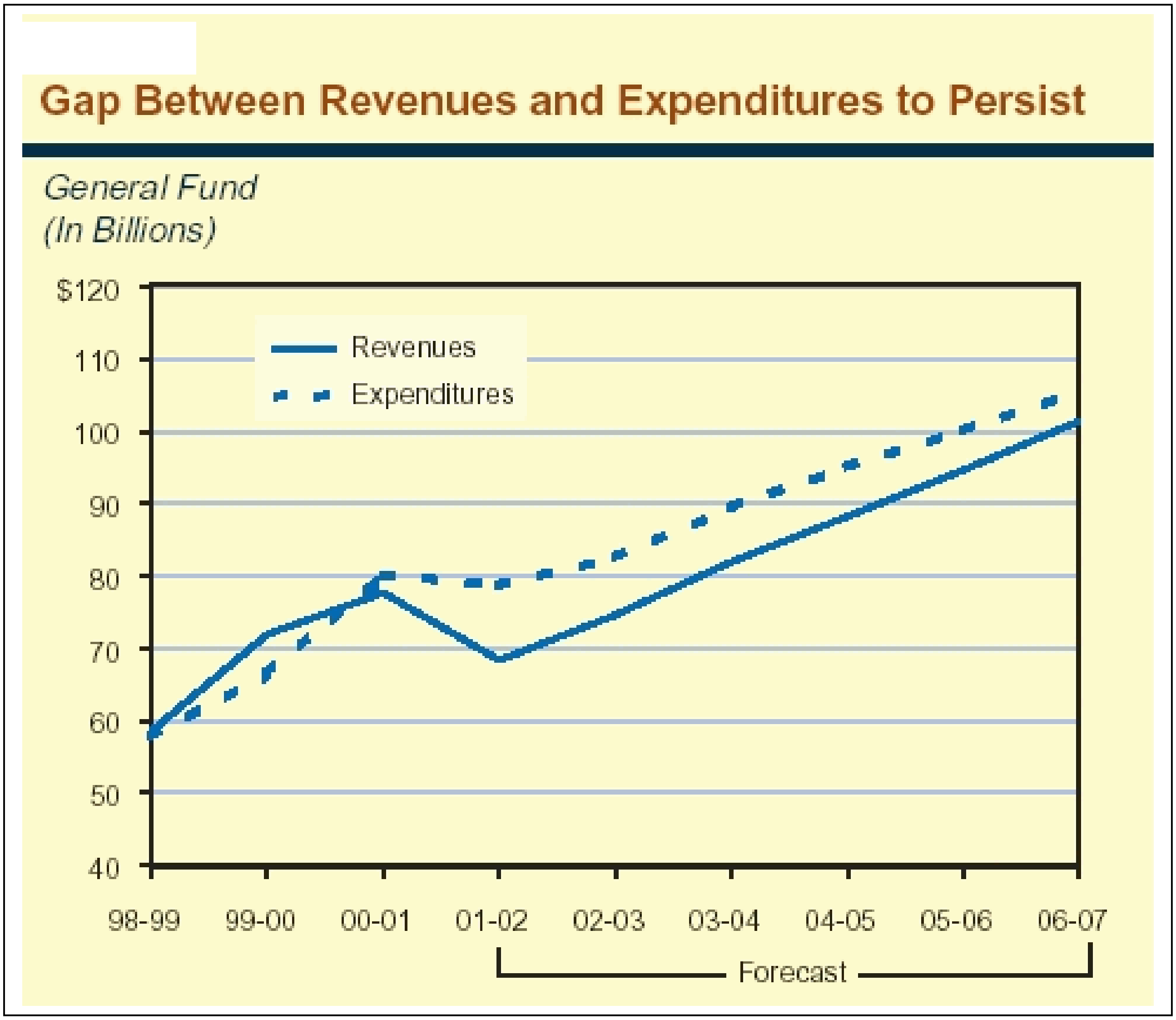
Finally, the state needs an adequate rainy-day fund built up during Good Times. The Legislature can adopt policies to see that one is accumulated during the next economic expansion, taking account of the experience of the late 1990s. If it doesn’t, we may yet see another up-or-down public referendum on fiscal policy, this time to require a specified rainy-day fund by formula.

CHART 1



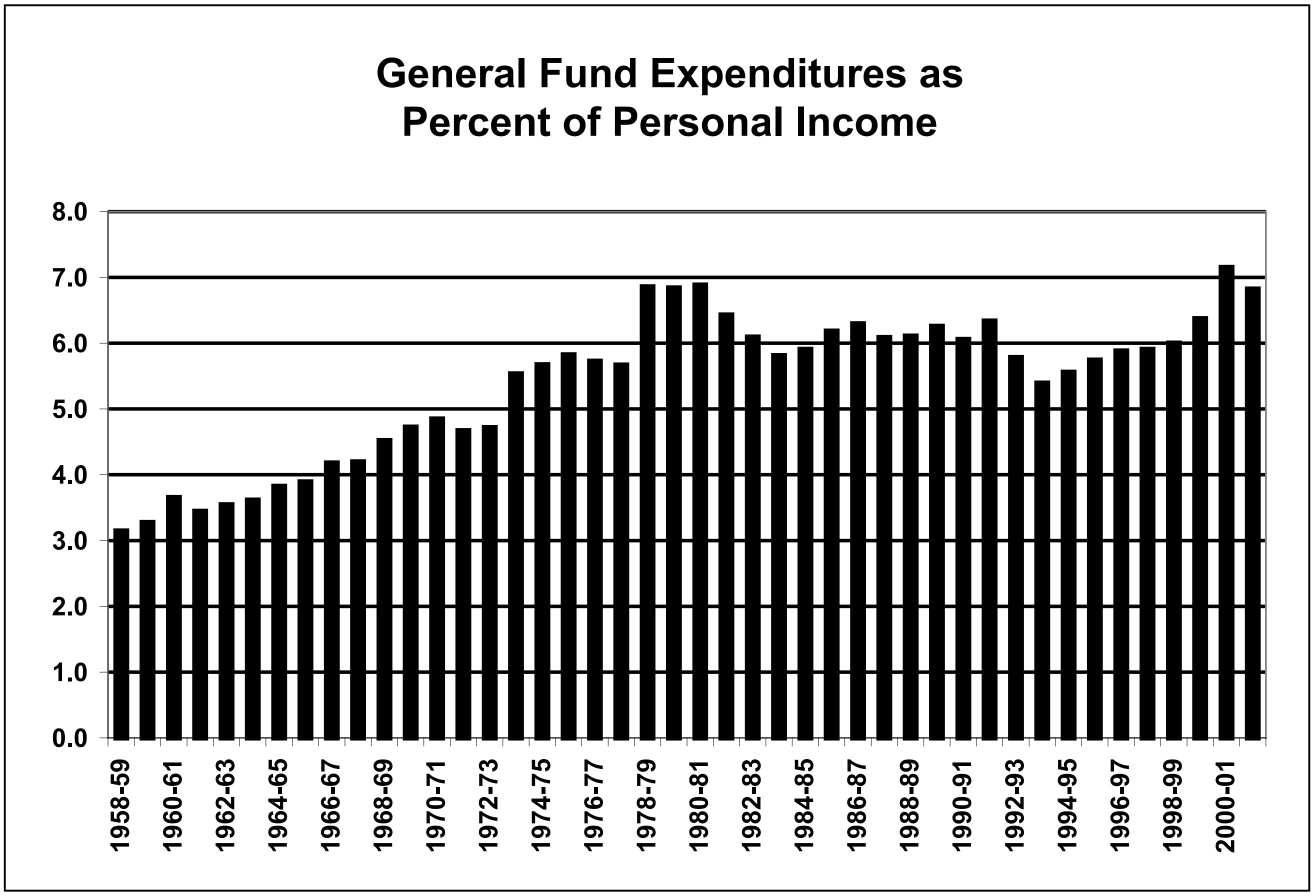
Source: Data from the Department of Finance website: www.dof.ca.gov. Estimates are as of the January 2002 budget presentation. Recent figures are projections.

CHART 2



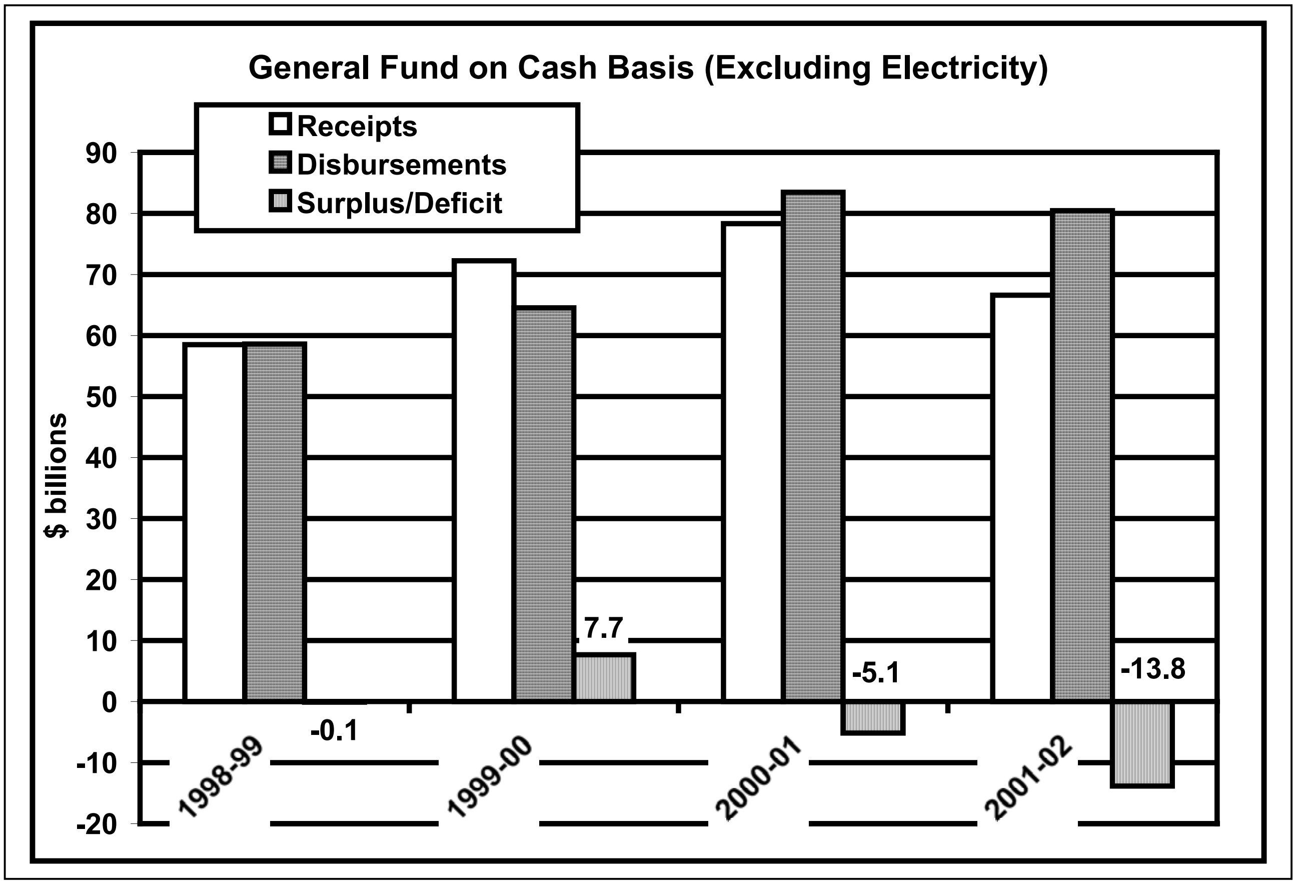
Source: Reproduced from Legislative Analyst's Office, California's Fiscal Outlook: 2001-02 Through 2006-07, November 2001, p. 4. Available on the web at www.lao.ca.gov.

CHART 3



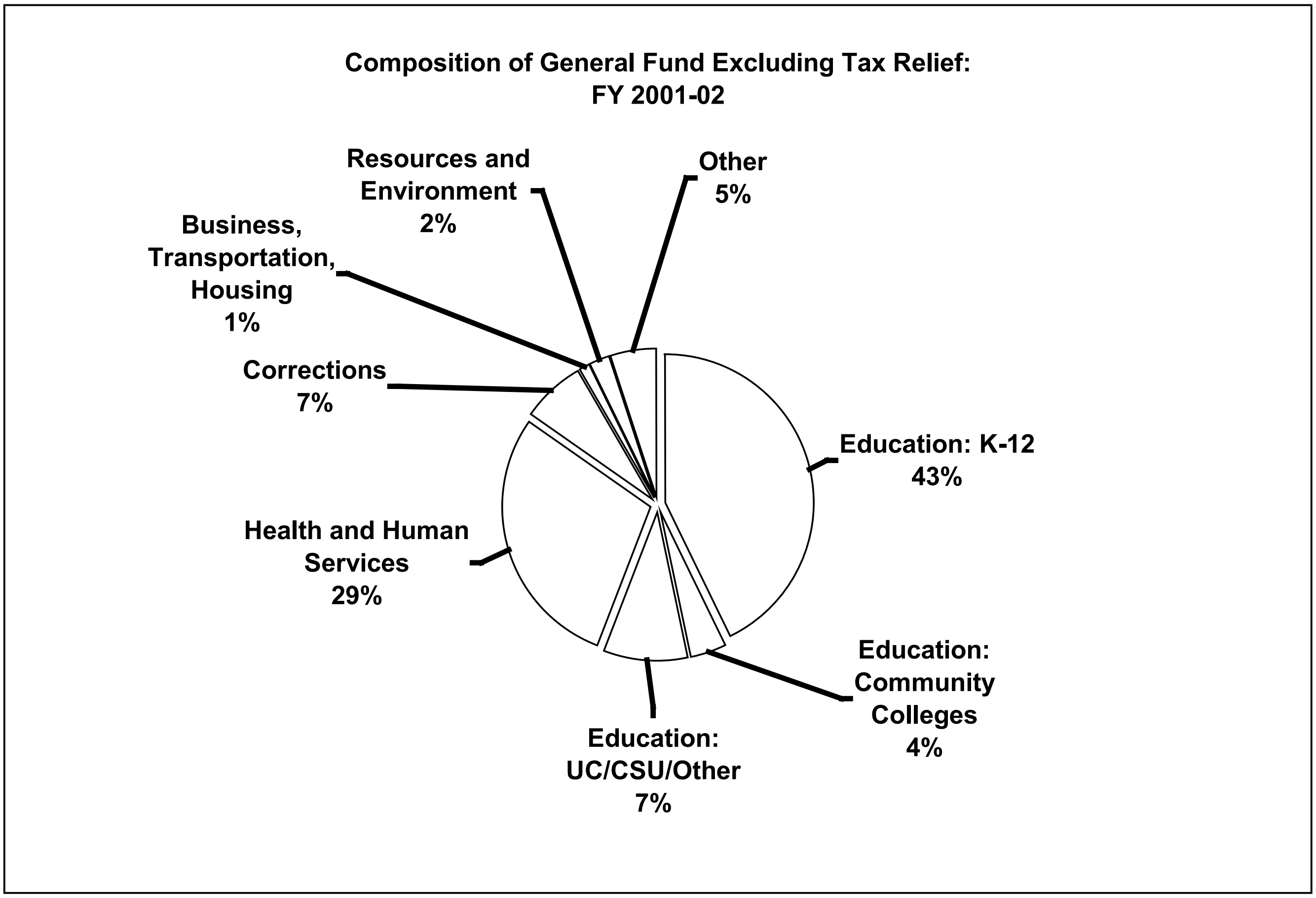
Source: Data from the California Department of Finance; U.S. Bureau of Economic Analysis; UCLA Anderson Business Forecast. Final year based on preliminary data.

CHART 4



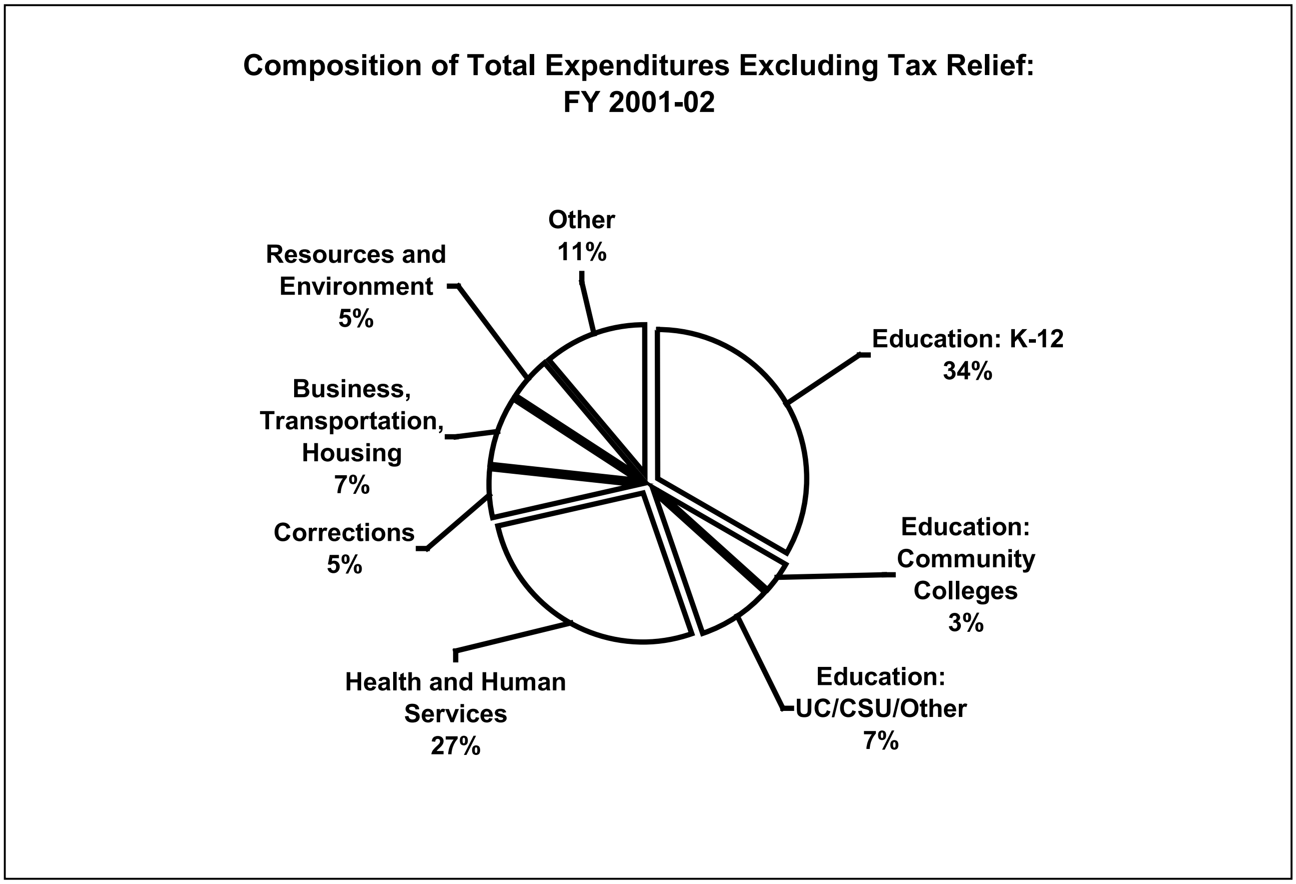
Source: Data from annual reports of the State Controller, available at www.sco.ca.gov.

CHART 5A



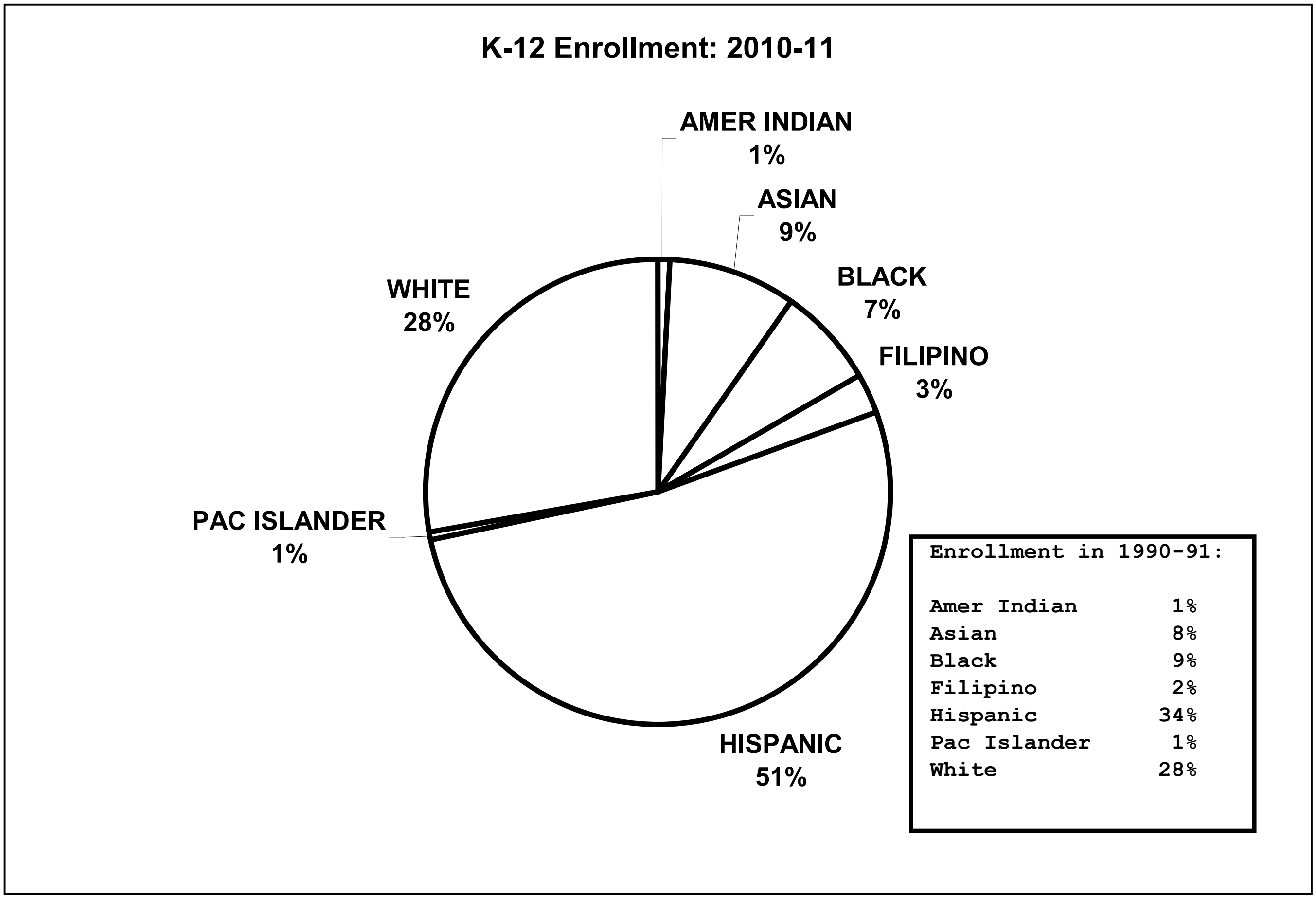
Source: Estimated from various state budget documents. Exclusion of tax relief slightly reduces percentage of "other" category.

CHART 5B



Note: See footnote, Chart 4A.

CHART 6



Source: Department of Finance, California Public K-12 Enrollment Projections by Ethnicity, 2001 Series, October 2001. Available at www.dof.ca.gov.

TABLE 1A:
Actual and Forecast General Fund Revenues as They Appeared in the Final Department of Finance Monthly Bulletin for Fiscal Year 2001-02: $ millions

Tax or Source	Actual	Forecast	Percent Difference
Personal Income	$33,333	$33,721	-1.2%
Sales and Use	21,538	21,752	-1.0
Corporation	5,080	5,052	+0.6
Insurance	1,591	1,656	-3.9
Estate	1,000	1,019	-1.9
Alcohol	291	289	+0.7
Tobacco	124	124	0.0
Other*	1,586	1,580	+0.4
Total	$64,543	$65,193	-1.0%

*Pooled money interest, horse racing, motor vehicle, other.

TABLE 1B:
Actual and Forecast General Fund Revenues
With Forecast Taken from Original Enacted Budget for Fiscal Year 2001-02: $ millions

Tax or Source	Actual	Forecast	Percent Difference
Personal Income	$33,333	$42,144	-20.9%
Sales and Use	21,538	21,949	-1.9
Corporation	5,080	5,938	-14.4
Insurance	1,591	1,452	+9.6
Estate	1,000	922	+8.5
Alcohol	291	291	0.0
Tobacco	124	125	-0.8
Other*	1,586	2,284	-30.6
Total	$64,543	$75,105	-14.1%

*See footnote, Table 1A.

TABLE 2:
General Fund "Reserve" as of June 30, 2002
as Estimated at Various Points in Time:$ billions

Initial Governor's Proposal for 2001-02 Fiscal Year, January 2001	$3.138
Governor's Revised Proposal for 2001-02 Fiscal Year, May 2001	1.811
Senate Proposal, June 2001	3.240
Assembly Proposal, June 2001	2.583
Conference Version,	3.004
Governor's "Final" Budget, July 2001	3.397
Legislative Analyst's Estimate, September 2001	3.397
Legislative Analyst's Estimate, November 2001	-3.718
Governor's Budget Proposal, January 2002	1.486
Governor's Revised Budget Proposal, May 2002	-0.123
Legislative Proposal Awaiting Final Action, June 2002	0.113
Governor's "Final" Budget, September 2002	0.072

Note: Versions and proposal beginning November 2001 refer primarily to the 2002-03 fiscal year but include estimates for the 2001-02 fiscal year including the reserve as of June 30, 2002.

Endnotes

[1] An earlier version of this paper was presented at a conference on "Fiscal Policy and Administration in Challenging Times" of the Association for Budgeting and Financial Management, Kansas City, Mo., October 10-12, 2002. All information contained in this chapter is as of early October 2002.

[2] Indeed, such pressures can extend beyond budgetary information. In the mid-1990s, there were complaints about inflation, sluggish real wage growth, lagging productivity, and reports of future deficits in the Social Security system. Changes in the methodology underlying the federal Consumer Price Index were implemented which seemingly improved all of these indicators, at least as officially measured. Lower measured inflation and higher productivity growth provided a rationale for easier monetary policy by the Federal Reserve. Why tighten up monetary policy when inflation was low and productivity – ostensibly the product of technology and the new economy – was growing?

[3] Werner Z. Hirsch and Daniel J.B. Mitchell, "Making California's State Budget More User-Friendly and Transparent" in Daniel J.B. Mitchell, California Policy Options 2002 (Los Angeles: UCLA School of Public Policy and Social Research, 2002), pp. 20-46.

[4] The first newspaper citations of the $23.6 billion figure appeared on May 14, 2002. The search words in Nexis/Lexis were "$23.6 billion" and "California." Substituting "$24 billion" for "$23.6 billion" produced 406 citations.

[5] "Deaf to Health Fund Crisis," Los Angeles Times, August 18, 2002, p. M4.

[6] Legislative Analyst's Office, 2002-03: Overview of the Governor's Budget, January 15, 2002. Available on the LAO website: www.lao.ca.gov.

[7] Data from Legislative Analyst's Office, California's Fiscal Outlook: LAO Projections 2001-02 Through 2006-07, November 2001. Available on LAO website: www.lao.ca.gov.

[8] The Legislative Analyst issued a publication essentially devoted to explaining the state budget plan in the context of the $23.6 billion figure. Of course, it is possible to analyze the budget in that context, just as it was possible for the position of the planets to be explained by epicycles and an Earth-centered system in ancient times. But just as the epicycle format was confusing when compared with the simpler Sun-centered solar system, so, too, is it difficult to explain the budget plan in the context of the $23.6 billion "shortfall" compared with a transparent approach. See Legislative Analyst's Office, California Spending Plan 2002-03: The Budget and Related Legislation, September 2002. Available on www.lao.ca.gov.

[9] See Office of the Governor, Proposed Reduction in 2001-02 Spending, November 2001. Available on the Department of Finance website: www.dof.ca.gov.

[10] The pension deferral was dropped in the Governor's May revision, although pension fund trustees were amenable. Part of the reason for their willingness to go along with the idea was that a relatively high interest rate would have been paid by the state. The interest cost may have been a factor in the dropping of the proposal.

[11] For example, $50 million of a $95 million appropriation from the General Fund to the University of California for a science institute was to be financed by lease revenue bonds.

[12] The Bush administration gave permission to California to expand its "Healthy Families" program that provides health insurance to children of the working poor. The information was apparently leaked to Riordan. Due to the budgetary impact, Davis initially proposed delaying the expansion to July 2003, a decision Riordan termed "despicable." Megan Garvey and Charles Ornstein, "U.S. to Back State Plan to Help Insure More Poor," Los Angeles Times, January 24, 2002, pp. B1, B14.

[13] An analysis of the California electricity plan can be found in Paul L. Joskow, California's Electricity Crisis, National Bureau of Economic Research, Working Paper #8442, August 2001.

[14] In areas of the world where electricity supply is unreliable, consumers must purchase and maintain costly auxiliary generators if they want to have power on demand.

[15] The official offering documents for the electricity bond issue became available in October 2002 and can be found on www.treasurer.ca.gov. Although funded through a surcharge on electric bills, the offering did not receive top ratings from bond rating services. Legal issues related to the PG&E bankruptcy and potential shortfalls in surcharge revenue collection account for the risk attributed to these bonds. For example, a jump in electricity prices could affect usage and revenues. In principle, the authorities are supposed to adjust the surcharge to ensure sufficient revenue to pay off the bonds.

[16] On a much more modest scale, the Senate version of the budget following the Governor's May 2002 revision pushed about $600 million of the deficit for 2002-03 into 2001-02. See Legislative Analyst's Office, The 2002-03 Senate Budget Bill SB 1261 (Peace), May 28, 2002, p. 1. Available at www.lao.ca.gov. However, this effort was dropped when the budget was reconciled with the Assembly version.

[17] Legislative Analyst's Office, California's Fiscal Outlook: 2001-02 Through 2006-07, November 2001. Available on the web at www.lao.ca.gov.

[18] Governor Donald Siegelman quoted in Adam Nagourney, "In Sharp Change, Governors Share Woes on Budgets," New York Times, July 15, 2002, p. A11.

[19] Paul Krugman, "Our Banana Republics," New York Times, July 30, 2002, p. A23.

[20] The earlier history of these ratings can be found on the California State Treasurer's website <www.treasurer.ca.gov>. The highest Standard and Poor's and Fitch ratings are AAA followed by AA and A. Ratings from AA and below can be modified with plus or minus to show best and worst within the grade. The highest Moody's rating is Aaa followed by Aa and A. Numerical grades are added for ratings of Aa and below with 1 being the best and 3 being worst. (Separate ratings systems apply to short-term securities with maturity below one year.)

[21] Relevant sections of the state constitution are Article IV, Section 12(a), Article XIIIB, Section 5.5, and Article XVI, Section 1. The authors thank Steve Olsen for these references.

[22] In a legal quirk, the State Controller (rather than the Treasurer) issues such warrants. $7.5 billion in revenue anticipation warrants were issued by the Controller in mid-June 2002 to be repaid during the following October-January.

[23] For example, the Legislative Analyst noted in August 2002 that House proposals for welfare reform could cost California $2.2 billion over a five-year period while the Senate version could save the state $140 million over the same period. Legislative Analyst's Office, Fiscal Effect on California: Congressional Welfare Reform Reauthorization Proposals, August 29, 2001. Available on the web at www.lao.ca.gov.

[24] To improve accuracy of official forecasting, and to make forecasting feasible for outside observers, it is necessary to have accurate historical data. Although past data on revenues and expenditures do exist, as noted in our previous article, there appear to be deficiencies in the historical series. Final corrections and adjustments in the data may not be reflected in earlier information.

[25] The systematic under- and overestimation extends to the net budget surplus or deficit.

[26] The California Supreme Court agreed to review a lower court ruling that would limit state government employees' salary payments to the federal minimum wage until a budget was approved. Once the budget passed, the issue was moot, at least for 2002-03.

[27] Construction of a new veteran's home was reportedly included in the budget for the hometown of the renegade Republican senator in 2002. See Julie Tamaki, "Senator Pays Price for Defying GOP," Los Angeles Times, August 26, 2002, available through www.latimes.com.

[28] Dropping of proposals for increased tobacco and car taxes appeared to be the lever that secured needed Republican support in the Assembly.

[29] The charts exclude "expenditures" for tax relief, contrary to official budget presentations.

[30] Thus, the Governor's January 2002 highlights budget reported University of California "funding" of $4.4 billion for 2001-02, although the General Fund allocation was about $3.5 billion as reported in the separate budget summary. Funding for the California State University system was reported as $3.7 billion, although the actual General Fund contribution was about $2.5 billion. See Office of the Governor, California Governor's Budget Highlights 2002-03, January 2002, p. 19; Office of the Governor, California Governor's Budget Summary 2002-03, January 2002, p. Appendix 47; both available on the web: www.dof.ca.gov.

[31] Property taxes are assessed on asset values rather than on incomes or other flows and so tend to be relatively stable. In addition, as actually practiced before Prop 13, property tax assessments tended to lag market values. So even a fall in asset values might not reduce tax collections. The Prop 13 formula is essentially one percent of the sales value with an upward limit of 2% per annum in the event of a rise in property values. Because 2% was substantially below the inflation of property values, the remainder of the property tax post-Prop 13 tends to be stable. Even a fall in property values, as occurred in the early 1990s, may not drop official valuations since market prices may remain above them.

[32] Deborah Reed, California's Rising Income Inequality: Causes and Concerns (San Francisco: Public Policy Institute of California, 1999).

[33] U.S. Bureau of the Census, Poverty in the United States: 2000 (Washington: GPO, 2001), Table D.

[34] E. Richard Brown et al, The State of Health Insurance in California: Findings from the 2001 California Health Interview Survey (Los Angeles: UCLA Center for Health Policy, 2002).

[35] Rand California (See http://ca.rand.org/stats/statlist.html summary for originating data source.)

[36] Public Policy Institute of California, "Casting a Long Shadow: Californians' Distrust of Government," Research Brief, September 2002.