High Risk:

The California State Auditor Has Designated the State Budget as a High-Risk Area

February 2009 Report 2008-603

CALIFORNIA STATE AUDITOR

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February 3, 2009 2008-603

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As authorized by Chapter 251, Statutes of 2004, the Bureau of State Audits (bureau) presents its report concerning its addition of the State's budget condition to its list of high-risk issues. In May 2007 the bureau published its initial assessment of the high-risk issues the State and select state agencies face. Our initial assessment identified five significant statewide risk areas and two specific state agencies facing challenges to their day-to-day and long-term operations. Based on the current fiscal crisis and a history of ongoing deficits, the bureau has added the State's budget condition to its list of high-risk issues. We believe that the record-breaking delays in passing the fiscal year 2008–09 budget, the need for subsequent special sessions focused on the budget, and the multibillion dollar budget gap lawmakers are attempting to close highlight the potential for the State's budget process and condition to add significant roadblocks to the tasks of managing and improving state and local government.

In analyzing information on budget deficits and surpluses during the last 20 years, using various methods of determining the budget condition, we found that all measures pointed to the same conclusion—the State has experienced ongoing deficits that greatly outweigh any surpluses. Although these results indicate that the State has faced a long-standing problem, we found that nearly half of the amounts related to the budget solutions implemented to resolve the shortfalls have only pushed the problem into the future. This report also identifies various factors that make it difficult for decision makers to reverse this course. Because we have designated the State's budget condition as high risk, the bureau will continue to monitor developments in this area, clarify issues when needed, and attempt to help decision makers find areas to streamline government or enhance revenues.

Respectfully submitted,

Elaine M. Howle

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Results in Brief

Based on the current fiscal crisis and a history of ongoing deficits, the Bureau of State Audits (bureau) has added the State's budget condition to its list of high-risk issues. The record-breaking delays in passing the fiscal year 2008–09 budget, the need for subsequent special sessions, and the multibillion dollar budget gap lawmakers are attempting to close highlight the potential for the State's budget process and condition to add significant roadblocks to the tasks of managing and improving state and local government. As of the publication of this report, the Legislature and the governor continue to negotiate in an attempt to address the gap in the fiscal year 2008–09 budget.

In analyzing information on budget deficits and surpluses during the last 20 years, using various methods of determining the budget condition, we found that all measures pointed to the same conclusion—the State has experienced ongoing deficits that greatly outweigh any surpluses. For example, when we examined the projected shortfalls and surpluses as of May in each of the past 20 years, we found projected budget surpluses for eight of those years, totaling about $30 billion, and projected shortfalls for 12 years, totaling $146 billion. Although these results indicate that the State has faced a long-standing problem, nearly half of the amounts related to the budget solutions implemented to resolve the shortfalls have only pushed the problem into the future. Specifically, more than 27 percent of these amounts involved increasing the State's debt and another 22 percent were related to fund shifts and transfers, accelerated revenue payments that reduce future revenues, and expenditure deferrals. These solutions cause larger budget shortfalls in subsequent years.

Some of the factors that make it difficult for decision makers to correct this course are as follows:

- Because the California Constitution requires that all state tax revenue increases be approved by the Legislature with a two-thirds majority vote, this among other factors can make it difficult for decision makers to close budget shortfalls by increasing tax revenues.

- In the last two decades, the populations served by some of the State's most significant programs have grown faster than the general population. Specifically, although the State's general population has increased by 28 percent, the number of inmates in correctional facilities has increased by 82 percent, the number of persons eligible for the California Medical Assistance

Review Highlights . . .

Our review of the State's budget condition revealed the following:

- *During the past 20 years, the State has had eight projected budget surpluses, totaling about $30 billion, and 12 projected budget shortfalls, totaling $146 billion.*
- *Solutions to budget shortfalls, such as increasing the State's debt, fund shifts and transfers, accelerating revenue payments, or deferring expenditures, have pushed budget problems into the future.*
- *The populations of the State's prisons, medical assistance programs, and K-12 schools have grown faster than the State's general population. This has caused General Fund expenditures to increase at a greater rate than the combined rate of inflation and general population growth.*
- *Voter-approved ballot measures have added programs and projects but lacked specified funding sources. Instead, these programs and projects are often financed with bonds. In the last 10 years, voters have approved roughly $105 billion in bonds that could cost the State $98 billion in interest.*
- *Because of various legal, political, business, and humanitarian considerations, state lawmakers cannot easily reduce expenditures in response to revenue swings coming from the State's volatile revenue structure.*

Program has grown by 90 percent, and there are 32 percent more school-age children. This disproportionate growth has caused increases in the State's General Fund expenditures to outpace the combined rate of inflation and general population growth.

- Voters have approved ballot measures that add programs and projects but do not identify specific funding sources. Instead, these programs and projects are often financed with bonds that must be repaid over time from the General Fund. In the last 10 years, voters have approved roughly $105 billion in general obligation bonds. In addition to repaying the principal, the State could pay as much as $98 billion in interest on these bonds.

- The State's revenue structure, which depends to a large degree on personal income taxes, is very sensitive to changes in the economy. As a result, decision makers tend to be constantly reacting to boom and bust cycles of the economy.

- Because of various legal, political, business, and humanitarian considerations, it is difficult for decision makers to reduce expenditures to a level that will eliminate the ongoing deficits. For example, nearly 41 percent of the General Fund budget relates to expenditures that are mandated by the California Constitution. Additionally, another 22 percent relates to expenditures that secure federal funding and help support an underprivileged portion of the population. Although discretionary, other expenditures, such as those in support of the State's universities, represent investments in the future of California's economy that would be difficult, if not unwise, to significantly reduce.

The combination of all these factors has created a situation in which resolving the State's budget problems will not be easy. The bureau has added the state budget to its list of high-risk areas because we recognize that it is an issue that will likely continue to affect the state government's ability to effectively carry out its mission. We will continue to monitor developments related to the state budget and will attempt to help decision makers find areas where expenses could be streamlined or revenues increased.

Introduction

Background

In May 2007 the Bureau of State Audits (bureau) published its initial assessment of the high-risk issues the State and select state agencies face. As shown in the text box, our assessment identified five significant statewide risk areas and two specific state agencies facing challenges to their day-to-day and long-term operations.

> **Statewide High-Risk Areas**
>
> - Emergency preparedness
> - Maintaining and improving infrastructure
> - Information technology
> - Management of human resources
> - Postemployment benefits of retiring state employees
>
> **State Agencies Meeting the Criteria for High Risk**
>
> - Department of Corrections and Rehabilitation
> - Department of Health Services*
>
> Source: *High Risk: The California State Auditor's Initial Assessment of High-Risk Issues the State and Select State Agencies Face*, Bureau of State Audits, May 2007, 2006-601.
>
> * Effective July 1, 2007, the Department of Health Services was reorganized and became two departments—the Department of Health Care Services and the Department of Public Health.

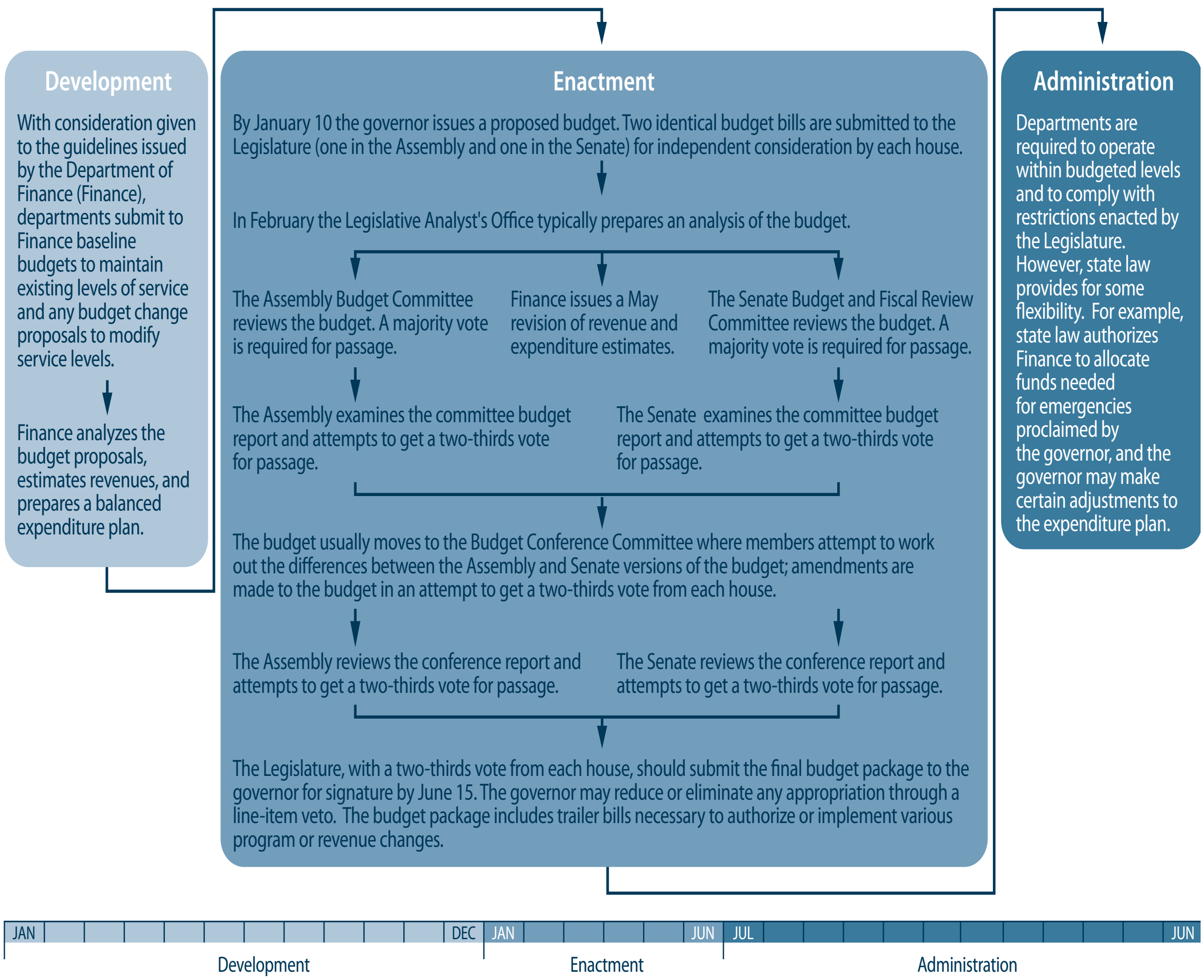
The bureau has now added the State's budget condition to the list of high-risk issues the State is facing. The record-breaking delays in passing the fiscal year 2008–09 budget, the need for subsequent special sessions focused on the budget, and the multibillion dollar budget gap lawmakers are attempting to close highlight the potential for the State's budget condition and process to add significant roadblocks to the State's efforts to improve the areas we originally identified as being at high risk, as well as many other aspects of state and local government. Consequently, under the high-risk audit program authorized by California Government Code, Section 8546.5, the bureau decided to review the State's budget process and condition to determine whether it should be added to the high-risk list. For a description of the criteria used to determine whether an issue merits a high-risk designation, see the Appendix of our May 2007 report on high-risk issues.

California's Budget Process

The entire budget process begins approximately a year and a half before the budget becomes law. The multistep process starts as early as January of the prior year, when—under the policy direction of the governor—the Department of Finance (Finance) issues guidelines for budget preparation to state agencies and departments. During the months of July through September, agencies and departments submit to Finance their baseline budgets and budget change proposals. Finance analyzes the documents, focusing on the fiscal impact of the proposals and their consistency with the policy direction of the governor. Using information available through late December, Finance estimates revenues and expenditures for the coming fiscal year and prepares a balanced expenditure plan for the governor's approval.

The California Constitution requires that the governor submit a budget package to the Legislature by January 10. The budget package consists of a budget, a budget summary, and a budget bill. The budget bill requests the spending authorization necessary to carry out the governor's expenditure plan. As indicated in Figure 1, an identical budget bill is submitted in each house of the Legislature.

Figure 1
Summary of the State Budget Process



Sources: Department of Finance, *California's Budget Process*, January 2006; *The Annual Budget Process*, July 2002; Governor's Budget for fiscal year 2002–03, *Budgetary Process*.

After the issuance of the budget package, the Legislative Analyst's Office (legislative analyst)—a nonpartisan fiscal and policy adviser to the Legislature—prepares an analysis of the budget bill, which is generally released in February. The Senate Budget and Fiscal Review Committee and the Assembly Budget Committee, which are divided into various subcommittees, then hold budget hearings.

No later than May 14, Finance submits an update of projected General Fund revenues, expenditures, and reserves based on the latest economic forecast (May Revision). The Legislature typically waits for the May Revision before making final budget decisions on major categories such as education, health and human services, and corrections. After the May Revision is released, the budget committees of the Assembly and Senate vote on their respective versions of the budget and pass them with a majority vote. Next, the budget moves to the Assembly and Senate floors for consideration by all members. The California Constitution requires each house to obtain a two-thirds vote to pass its version of the budget. Because of changes made during committee hearings or on the floor, there typically are differences between the two houses' versions of the budget. Consequently, the budgets are usually sent to the Budget Conference Committee (conference committee) to work out the differences between the Assembly and Senate versions and to amend the document in an attempt to obtain the required two-thirds majority vote.

After being revised in the conference committee, the budget bill is generally sent back to both floors for a vote. However, if the conference committee does not reach an agreement, or if one or both houses do not achieve the required majority, the "Big 5"—the governor, the speaker of the Assembly, the Senate president pro tempore, and the minority leaders of both houses—meet in order to reach a compromise. When each house passes the budget with a two-thirds majority vote, the budget is sent to the governor for signature. The California Constitution requires that this occur by midnight on June 15.

After a budget is enacted, departments have the responsibility to operate within the appropriation limits established within the budget. However, in the event that changes to the budget are needed, the Legislature has included provisions in the Budget Act to allow for budget adjustments. Most of these adjustments require Finance approval, and many require a formal notice to the Legislature and a waiting period to provide the opportunity for legislative review and response.

In addition to giving the governor the authority described in Figure 1, the California Constitution authorizes the governor to proclaim a fiscal emergency if he or she determines, after a budget is enacted, that the revenues will decline substantially below or expenditures will increase substantially above, the estimates upon which that budget was based. If the governor proclaims a fiscal emergency under this authority, he or she must call the Legislature into special session and propose legislation to address the fiscal emergency. If the Legislature does not pass and send to the governor legislation to address the fiscal emergency within 45 days of the governor's proclamation, the Legislature is prohibited from acting on any other bill or adjourning until such legislation is passed and sent to the governor. The governor has called several special sessions of this type in the past year.

Major Constitutional Provisions Affecting the State Budget

In addition to the special session provisions and the mandated dates of January 10 and June 15 that were discussed earlier, the California Constitution contains numerous provisions that affect the budget as shown in Table 1. Many of these provisions were the result of voter initiatives. The California Constitution authorizes voters to change the constitution or other state laws by enacting an initiative and allows the Legislature to modify a voter initiative only if voters approve the change or if the original initiative includes provisions allowing the Legislature to change it without further voter approval. Consequently, taxation and spending required by an initiative are beyond the immediate control of policy makers, unless the initiative provides otherwise. Moreover, voters must approve changes to the California Constitution. Consequently, changing the constitutional provisions in Table 1 is also beyond the immediate control of policy makers. Our summary of the legal provisions affecting the state budget also includes various constitutional provisions that limit local government taxation and spending, because reductions in local government revenue have resulted in additional state spending. An example of a reduction in local government revenue is the property tax cut provided by Proposition 13, which limited property tax rates to 1 percent of assessed value. As a result, the State offset a large portion of this revenue loss with short-term state aid to local governments, followed by a more permanent increase in state funding for local schools.

The General Fund Budget for Fiscal Year 2008–09

The enacted budget for fiscal year 2008–09 includes the State's General Fund appropriations of roughly $103 billion. The General Fund is the predominant fund by which the State finances its programs and is used to account for revenues, including personal income, sales, and corporation taxes, that are not specifically designated for any other fund. As Figure 2 on page 8 shows, activities related to education, health and human services, and corrections make up roughly 92 percent of the General Fund budget.

Table 1
Major Constitutional Provisions Affecting the State Budget

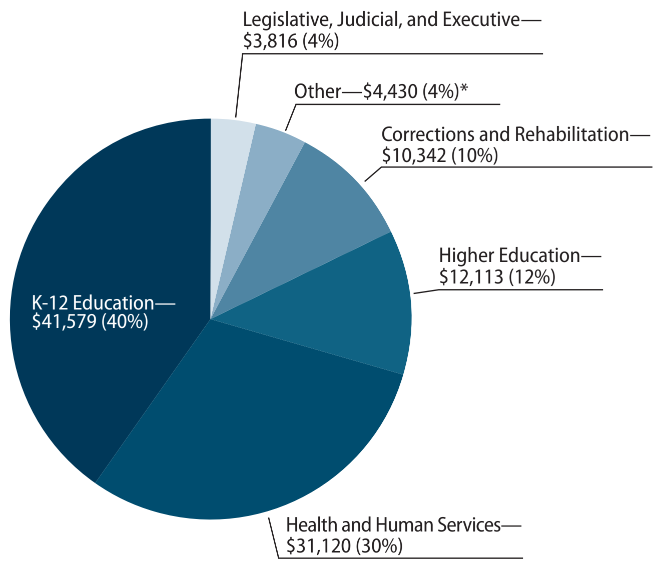
VOTER INITIATIVE	YEAR ENACTED	CITATION	SUMMARY
Constitutional Limits on Raising Revenue			
Proposition 13	1978	State Constitution (Article XIII A)	Requires a two-thirds majority vote in each house of the Legislature to increase state tax revenues. Limits property tax rates to 1 percent of assessed property value and limits annual increases in assessed value to 2 percent. Requires approval from two-thirds of local voters for any local government, special purpose tax.
Proposition 163	1992	State Constitution (Article XIII)	Prohibits new sales or use taxes on food for human consumption.
Proposition 218	1996	State Constitution (Article XIII C)	Requires approval from a majority of local voters for any local government tax other than a special purpose tax, which requires a two-thirds vote as specified above.
Constitutional Provisions Affecting Spending			
Proposition 16	1962	State Constitution (Article IV)	Requires a two-thirds vote in each house of the Legislature for General Fund appropriations, except for appropriations in support of public schools. Effectively requires a two-thirds majority vote to pass the state budget.
Proposition 5	1974	State Constitution (Article XIX)	Generally requires that vehicle and fuel taxes be used for some transportation-related purpose.
Proposition 4	1979	State Constitution (Article XIII B)	Generally prohibits state and local governments from making appropriations of tax revenue in excess of previous-year appropriations, adjusted for changes in population and cost of living. Whenever the State mandates a new program or higher level of service from local governments, the State generally must reimburse local governments for the cost involved.
Proposition 98	1988	State Constitution (Article XVI)	Requires a minimum level of funding each year for K-12 education and community colleges. Can be suspended with a two-thirds vote of the Legislature, but if suspended, school entities must eventually receive the minimum funding level required without the suspension.
Proposition 58	2004	State Constitution (Article IV)	Requires a *balanced budget* by prohibiting the enactment of a state budget that appropriates more General Fund revenue than is estimated to be received for that fiscal year. Requires the transfer of specified amounts from the General Fund to the Budget Stabilization Account, unless suspended or reduced by the governor.
Proposition 1A	2004	State Constitution (Article XIII)	Prohibits the reallocation of property tax revenue from cities, counties, and special districts to school entities. Also, prohibits the State from designating property tax revenue as reimbursement to local governments for the cost of a state mandate.
Not Applicable	1849	State Constitution (Article IV)	Requires that bills relate only to a single subject. The Department of Finance explained that, in addition to requiring the budget bill to be accompanied by numerous trailer bills that address subsidary subjects, this provision limits the governor's power to veto appropriations for certain programs in the budget because vetoes in these areas may in effect negate statutory requirements not in the budget bill itself.

Source: California Constitution.

The Rise in General Fund Expenditures

Over the last 20 years General Fund expenditures have experienced years of limited growth and years of dramatic growth. For example, the two-year increase between fiscal year 2006–07 expenditures and the fiscal year 2008–09 enacted budget was approximately $2 billion, or 2 percent. In contrast, the two-year expenditure increase between fiscal years 1998–99 and 2000–01 was roughly $21 billion, or 36 percent. Although there have been a few years in which General Fund expenditures have decreased from the previous year, the overall trend has been toward increased expenditures.

Figure 2
General Fund Budgeted Expenditures for Fiscal Year 2008–09
(Dollars in Millions)



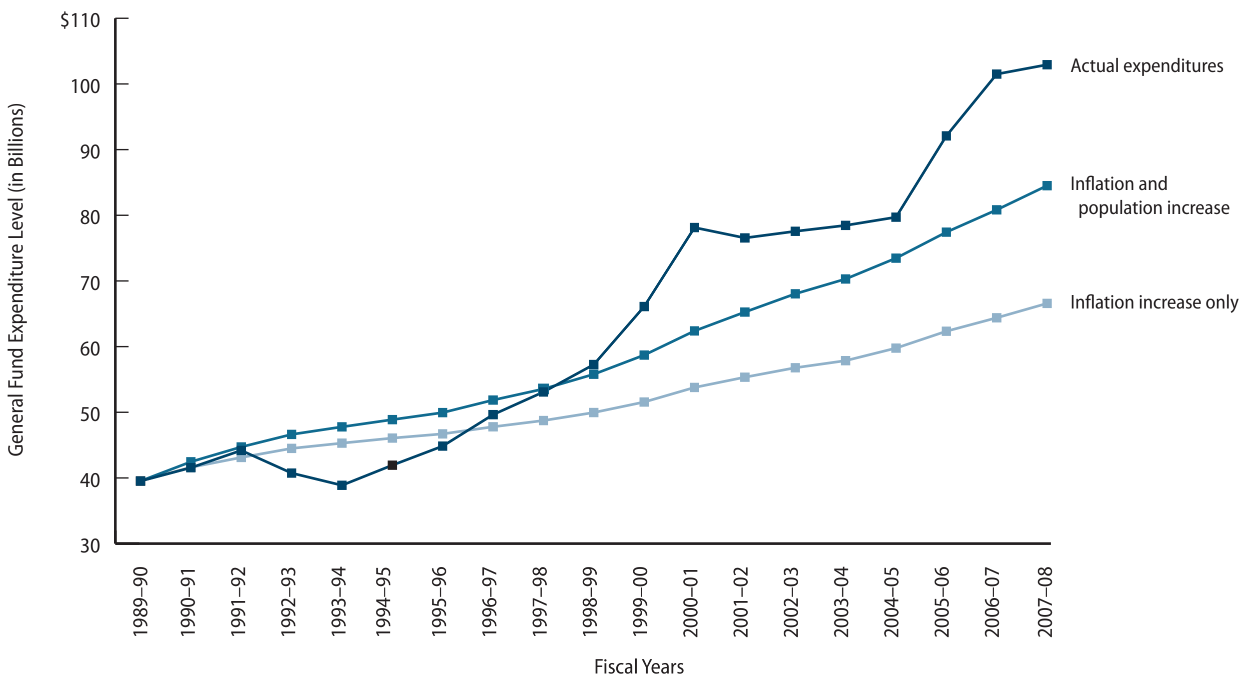
Source: Department of Finance, 2008–09 enacted budget.

* Other includes Business, Transportation and Housing; Resources; Environmental Protection; State and Consumer Services; Labor and Workforce Development; and General Government.

In the nearly two-decade span shown in Figure 3, General Fund expenditures more than doubled, from roughly $40 billion to about $103 billion. Although part of this increase is due to the effects of inflation and growth in the general population, these factors do not account for all of the increase in expenditures. For example, if General Fund expenditures had increased only at the rate of inflation, the total would have been roughly $67 billion by fiscal year 2007–08.[1] However, the growth in some segments of the population has a disproportionate effect on General Fund expenditures. In particular, certain population groups, such as inmates in state correctional facilities, persons eligible for the California Medical Assistance Program, and school-age children, traditionally require more government services paid out of the General Fund than do other groups. As we will discuss in the Analysis Results beginning on page 13, the rate at which these population segments are growing is greater than the growth rate for the general population and can explain much of the increase in General Fund expenditures over the last 20 years.

1 The yearly inflation rates used in this calculation come from the *California Consumer Price Index*, published by the Department of Finance.

Figure 3
Actual General Fund Expenditures Compared to Expenditure Levels Expected Based on Inflation and State Population Growth
Fiscal Years 1989–90 Through 2007–08

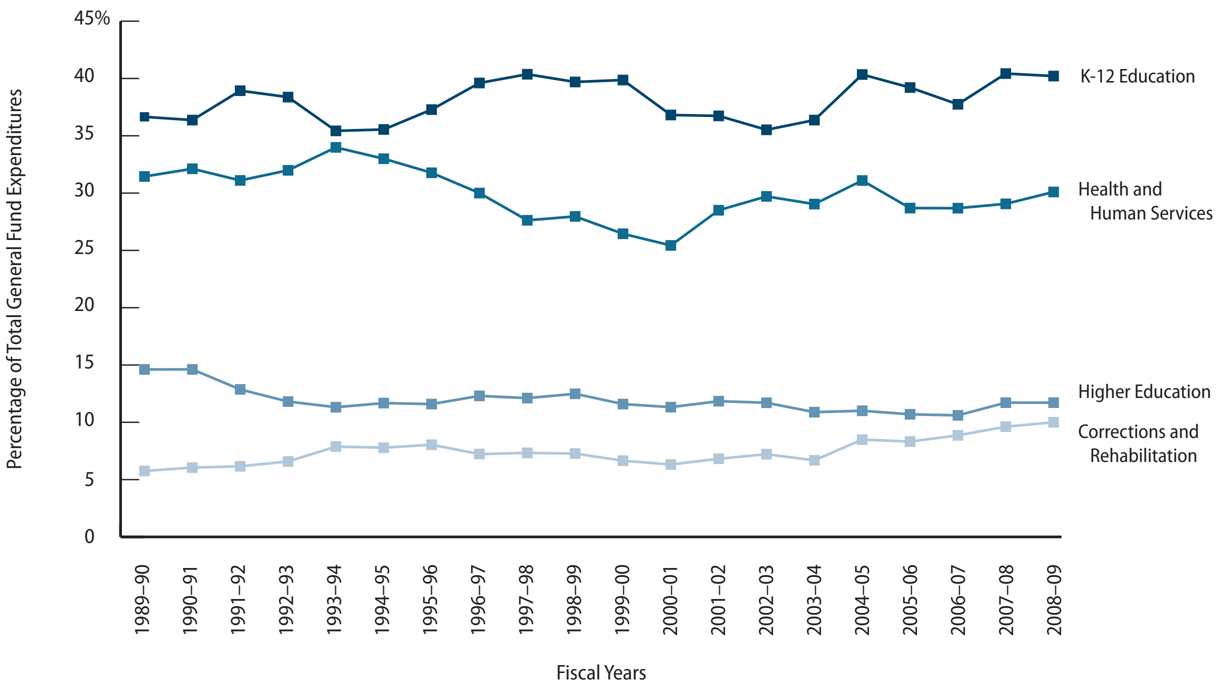


Sources: Budgetary basis information from the State Controller's comprehensive annual financial reports, reporting system, and annual reports; Department of Finance's population estimates and California Consumer Price Index.

The Distribution of General Fund Expenditures Over Time

Although General Fund expenditures have increased dramatically over the last 20 years, the distribution of these expenditures among the four major budget categories has remained relatively stable. As shown in Figure 4 on the following page, spending on K-12 education has ranged between 35 percent and slightly more than 40 percent of General Fund expenditures. Expenditures for health and human services—showing the widest swings among the four categories—have been between 25 percent and 34 percent of General Fund expenditures. Higher education expenditures from the General Fund have declined from roughly 15 percent in fiscal year 1989–90 to 12 percent in the most recent budget. Conversely, the share of General Fund expenditures devoted to the Department of Corrections and Rehabilitation has increased over time, from a low of 6 percent in fiscal year 1989–90 to a high of 10 percent in the fiscal year 2008–09 enacted budget.

Figure 4
Percentages by Fiscal Year of General Fund Expenditures for Major Budget Categories
Fiscal Years 1989–90 Through 2008–09



Sources: Budgetary basis information from the State Controller's comprehensive annual financial reports, reporting system, and annual reports; Department of Finance's enacted budget totals for fiscal years 2007–08 and 2008–09.

Scope and Methodology

California Government Code, Section 8546.5, authorizes the bureau to establish an audit program for identifying state agencies that are at high risk for potential waste, fraud, abuse, and mismanagement or that have major challenges associated with their economy, efficiency, or effectiveness. The law also authorizes the bureau to audit any state agency that it identifies as being at high risk and to publish related audit reports at least once every two years. The considerations the bureau uses for determining high risk are set forth in the Appendix to our inaugural high-risk list. (*High Risk: The California State Auditor's Initial Assessment of High-Risk Issues the State and Select State Agencies Face*, Bureau of State Audits, May 2007, 2006-601). This report adds the condition of the state budget to the initial list of high-risk areas the bureau identified.

Throughout this report we cite information provided by Finance, the legislative analyst, the State Controller's Office, and other agencies and entities. Other than confirming that the information appeared reasonable given the collection of other information in our possession, we did not perform procedures to test the reliability of the data presented. Where possible, we relied on data from financial statements and enacted budgets to perform our analysis.

In our review of the discretion lawmakers have each year over budgetary expenditures, we interviewed various subject-matter experts working for the legislative analyst. They were very helpful in identifying the major issues, critical documents, and data surrounding each of the budget areas we reviewed. We also obtained feedback on this report from professionals within Finance and the State Controller's Office.

Analysis Results

The State Faces a Major Financial Challenge

A fiscal crisis surrounding the fiscal year 2008–09 budget threatens the State's ability to meet its obligations, and financial forecasts for the future continue to paint an ominous budget picture. In the 2008–09 Governor's Budget Highlights, which was published in January 2008, the governor projected that in the absence of any changes in laws or policies, a $14.5 billion budget shortfall would exist in the State's General Fund as of June 30, 2009. Roughly $7 billion of this projected shortfall was related to an expected operating deficit for fiscal year 2007–08 that would be carried into fiscal year 2008–09 if no changes were made.

To avoid a cash shortfall in fiscal year 2007–08, and to achieve his proposed budget recovery timeline, the governor declared a fiscal emergency under the California Constitution and called the Legislature into a special session. As a result of this special session, the Legislature adopted in February 2008 budget solutions totaling almost $7.5 billion. However, more than $6 billion of this amount was related to solutions that were, as stated by the Legislative Analyst's Office (legislative analyst), "one-time in nature and, therefore, did not address the State's ongoing shortfall between revenues and expenditures."

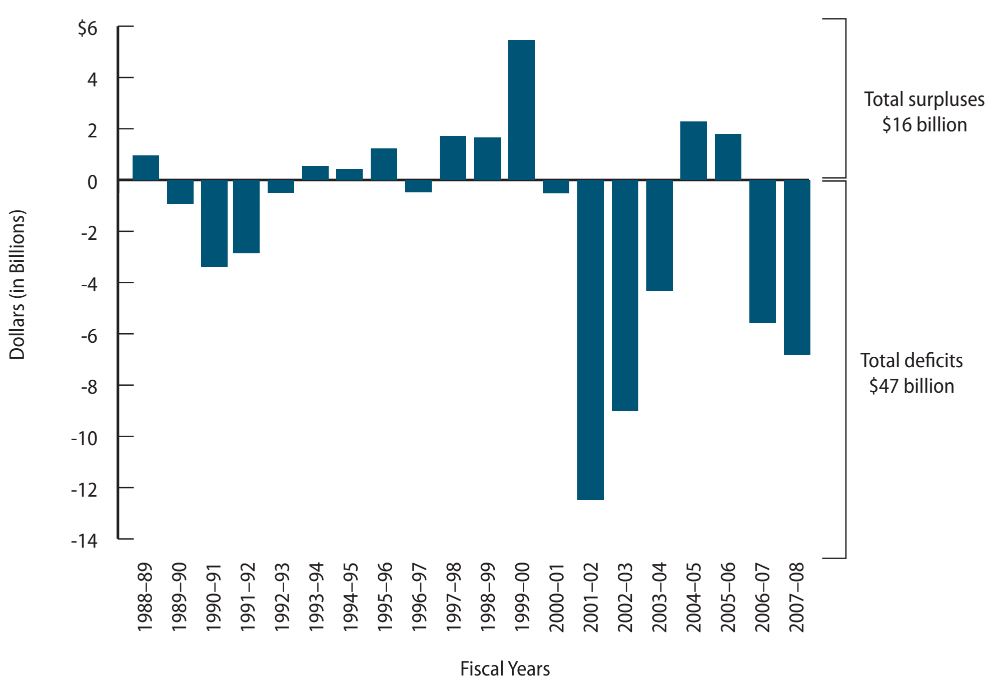
The budget solutions adopted in the February 2008 special session were more than offset by a budget outlook that had worsened by an additional $8 billion as of the May Revision. According to estimates by the legislative analyst, this was due mainly to further deterioration of economic conditions, causing a decrease in tax revenue projections. Consequently, the projected budget shortfall the Legislature was attempting to close in the summer of 2008 exceeded $15 billion.

On September 16, 2008—93 days after the constitutionally mandated deadline of June 15—the Legislature passed the fiscal year 2008–09 state budget, containing initial solutions for the predicted $15 billion shortfall. The governor signed the budget bill on September 23. Less than two months later, however, in November 2008, the governor announced that, due to a further deterioration in economic conditions, the State was facing a current year (2008–09) budget shortfall of $11.2 billion and, if no action was taken, the State would run out of the cash needed to meet its obligations in February 2009. In light of the urgency of this situation, the governor called a special session of the Legislature and proposed additional budget solutions of $4.5 billion in spending reductions and $4.7 billion in revenue increases. As of the publication date of this report, the Legislature and governor continue to negotiate in an attempt to address the gap in the fiscal year 2008–09 budget. However, unless the current shortfall is addressed, the governor's proposed budget for fiscal year 2009–10 projects a $14.8 billion deficit by the end of fiscal year 2008–09 and a $41.6 billion deficit by June 30, 2010.

Past Operating Deficits Have Outweighed Operating Surpluses, Which Has Led the State to Issue Budget-Balancing Debt

In the last 20 years, California has experienced periods in which General Fund revenues exceeded General Fund expenditures (operating surpluses) and periods in which expenditures outpaced revenues (operating deficits). Overall, however, the operating surpluses have been outweighed by the operating deficits. Specifically, the surpluses, as shown in Figure 5, total approximately $16 billion, while the deficits total roughly $47 billion. To close this gap, one method the State has used was to issue budget-balancing bonds.

Figure 5
The Differences Between General Fund Revenues and Expenditures
Fiscal Years 1988–89 Through 2007–08



Sources: Budgetary-basis information from the State Controller's comprehensive annual financial reports, reporting system, and annual reports.

The amounts in Figure 5 are the actual operating deficits and surpluses that the General Fund experienced throughout that year, or put simply, they are operating revenues minus operating expenditures for a given year. They do not include any General Fund balances carried over from the previous year. For example, the $12.5 billion gap between revenues and expenditures shown in Figure 5 for fiscal year 2001–02 was largely mitigated by an $8.5 billion General Fund balance from the previous fiscal year. However, no remaining balance was available to mitigate the next year's operating deficit, and the General Fund ended with a negative balance in fiscal year 2002–03.

The operating deficits and surpluses in Figure 5 also do not include any nonoperating sources and uses of funds, such as inflows from the budget-balancing bonds discussed in the next paragraph, which would mask the extent to which annual spending is supported by annual revenues. Finally, the amounts in Figure 5 do not reflect the budget shortfalls and surpluses that decision makers were considering during the budget-making process. In fact, as we discuss in the next section, the shortfalls decision makers were facing were much larger before various budget solutions were implemented. Even so, this year-end view of the General Fund's operating results indicates that the State faces an ongoing problem of deficits.

These imbalances became especially problematic during the economic downturn earlier this decade. In March 2004—after the State experienced three years of multibillion dollar shortfalls—voters approved Proposition 57, which authorized $15 billion in general obligation bonds to help pay off the State's accumulated budget deficit and other obligations. See the text box for a definition of general obligation bonds. In May and June of 2004, the State raised $11.3 billion through the sale of these bonds, and it sold the remaining amounts authorized in February 2008.[2] Although state law also requires that one-quarter cent of the State's sales tax revenues be diverted to pay for the debt service on these budget-balancing bonds, if the sales tax revenues are insufficient to do so in any given year, the General Fund will make up the difference. Further by diverting these sales tax revenues for this purpose, these revenues are not available for other state programs.

General Obligation Bonds

Long-term borrowing that is paid off over time using General Fund revenues. These bonds must be approved by voters, and their repayment is guaranteed by the State's general taxing power.

Source: Legislative Analyst Office's *An Overview of State Bond Debt*.

[2] The amount sold in February 2008 was $3.3 billion. The total amount issued was less than the $15 billion authorized because Finance later found that the accumulated state budget deficit was slightly less than $15 billion.

Decision Makers Grapple With Large Budget Shortfalls and Often Exceed Mandated Deadlines

In the last 20 years, lawmakers have sometimes had the luxury of deciding what to do with budget surpluses, but these surpluses have been dwarfed by the large budget shortfalls that they have had to resolve during other years. As decision makers have worked to reach a compromise, both in years of budget surplus and shortfall, they have often significantly exceeded the constitutionally mandated date of June 15 to complete their budget-related work. We compared the length of time lawmakers spent to pass a budget to the condition of the budget they were attempting to approve and did not find a statistically valid correlation between the budget delays and the projected shortfalls or surpluses involved. We did, however, find a statistically valid correlation between the lateness of passing a budget and the condition of the next year's budget. In other words, later budgets were correlated with deeper budget shortfalls in the next year, and conversely, budgets passed just slightly late were correlated with better budget conditions in the next year. This is an indication that when budgets are significantly late, compromises end up being made that push fiscal problems into the next year's budget.

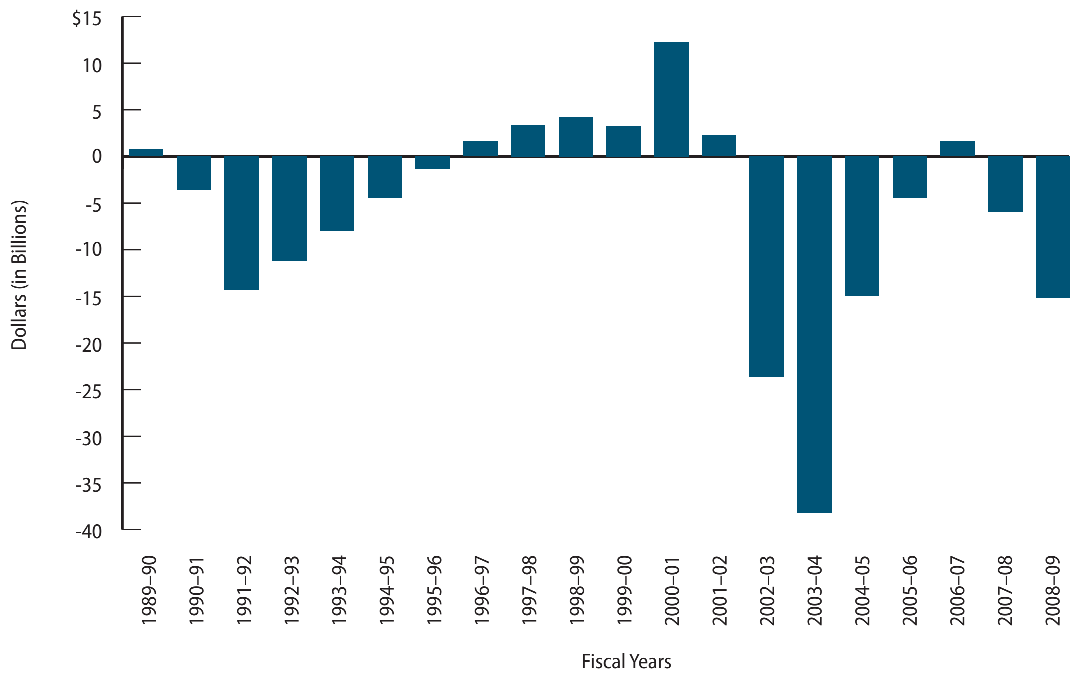
Projected Budget Shortfalls Have Been Dramatically Larger Than Any Projected Surpluses

When the budget is proposed in January of each year, the governor often identifies a General Fund budget shortfall that will occur if no changes in budgetary levels occur. The governor then proposes various ways to bring the budget into balance. As discussed in the Introduction, the Department of Finance (Finance) updates these estimates in the May Revision and the legislative analyst provides an analysis of these estimates. We examined the projected shortfalls and surpluses for the past 20 years as of the May Revision and present the results in Figure 6. Although there were years of projected surplus, overall, the projected deficits greatly outweighed these surpluses. Specifically, eight of the years had surpluses totaling about $30 billion and 12 of the years had shortfalls totaling $146 billion. In addition, the largest surplus of $12.3 billion in fiscal year 2000–01 was far outpaced by the largest shortfall of $38.2 billion in fiscal year 2003–04.

The Legislature Has Not Been Able to Meet Budget Deadlines

As discussed in the Introduction, the Legislature has until midnight on June 15 to submit a balanced budget to the governor for his or her signature. However, as Figure 7 on page 18 indicates, this date has often been significantly exceeded.

Figure 6
Projected General Fund Budget Surpluses and Shortfalls as of the May Revision
Fiscal Years 1989–90 Through 2008–09

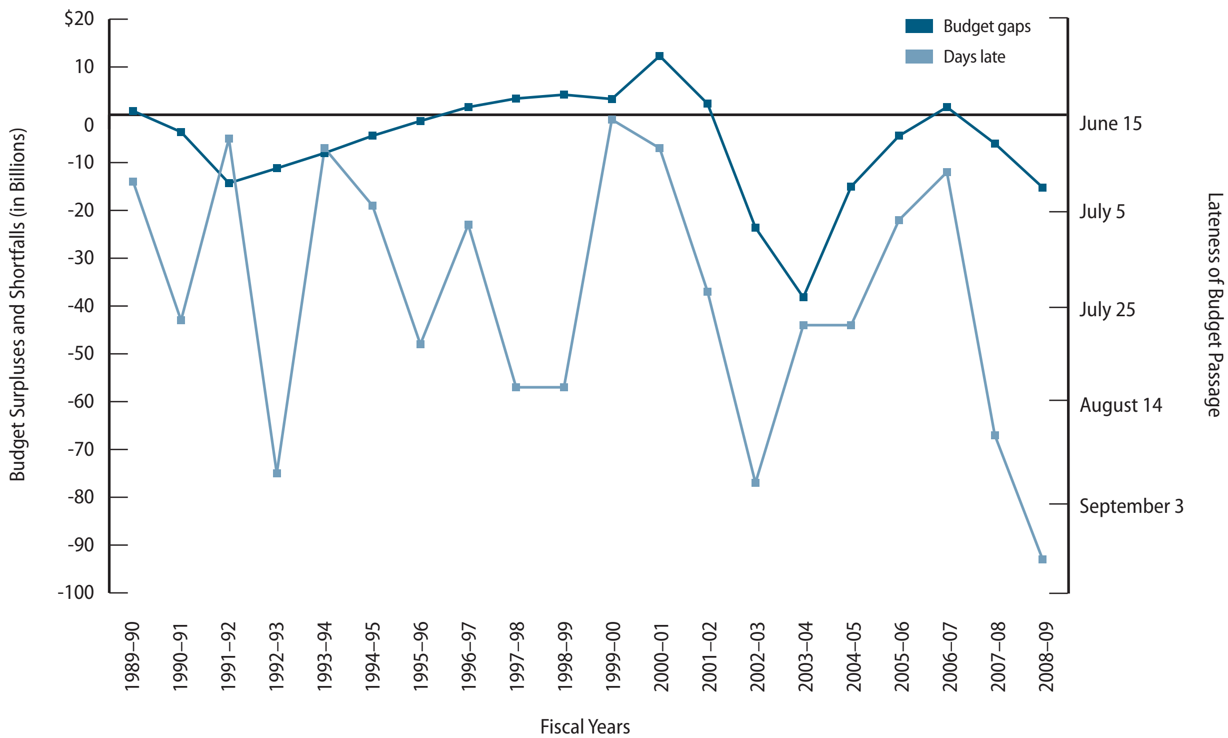


Sources: Department of Finance's governor's budget summaries and the May revisions; Legislative Analyst's Office's perspectives and issues, state spending plans, and overviews of the May revisions.

A potential explanation for these late budget agreements is that the resolution of large projected budget shortfalls takes additional time, and thus it is the ongoing deficits that are causing budgets to be late. By comparing the data shown in Figure 6 with the lateness data, we examined this explanation. Figure 7 on the following page shows that in recent years, budget conditions and lateness have moved in line with each other, while there is no clear connection between budget conditions and lateness in the more distant past.

Using a standard statistical technique called correlation, we determined the strength of the relationship between the budget condition and the lateness of budget passage. When we performed this analysis, we found that on a scale of 0 (no correlation between the two variables) to 1 (perfect correlation between the two variables) there was a correlation of .61 for the most recent 10 years and an overall correlation of .39 for the past 20 years. As Table 2 on page 19 indicates, both of these results were slightly under their respective threshold for confirming the existence of a correlative

Figure 7
A Comparison Between Budget Surpluses and Shortfalls and the Lateness of Corresponding Budgets Fiscal Years 1989–90 Through 2008–09



Sources: Department of Finance's *Chart P: Historical Data, Dates for May Revision and Budget Bill Enactment*, governor's budget summaries, and May revisions; Legislative Analyst's Office's perspectives and issues, state spending plans, and overviews of the May revisions.

relationship.[3] Therefore, we cannot conclude with certainty that the condition of the budget as of the May Revision affects the length of time it takes the Legislature to pass a budget. Thus, it is likely that other factors beyond the budget condition make it difficult to obtain the compromises necessary to pass a budget by the mandated deadline.

We also examined the relationship between a late budget and the subsequent year's budget condition and found a stronger relationship. As indicated in Table 2, we found a correlation of .70 for the most recent 10 years and .47 for the past 19 years (one data point from the 20-year period is not available when doing this type of comparison). Both of these figures exceed the thresholds necessary to conclude, with 95 percent certainty, that these variables are correlated.

3 We used the 95 percent confidence interval on the Pearson Correlation Coefficient Table. The higher the number of data points, the lower the threshold for statistical significance.

Table 2
Relationships Between Budget Surpluses and Shortfalls and Budget Lateness

	ALL 20 YEARS*		LAST 10 YEARS		
LATENESS OF BUDGET COMPARED TO:	CORRELATION COEFFICIENT	LEVEL REQUIRED FOR STATISTICAL SIGNIFICANCE	CORRELATION COEFFICIENT	LEVEL REQUIRED FOR STATISTICAL SIGNIFICANCE	SUMMARY
The budget condition of the same fiscal year	0.39	0.44	0.61	0.63	The results fall just short of being statistically significant
The budget condition of the next fiscal year	0.47	0.46	0.70	0.63	Correlation levels are statistically signficant

Source: Bureau of State Audits' analysis.

* In comparing the relationship in the second row of the table, one data point is not available, and thus the number of data pairs examined is actually 19. As can be seen in the table, this results in a slight increase in the threshold necessary to achieve statistical significance.

There are several examples in which significantly late budgets in one year coincided with larger budget shortfalls in the next. For example, as can be seen in Figure 7, the late passage of the budget for fiscal year 2002–03 coincided with a steep drop in the projected condition of the fiscal year 2003–04 budget. Examples running counter to this trend can also be seen in the data. For instance, Figure 7 shows that passage of the budget for fiscal year 1992–93 was significantly late, but the next year's budget condition improved. The statistical technique of correlation calculates an overall score by which we can evaluate whether two events, or variables, frequently occur together. With any correlation, we cannot immediately assume that one event causes the other, because there may be factors affecting both simultaneously. Even so, the fact that late budgets of one year—which occur first—often coincide with larger deficits in the next year—which occur subsequently—is an indication of causation. In the next section we summarize the solutions that have been implemented in response to yearly shortfalls and describe how some of these solutions merely pushed the problem into the next year.

Some Solutions Used to Close Budget Gaps Simply Defer the Problem

Although budget shortfalls have been a long-standing problem for the State, almost half of the amounts related to the budget solutions used to resolve the shortfalls have only deferred the problem into the future. As shown earlier in Figure 6, lawmakers have had to close projected budget gaps in six of the last 10 fiscal years. The budget solutions for these six General Fund shortfalls have totaled about $114 billion. Specifically, Table 3 on the following page shows that 27 percent of these amounts involved increasing debt and another 22 percent[4] were related to fund shifts or transfers, accelerated revenue payments that reduce future revenues, and expenditure deferrals. These types of solutions, while balancing a single year's budget, contribute to future budget shortfalls.

Table 3
Types of Solutions Implemented to Reduce Budget Shortfalls
Fiscal Years 2002–03 Through 2008–09

	2002–03	2003–04	2004–05	2005–06	2007–08	2008–09	OVERALL
Total Amount of Budget Solutions (in Billions)*	$23.6	$39.4	$16.1	$5.9	$4.9	$24.0	$113.9
Percentage by Solution Type†							
Expenditure reductions	32%	21%	31%	71%	28%	36%	31%
Revenue increases	17	15	15	2	33	17	16
Increased debt	13	41	39	15		17	27
Fund shifts or transfers	12	10	15	12	26	4	11
Accelerated revenues	19	5			12	11	9
Expenditure deferrals	7	5				8	5
Accounting changes		2				8	2

Sources: Legislative Analyst Office's California spending plans and various publications prepared by the Department of Finance pertaining to the enacted budgets.

Note: Fiscal year 2006–07 is not shown in the table because there was a projected budget surplus in that year.

* The solutions in this table do not precisely link with the May shortfalls presented in Figure 7 because of timing differences and the differences between the shortfalls and the solutions to resolve them.

† Some percentages do not add to 100 percent due to rounding.

Other gap-closing solutions shown in Table 3 have more directly addressed shortfalls. Decision makers closed large parts of the gaps by reducing expenditures (31 percent) and increasing revenues (16 percent). However, of the $18 billion in increased revenues occurring over these six years, about $2.8 billion was realized by changing revenue assumptions, and these assumptions have not always proven to be accurate. For example, a fiscal year 2007–08 solution involved raising $1 billion in revenues by selling EDFUND, the nonprofit public benefit auxiliary of the California Student Aid Commission. However, this sale has not yet occurred.

Our designation of categories for this analysis relied largely on classifications of gap-closing efforts as specified in the legislative analyst's California spending plans and enacted budgets published

4 This 22 percent includes 11 percent from fund shifts and transfers, 5 percent from expenditure deferrals, and 6 percent from accelerated revenue payments. This last category represents only the portion of accelerated revenues that reduce future revenues, which is the reason the 6 percent for this category does not agree with the 9 percent shown in Table 3.

by Finance. For items that did not readily fit into one of these classifications, we determined the best match by reviewing additional details from budget-related documents. Some examples of budget solutions summarized in the legislative analyst's 2008–09 California Spending Plan (and our classifications) include a reduction in California Medical Assistance Program (Medi-Cal) provider rates (expenditure reduction), the sale of additional deficit-financing bonds (increased debt), casino compact revenues (revenue increase), transfers from special funds to the General Fund (fund shift or transfer), requiring companies to pay fees earlier (accelerated revenue), deferring mandated repayment (expenditure deferral), and recording certain tax payments earlier than otherwise would be the case (accounting change).

Decision Makers Face Constitutional Constraints That Limit Their Ability to Raise Additional Revenue to Cover Budget Shortfalls

As legislators and the governor worked to close a $15.2 billion gap for the 2008–09 budget year, they had the choices of decreasing spending, increasing revenues, issuing debt, or combining some or all of these options. However, because the California Constitution requires that any increase in state tax revenue must be approved by a two-thirds vote in both houses of the Legislature, reaching a consensus to raise revenue by increasing state taxes can be difficult. For example, to resolve the fiscal year 2008–09 budget gap, certain broad-based tax increases were proposed, but—according to the legislative analyst—none were enacted as part of the budget passed in September 2008. Specifically, the Legislature's Budget Conference Committee (conference committee), described in the Introduction, adopted a version of the budget that included a $10 billion tax revenue package that would have added new 10 percent and 11 percent personal income tax brackets and raised the corporation tax rate, among other solutions.

Reaching a consensus to raise revenue by increasing state taxes can be difficult because any increase must be approved by a two-thirds vote in both houses of the Legislature.

After budget negotiations stalled, the governor issued an "August compromise," which replaced most of the tax revenue provisions of the conference committee version of the budget with a temporary 1-cent increase in the sales tax for three years, followed by a permanent 0.25-cent reduction. Rather than accept any of these proposals, lawmakers adopted a number of one-time revenue increases that, according to the legislative analyst, will have little long-term impact on the condition of future budgets and will even reduce revenues below what they otherwise would have been for budgets following fiscal year 2009–10. Finally, as mentioned earlier, less than two months after the September budget was passed, the governor called a special session related to the budget. As of the publication of this report, lawmakers and the governor are continuing negotiations to attempt to address the gap in the fiscal year 2008–09 budget.

The Growth in Populations Served by Major Programs Has Driven Up General Fund Expenditures

As discussed in the Introduction, the increase in General Fund expenditures has exceeded the rate of inflation and growth in the State's general population. However, the growth in General Fund expenditures can largely be explained by considering the growth rate in the populations served by key programs—inmates, persons eligible for Medi-Cal, K-12 students, and higher education students.

Figure 3 in the Introduction provides an estimate of what the State's General Fund expenditures would have been if they had increased only at the rate of inflation as well as at the rate of inflation plus the growth in the general population. However, as Table 4 shows, certain segments of the population, to which the State has historically devoted more resources, increased at rates greater than that of the general population. In particular, since the late 1980s, the populations of inmates housed in state correctional facilities (82 percent increase), persons eligible for Medi-Cal (90 percent increase), and K-12 students (32 percent increase) have grown faster than the State's general population (28 percent increase). Although, the growth rate for students enrolled in higher education (22 percent) did not keep pace with general population growth, this segment was included in the analysis because of its significant impact on General Fund expenditure levels.

Table 4
The Growth Rate of California's General Population Compared to the Growth Rates of Specific Groups
Fiscal Years 1989–90 Through 2007–08

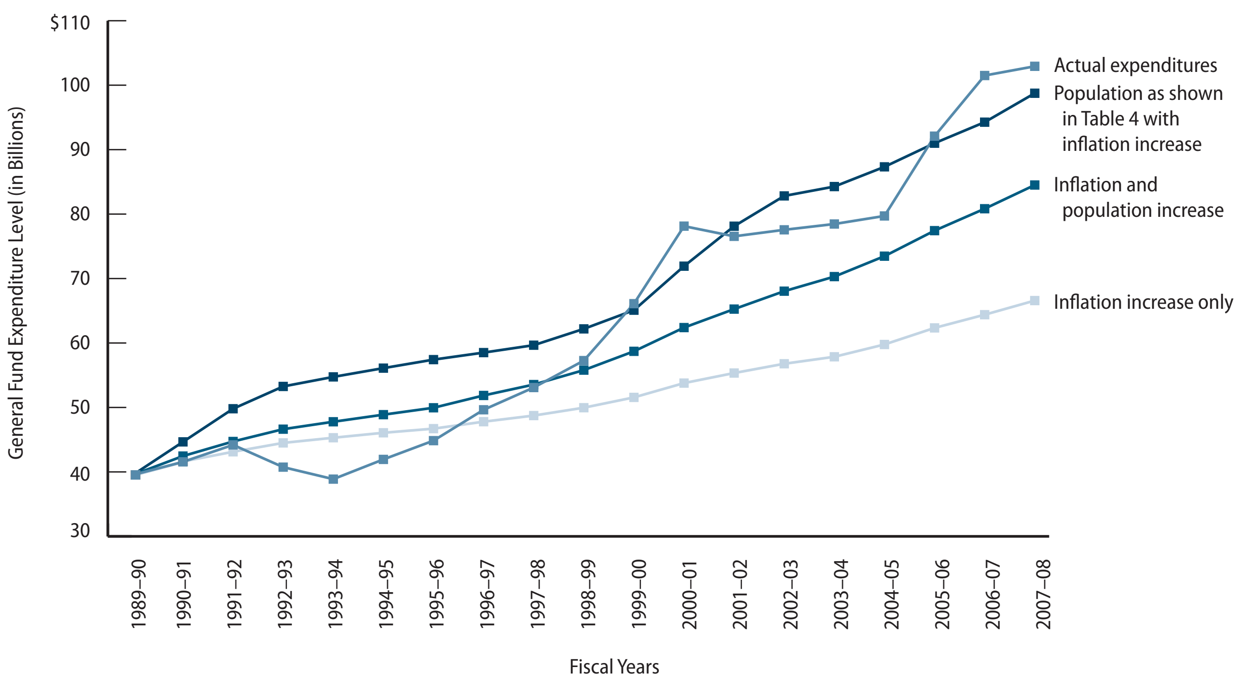
FISCAL YEAR	GENERAL POPULATION	INMATES	PERSONS ELIGIBLE FOR MEDI-CAL	K-12 STUDENTS	HIGHER EDUCATION STUDENTS
1989–90	29,828,000	93,810	3,510,362	4,771,978	1,864,817
1992–93	31,314,000	115,534	5,211,484	5,195,777	1,823,586
1995–96	31,963,000	141,017	5,439,732	5,467,224	1,636,641
1998–99	33,419,000	162,064	5,066,575	5,844,111	1,776,401
2001–02	35,361,000	157,979	6,162,782	6,147,375	2,168,949
2004–05	36,899,000	164,179	6,558,873	6,322,141	2,119,773
2007–08	38,148,000	170,973	6,685,969	6,275,469	2,268,261
Percent Increase	**28%**	**82%**	**90%**	**32%**	**22%**

Sources: Department of Finance's Demographic Research Unit's population estimates; Department of Corrections and Rehabilitation, reports prepared by its Offender Information Services Branch; Department of Education's enrollment reports prepared by the Educational Demographics Office; Department of Health Care Services, Medical Care Statistics Section; and California Postsecondary Education Commission higher education enrollment reports for the fall of each fiscal year.

Note: This table shows data for every third fiscal year.

We estimated what General Fund expenditures would have been had they increased at the combined growth rate of the four population segments in Table 4 with inflation. As Figure 8 indicates, we found that General Fund expenditures would have been roughly $99 billion in fiscal year 2007–08 had they grown at this rate. In contrast, actual spending was roughly $103 billion for the year. However, as shown in Figure 8, General Fund expenditures have often been catching up to an existing need and then have exceeded that need in some years—particularly in the recent 2005–06 and 2006–07 fiscal years. Based on this analysis, it would be difficult to characterize the growth in General Fund expenditures over the last two decades as excessive.

Figure 8
Growth in General Fund Expenditures
Fiscal Years 1989–90 Through 2007–08



Sources: Department of Finance's Demographic Research Unit's population estimates; Department of Corrections and Rehabilitation, reports prepared by its Offender Information Services Branch; Department of Education enrollment reports prepared by the Educational Demographics Office; Department of Health Care Services, Medical Care Statistics Section; and California Postsecondary Education Commission higher education enrollment reports for the fall of each fiscal year.

For the growth rate used for Figure 8, we opted to use a simple approach consisting of a calculation based on all four population groups combined, with each population group counting as much as the others. It could be argued, however, that the growth rate of the inmate population is much more important than that of any of

Average Annual Cost to the General Fund per Individual for Fiscal Year 2007–08

- $43,800 per Department of Corrections and Rehabilitation inmate
- $14,800 per University of California student
- $8,100 per California State University student
- $3,760 per community college student
- $6,600 per K-12 student
- $2,100 per person eligible for Medi-Cal

Source: Bureau of State Audits' analysis based on enacted budget totals and population statistics published or provided by departments. Higher education amounts are based on the number of full-time equivalent students.

the other groups because one additional inmate costs the General Fund much more than one additional student or individual eligible for Medi-Cal, as shown in the text box. We prepared estimates that weighted the growth of different groups in Table 4 on page 22 to consider the impact of these differing costs, but these estimates were nearly identical to our original estimates, and we therefore opted for the simpler approach.

Ballot Measures Have Locked in Future Spending to Pay for Bonds

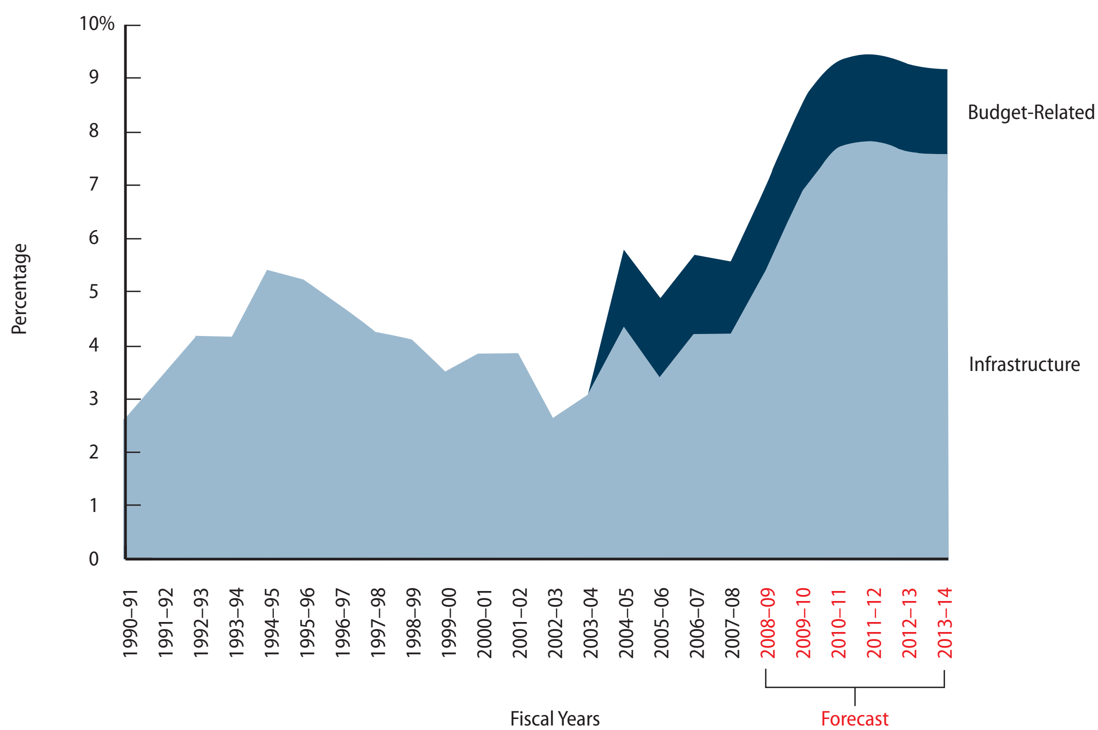
Payments to service the State's debt have also continued to rise. In fiscal year 2007–08, according to Finance, the General Fund made debt-service payments for general obligation bonds of $3.2 billion, and it estimates that these payments will rise to $4.9 billion in fiscal year 2009–10. Despite the burden these payments will place on future state budgets, California voters continue to authorize the issuance of large amounts of general obligation bonds through ballot measures. The California Constitution generally requires voter approval of general obligation bonds, whether proposed by the Legislature or by voters. Voter approval of these bonds obligates the General Fund to use its major revenue sources such as personal income, sales, and corporate income taxes to pay the principal and interest on the debt.

We reviewed the voter information guides published by the secretary of state for the 64 ballot measures approved by voters between June 1998 and November 2008 and found that 19 of them authorized the issuance of a total of roughly $105 billion in general obligation bonds. The legislative analyst estimates that the interest payments on these bonds could amount to as much as $98 billion. This amount, although spread out over 30 years, is roughly the size of one recent year's General Fund budget.

The totals just discussed do not include certain types of general obligation bonds for which the General Fund might incur some costs. For example, voters approved in November 2008 the issuance of bonds for California veterans to purchase homes and farms. Under the program, participating veterans cover the costs of these loans. However, if participants' payments are insufficient, the remainder of the debt could be paid from the General Fund. This ballot measure and others that entail unknown possible General Fund expenditures were excluded from the estimates given above. Our analysis examined the 19 ballot measures for which the potential costs to the General Fund were clearly estimated by the legislative analyst and published in official voter information guides. Although the amount of principal authorized by voters is known, interest on this debt is only estimated. In addition, bonds equal to the authorized amount are not sold immediately; the State often sells general obligation bonds in a series of issuances and can take many years to completely exhaust the authorized amounts.

Finally, one measure of the growth in the State's debt burden is the ratio of annual debt-service costs to annual revenues and transfers in the General Fund. This measure, known as the debt-service ratio, is generally expressed as a percentage. Figure 9 shows how this percentage has risen in recent years and gives the legislative analyst's projections for growth in the future. Specifically, the figure shows the percentage of General Fund revenues used to pay off debt increasing from nearly 3 percent in fiscal year 2002–03 to more than 9 percent in fiscal year 2010–11. This increase has come even while annual General Fund revenues have been rising, as shown in the next section. The darker shaded area in Figure 9 is directly

Figure 9
Past and Projected Debt-Service Ratios
Fiscal Years 1990–91 Through 2013–14



Source: Legislative Analyst's Office, *California's Fiscal Outlook*, November 2008.

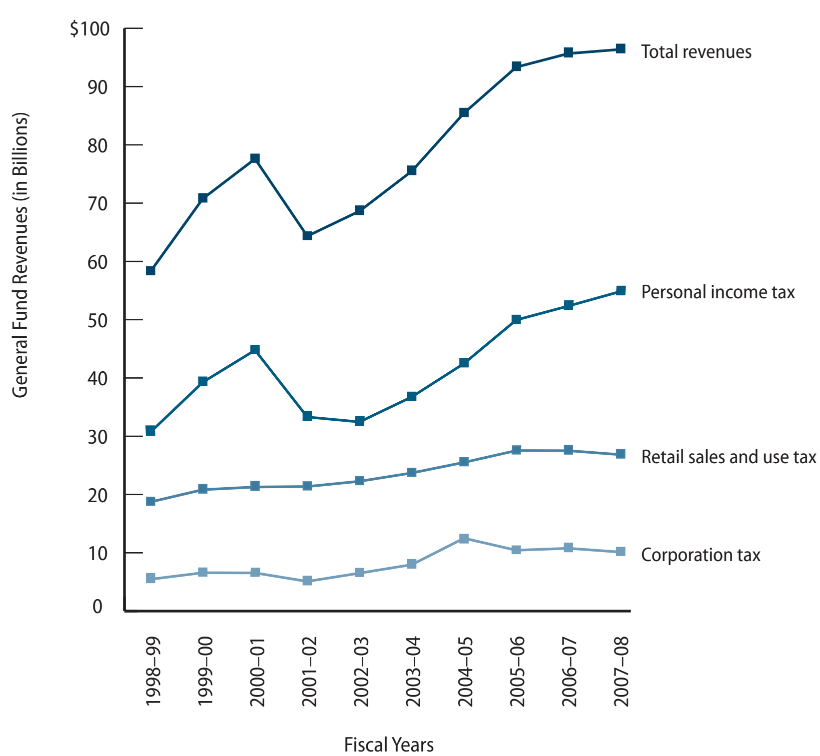
Note: Percentages represent the ratios of annual debt-service payments to General Fund revenues and transfers.

related to the budget-balancing bonds we discussed in an earlier section and represents nearly 2 percent of General Fund revenues. The lighter shaded area is related to general obligation bonds that were approved to pay for infrastructure projects, which include improvements to the State's transportation system, the building of educational facilities and hospitals, and water projects.

The Volatility Associated With the Major Sources of General Fund Revenues Complicates Budgeting

The General Fund depends on tax revenue streams that fluctuate more from year to year than other types of tax revenue, or even General Fund expenditures. This uncertainty makes effective budget planning difficult. Personal income tax, retail sales and use taxes, and corporation taxes account for more than 90 percent of General Fund revenues. As shown in Figure 10, General Fund revenues have generally increased in the last 10 years but experienced a major decline between fiscal years 2000–01 and 2001–02, mainly because of the drop in personal income tax revenues (historically the largest source of General Fund revenue).

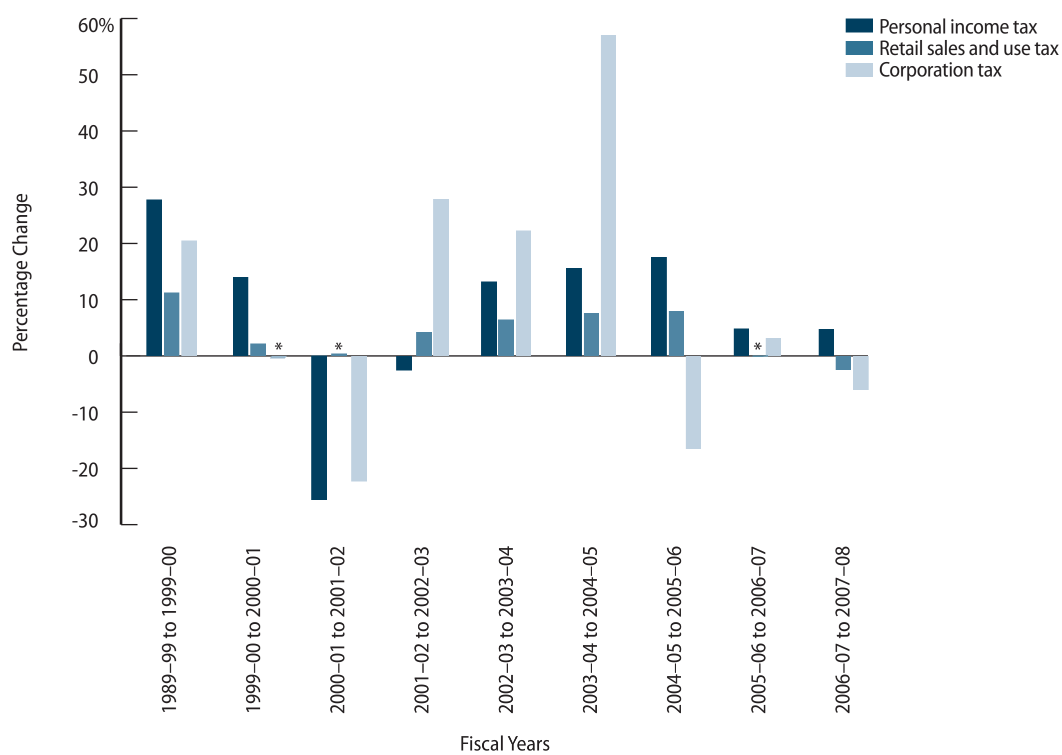
Figure 10
Total General Fund Revenues and Major Revenue Sources
Fiscal Years 1998–99 Through 2007–08



Source: *General Fund Cash Basis Reports*, published by the State Controller's Office.

The volatility of the General Fund's revenue sources is difficult to see when viewed simply in terms of dollar amounts, as shown in Figure 10. Viewing the year-to-year changes as percentages shows more clearly the wide fluctuations in some portions of the General Fund revenues. As shown in Figure 11, the greatest one-year percentage increase in revenue from the corporation tax was 57 percent, and the greatest decrease was 22 percent, while the percentage change in personal income tax revenues ranged from an increase of 28 percent to a decrease of 26 percent. The yearly swings (whether negative or positive) in corporation and personal income tax revenues averaged 19 percent and 14 percent, respectively. Sales tax was less volatile, with an average of 5 percent in year-to-year change. The three tax sources combined averaged yearly swings of 11 percent.

Figure 11
Year-to-Year Percentage Change in Significant General Fund Revenue Sources Fiscal Years 1998–99 Through 2007–08



Source: *General Fund Cash Basis Reports*, published by the State Controller's Office.

* The percentage change for this period is less than 1 percent.

Major Sources of California's Tax Revenue

California's personal and corporate income taxes in fiscal year 2006–07 accounted for 56 percent of total tax revenues (this total includes more than just General Fund revenues), while the national average for these taxes was just 43 percent of total tax revenues.

Source: United States Census Bureau, State Government Finances, 2007.

In contrast to the fluctuations in corporation and personal income taxes, property taxes—which support local schools, counties, cities, and other local districts but do not add to General Fund revenues—have shown less variation. Local property tax revenues have increased steadily in the last 10 years for which data are available, at an average rate of about 9 percent each year. So while local governments can depend on a relatively stable source for a major portion of their revenues, nearly two-thirds of the General Fund revenue is made up of a personal income tax (53 percent of General Fund revenues) and a corporation tax (10 percent of General Fund revenues) that vary more than other types of revenue streams. This makes estimating personal income and corporation taxes extremely important in the State's budget-making process, and places greater emphasis on the assumptions underlying these estimates. When these assumptions are wrong, large year-end shortfalls can and do occur.

Economic conditions during the late 1990s and early 2000s highlighted the State's vulnerability to revenue variability. Specifically, during the dot-com boom, personal income taxes increased by 28 percent from fiscal years 1998–99 to 1999–2000 and by an additional 14 percent in the next fiscal year. These tax revenues then dropped by 26 percent from fiscal years 2000–01 to 2001–02 and by another 3 percent during the following fiscal year. As discussed earlier, the State had built up resources—a General Fund reserve balance in particular—that could largely absorb the first year's decrease, but the second caused a major fiscal shortfall because these reserves were depleted.

Various Constraints Limit the Ability of Decision Makers to Achieve Substantial Reductions in Expenditure Levels

In comparison to revenues, the General Fund expenditures have remained relatively stable. When averaged over the last 10 fiscal years, the percentage of change in General Fund expenditures—whether negative or positive—was only 7 percent. As we discussed earlier, even when a budget shortfall was predicted, only 31 percent of the amounts from the implemented solutions involved a reduction in General Fund expenditures. One potential explanation for this is that decision makers' ability to reduce expenditures in a given year is limited by various constraints. We examined the state budget for fiscal year 2008–09 at a summary level and found that nearly 41 percent of the budget is, in fact, constrained by state constitutional provisions and another 22 percent is needed to secure federal funding in support of underprivileged portions of the population.

The State's enacted budget for fiscal year 2008–09 includes General Fund appropriations of more than $103 billion. The General Fund provides funding to 11 agency categories, four of which make up the majority of the General Fund budget. As Table 5 on the following page indicates, we examined the expenditures within two of these agency categories and, for the other two, examined department-level expenditures exceeding $2.5 billion. In total, we reviewed about $84.4 billion, or approximately 82 percent, of the General Fund budget. As shown in Table 5, $41.9 billion of the General Fund expenditures are constitutionally mandated, while a smaller amount of $22.9 billion secures federal funding as we will describe in later sections.

The Majority of K-12 Education Funding Is Constitutionally Mandated

At the time of the budget's enactment, K-12 education was slated to receive a total of $41.6 billion from the General Fund for fiscal year 2008–09. More than $37 billion of this funding, as shown in the text box, is provided as part of Proposition 98, which was the initiative approved by voters in 1988 that constitutionally guarantees a minimum level of funding for education. Generally, the minimum level of funding guaranteed under Proposition 98 (minimum guarantee) grows over time based on the prior year's funding level, adjusted for the growth in K-12 attendance and the growth in per capita personal income. The minimum guarantee represents more than 70 percent of the total funding for K-12 education and, as will be discussed later, about two-thirds of the total funding for the California Community Colleges (community colleges).

Proposition 98 Minimum Guarantee Using the Fiscal Year 2008–09 Budget Act (in Billions)

K-12 Education	
General Fund	$37.6
Local property tax revenue	14.0
Subtotal	**$51.6**
California Community Colleges	
General Fund	$4.3
Local property tax revenue	2.1
Subtotal	**$6.4**
Total, Proposition 98	**$58.0**

Source: Legislative Analyst's Office, 2008–09 California Spending Plan.

Historically, Proposition 98 funding has averaged about 42 percent of the total General Fund budget. For fiscal year 2008–09, the total is roughly 40 percent of the General Fund budget. Fluctuations in the Proposition 98 minimum guarantee are caused by several factors, two of which are the condition of the State's economy

Table 5
Enacted General Fund Budget Categorized by Various Constraints
Fiscal Year 2008–09
(in Billions)

AGENCY CATEGORY/DEPARTMENT	AGENCY LEVEL	DEPARTMENT LEVEL	CONSTITUTIONALLY MANDATED	FEDERAL LIMITATIONS ON DISCRETION	SECURES FEDERAL FUNDING	LEGISLATIVE DISCRETION	NOT REVIEWED
K-12 Education	$41.6		$37.6				$4.0
Higher Education	12.1						
California Community Colleges		$4.3	4.3				
University of California		3.3				$3.3	
California State University		3.0				3.0	
Other		1.5					1.5
Health and Human Services	31.1						
Department of Health Care Services		14.8			$13.6	1.2	
Department of Social Services		9.9			7.9	2.0	
Department of Developmental Services		2.8			1.4	1.4	
Other*		3.6					3.6
Corrections and Rehabilitation	10.3			$2.3		6.4	1.6
Other agency categories	8.3						8.3
Totals	**$103.4**		**$41.9**	**$2.3**	**$22.9**	**$17.3**	**$19.0**

Source: Bureau of State Audits' analysis of the enacted General Fund budget for fiscal year 2008–09.

* The other seven agency categories are Business, Transportation and Housing; Resources; Environmental Protection; State and Consumer Services; Labor and Workforce Development; General Government; and Legislative, Judicial, and Executive.

and the year-to-year changes in General Fund revenue. In some situations, the Legislature can suspend the minimum guarantee and provide any level of funding. The legislative analyst explained that since inception, the Legislature has provided K-12 education at a level that equaled or exceeded the minimum guarantee, with the exception of fiscal year 2004–05, when the Legislature suspended it. In a suspension year, the State provides less growth in Proposition 98 funding than the growth in the economy, which results in a gap called a maintenance factor. Consequently, the State saves the amount of the maintenance factor in the suspension year and several years thereafter. However, the State has an obligation in subsequent higher revenue years to make accelerated maintenance factor payments of roughly 55 percent of every new General Fund dollar until the funding levels are restored to the level they would have been without the suspension.

In contrast to a suspension, the Legislature can choose to fund K-12 education in excess of the minimum guarantee. For example, between fiscal years 1997–98 and 2001–02, the legislative analyst calculated that the Legislature appropriated a total of $9 billion in excess of the minimum guarantee. Although these additional appropriations are made at the Legislature's discretion, they are included when determining the Proposition 98 minimum guarantee in subsequent years and can cause the minimum guarantee to outpace the growth in K-12 attendance and the growth in per capita personal income. According to calculations provided to us by the legislative analyst, if the Legislature had appropriated funding at the minimum level each of those years instead of in excess of the minimum starting with fiscal year 1997–98, the minimum guarantee for fiscal year 2008–09 would have been about $2 billion lower.

Any appropriations for K-12 education in excess of the Proposition 98 minimum guarantee are included when determining the minimum guarantee in subsequent years. This can cause the minimum guarantee to outpace the growth in K-12 attendance and per capita personal income.

As previously stated, any amounts provided in excess of the minimum guarantee are done so at the Legislature's discretion and the Legislature can suspend the guarantee if need be. Nevertheless, Proposition 98 represents the intent of the electorate to have a protected revenue source for K-12 and community college education. Consequently, we categorized the General Fund appropriation of $37.6 billion in Proposition 98 funding as constitutionally mandated in Table 5.

More Than Half of Higher Education Appropriations Are Discretionary, but Reductions in This Area Could Have Long-Term Harmful Effects on the State's Economy

California's higher education system enrolled more than 2.2 million students in the 2007 fall term through three higher education segments, namely the community colleges, University of California (UC), and California State University (CSU). Higher education's $12.1 billion General Fund budget for fiscal year 2008–09 includes more than $4.3 billion for community colleges, about $3.3 billion for UC, and nearly $3 billion for CSU. The remainder primarily supports the Student Aid Commission and other higher education programs.

Funding levels for higher education are shaped by high-level planning efforts and, in the case of the community colleges, Proposition 98. In 1960 the State adopted a master plan for higher education, which detailed general policies for higher education but provided little guidance for funding its three segments. Instead, the governor, the Legislature, and the higher education segments themselves develop policies that guide higher education finance. According to the legislative analyst, the governor's annual budget proposal for higher education has been influenced in recent years by multiyear funding agreements developed jointly by the administration and UC and CSU. The most recent of these agreements, named the Higher Education Compact (compact), calls for the governor to propose funding that provides to UC and CSU a General Fund increase of 4 percent in fiscal year 2007–08 and annual 5 percent increases in fiscal years 2008–09 through 2010–11.

The compact specifies that these increases are to be in addition to regular funding increases for enrollment growth. However, as explained by the legislative analyst, the Legislature is not a party to these agreements and is not bound by them. Further, the State has not been able to maintain this schedule of General Fund increases for UC and CSU. As shown in Table 6, while community colleges received a 3.1 percent General Fund increase between fiscal years 2007–08 and 2008–09, the UC and CSU budgets dropped slightly.

Table 6
Higher Education General Fund Budget
Fiscal Years 2007–08 and 2008–09
(Dollars in Billions)

HIGHER EDUCATION SEGMENT	2007-08	2008-09	PERCENTAGE CHANGE
California Community Colleges (community colleges)	$4.20	$4.33	3.1%
University of California	3.27	3.25	(0.6)
California State University	2.99	2.97	(0.7)
Other*	1.52	1.56	2.6
Totals	**$11.98**	**$12.11**	**1.1%**

Source: Department of Finance, enacted budget totals for fiscal years 2007–08 and 2008–09.

* Includes Student Aid Commission, Hastings College of Law, California Postsecondary Education Commission, higher education general obligation bonds, and retirement costs for community college employees.

Among the three higher education segments, community colleges have the greatest enrollment and receive the most state funding. They accept all applicants who are high school graduates and others who can benefit from attendance. Community colleges are funded similar to K-12 education in that Proposition 98 guarantees a minimum level of funding. For fiscal year 2008–09, Proposition 98 provides $4.3 billion in community college General Fund appropriations. UC and CSU are administered by a Board of Regents (regents) and Board of Trustees (trustees), respectively. UC offers undergraduate and graduate programs to the top one-eighth of public high school graduates in the State, as well as providing access to community college transfer students. It also serves as the State's primary public research institution and has exclusive jurisdiction over instruction in law, medicine, dentistry, and veterinary medicine. CSU serves the top one-third of public high school graduates in the State, as well as providing access to community college transfer students. CSU graduates account for about 60 percent of California's teachers.

Unlike community colleges, UC and CSU are not funded under Proposition 98. Rather, each year the Legislature considers the governor's budget proposal—which, as stated earlier, is influenced by the compact—in light of the State's available resources, legislative priorities, and other factors. When fiscal conditions facing the State are difficult, the General Fund budgets of UC and CSU typically suffer. Some of the lost revenue is typically replaced with increased student fees. For example, between the mid-1990s and early 2000s, when General Fund contributions to the UC and CSU budgets were growing, student fees remained flat or declined. In contrast, starting in fiscal year 2002–03, when General Fund revenues were falling, student fees increased.

Although the State sets the fee levels for the community colleges, the regents and trustees set student fee levels for UC and CSU, respectively. Each year the state budget includes General Fund support that assumes a particular level of student fee revenue. If UC or CSU charges fees that are less than the assumed level, they could experience a budget shortfall. If their fees are greater than the assumed level, they could experience a reduction in General Fund support. Consequently, according to the legislative analyst, the State has considerable influence over fee levels at these institutions. Therefore, it would not be correct to assume that the fee increases shown in Figure 12 on the following page are solely the result of decisions made by the UC regents and the CSU trustees.

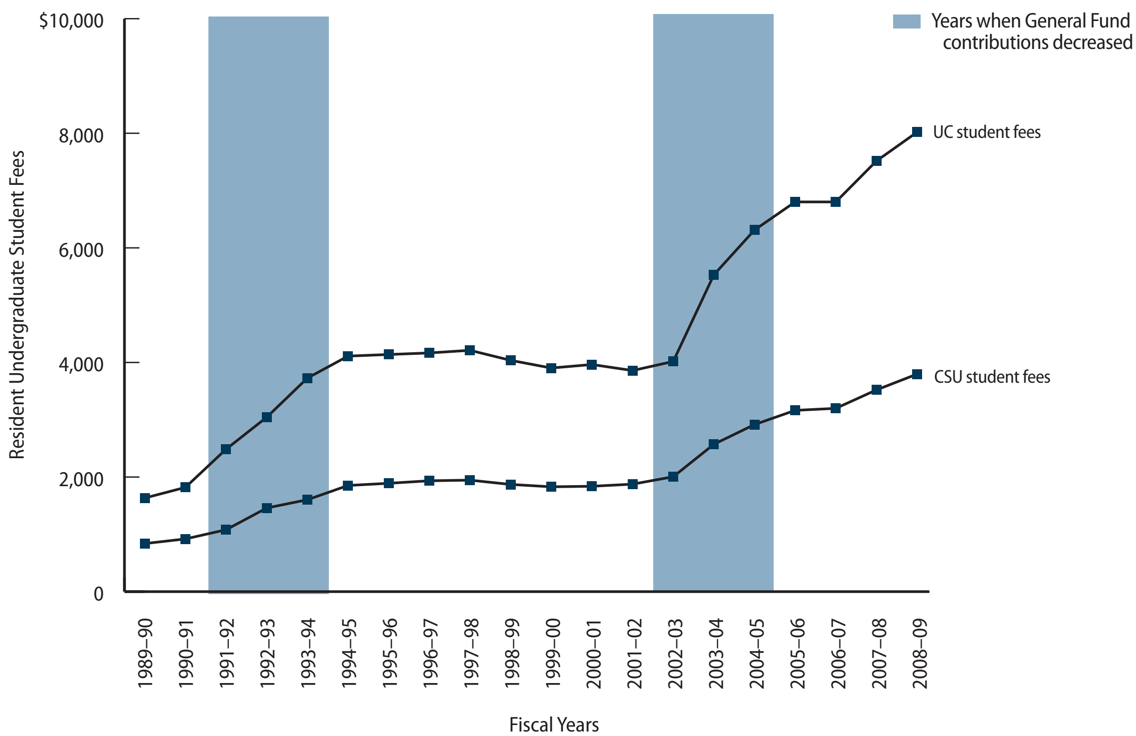
In addition to rising student fees, UC and CSU officials placed limits on freshman enrollment beginning fall 2009 in response to proposed General Fund reductions and insufficient funding for enrollment growth. Freshmen enrollment caps and other cost saving measures, such as fewer course offerings, can create barriers to those wanting a college education. Consequently, although the General Fund budgets of UC and CSU are set at the discretion of the Legislature, dramatic reductions in this area have the potential to reduce the number of college graduates entering the workforce in the future. This is particularly problematic in light of a recent study by an economist at the Public Policy Institute of California, which concluded that the supply of college educated workers in California will not meet the demand in 2020, and that the salaries of college educated workers will increase as a result. For example, with the State facing a shortage of qualified teachers (as reported by the Department of Education), major reductions in the CSU budget in particular would raise concerns about the State's ability to produce and hire enough teachers for its K-12 schools.

A Decline in College Graduates Could Affect California's Future Economic Growth

"In the coming decades, the lack of college-educated workers will be a limiting factor that changes the path of the state's economic growth."

Source: *California's Future Workforce*, Public Policy Institute of California, December 2008.

Figure 12
University of California and California State University Annual Student Fees Compared to Total General Fund Support for Both Segments
Fiscal Years 1989–90 Through 2008–09



Source: California Postsecondary Education Commission.

Note: Includes systemwide and average campus fees for each higher education segment shown above.

Most of the Health and Human Services Agency Budget Supports Services for Programs That Secure Federal Funding

The Health and Human Services Agency (Health and Human Services) oversees 12 departments that provide a wide range of health care services. For fiscal year 2008–09, Health and Human Services' General Fund budget is more than $31 billion, second only to K-12 education. The combined budgets of Health and Human Services' three largest departments—the Department of Health Care Services (Health Care Services), the Department of Social Services (Social Services), and the Department of Developmental Services (Developmental Services)—represent $27.5 billion of Health and Human Services' $31 billion General Fund budget.

Health Care Services, which has the largest budget of the three departments we reviewed, administers a number of programs, including Medi-Cal, the State's Medicaid program.

For fiscal year 2008–09, Medi-Cal accounts for $14.4 billion (97 percent) of Health Care Services' $14.8 billion General Fund budget. Medi-Cal is a public health program funded and administered through a state and federal partnership to benefit low-income people. Participation by states in Medicaid is not mandatory; however, all states participate, and the federal government generally provides matching federal funding for amounts spent by the states. California generally receives one federal dollar for every state dollar spent to meet the minimum program requirements. In addition, the State receives a similar federal match for most optional federal programs in which it chooses to participate. Finally, there are smaller state-only programs that do not qualify for the federal match.

Federal law requires states that participate in Medicaid to cover certain groups in order to receive matching funds, and it outlines basic minimum requirements that all state Medicaid programs must fulfill. According to Health Care Services, California participates in optional programs (see text box) that serve nonmandatory groups, including the Medically Needy program and the Family Planning, Access, Care, and Treatment (PACT) program; however, combined funding for these optional programs account for only a small portion of the department's General Fund budget. Using information provided to us by Health Care Services, we calculated that for fiscal year 2008–09, the basic federal minimum programs and optional federal matched programs combined account for $13.6 billion (about 92 percent), and state-only programs account for about $750 million (about 5 percent) of the department's General Fund budget.

Descriptions of Two Optional Programs Within Health Care Services

Medically Needy: Provides health coverage to a category of recipients who do not have sufficient income to pay their medical costs, but their income is too high to qualify for other assistance programs.

Family PACT: Provides to low-income men and women, including teens, education and services related to family planning.

Sources: Chief, Medi-Cal Eligibility Division, Department of Health Care Services and the Family PACT Web site.

Many reductions in the General Fund budget for federally matched programs would result in a duplicate loss of both state and federal funds. The Legislature has the discretion to cut in these areas, but because these reductions would reduce federally matched support for underprivileged portions of the population, there are business and humanitarian reasons not to do so. Nevertheless, the State's decision to provide this aid has had an ever-increasing cost. As shown in Table 4 on page 22, the population of persons eligible for Medi-Cal roughly doubled, from 3.5 million (less than one in eight Californians) in fiscal year 1989–90 to 6.7 million (about one in six) in fiscal year 2007–08. Over that same time period, Medi-Cal costs have more than quadrupled; the program's General Fund budget has increased from about $3.5 billion to over $14 billion.

Based on estimates provided by Social Services, $7.9 billion (80 percent) of its fiscal year 2008–09 General Fund budget will secure federal funding.

Social Services provides aid, services, and protection to needy children and adults through a number of programs that are administered and funded through a state and federal partnership. For fiscal year 2008–09, Social Services has a General Fund budget of $9.9 billion. Some of Social Services largest programs include the Supplemental Security Income/State Supplementary Payment, California Works Opportunity and Responsibility to Kids, In-Home Supportive Services, and Child Welfare Services, in addition to several smaller programs. Participation in these programs is not mandatory; however, similar to the State's Medicaid program, California has chosen to participate in them. As such, the State is required to spend a certain amount of its own funds to receive the federal funds related to these and other programs. Based on estimates provided by Social Services, $7.9 billion (80 percent) of its fiscal year 2008–09 General Fund budget will secure federal funding. The remaining portion of its budget provides funding above the federal minimum required for the State Supplementary Payment program and support for smaller programs such as Adult Protective Services, Community Care Licensing, and Child Abuse Prevention. Although these programs are funded at the discretion of the Legislature, they each protect a vulnerable sector of the population.

Developmental Services, the smallest of Health and Human Services' three departments we reviewed, serves the State's persons with developmental disabilities through its Community Services and Developmental Centers programs. Unlike most other Health and Human Services programs, these programs do not require recipients to demonstrate financial need in order to receive services. Instead, recipients qualify for services based on the diagnosis of a developmental disability and their age at the time of diagnosis. A developmental disability is defined as a severe and chronic disability, attributable to a mental or physical impairment that is expected to continue indefinitely. Developmental Services operates both programs under the Lanterman Developmental Disabilities Services Act (Lanterman Act), which is a California law that provides services and support for persons with developmental disabilities. For fiscal year 2008–09, these two programs make up Developmental Services' $2.8 billion General Fund budget.

A federal program operations manager at Developmental Services explained that $1.4 billion of the Community Services program budget is associated with federal matching funds. The remaining $1.4 billion does not receive federal matching funds and, as we indicate in Table 5 on page 30, is provided at the Legislature's discretion. Unless the Legislature wants to reduce services or further restrict program eligibility, it would be difficult to reduce spending significantly in this area in the near term. Developmental Services' caseload has grown, partly because medical professionals are identifying more people with developmental disabilities such as autism at an earlier age, and also because medical care and technology have increased the life expectancy of affected individuals. For example, those diagnosed with autism currently account for about 19 percent of Developmental Services' caseload, compared to about 12 percent only five years ago.

The Majority of the Department of Corrections and Rehabilitation's Budget Is Funded at the Legislature's Discretion

The Department of Corrections and Rehabilitation (Corrections) oversees the incarceration, training, education, and care of the State's growing population of adult and juvenile inmates. For fiscal year 2008–09, Corrections' General Fund budget is about $10.3 billion, nearly twice its $5.5 billion budget in fiscal year 2003–04. Corrections' largest program, adult corrections and rehabilitation, accounts for more than half of its budget, at about $5.2 billion. State statute requires Corrections to accept convicted felons when their sentence is imprisonment in a state correctional facility. The funding to support this program is included in the Legislative Discretion column of Table 5 on page 30 but is constrained by the need to provide safe and secure housing for a growing inmate population. Major reductions in this area of the budget may not be possible without first addressing the factors causing the rising levels of inmates housed in correctional facilities.

Corrections' General Fund budget nearly doubled from $5.5 billion to $10.3 billion in just the past five years.

The Eighth Amendment of the U.S. Constitution, which prohibits the infliction of cruel or unusual punishment, also requires Corrections' second largest program—health care services—to provide adequate medical services to its inmates. Under the health care services program, Corrections provides the inmates housed in its correctional facilities medical, dental, and mental health care as well as other related services. The program's General Fund budget for fiscal year 2008–09 is more than $2.3 billion, or 22 percent of Corrections' total General Fund budget. However, since April 2006, certain activities of Corrections' medical care services program have been operating under a federally appointed receiver. The court appointed a receiver because it believed the State delayed implementing changes required under a lawsuit that contended the State was in violation of the Eighth Amendment by providing inadequate medical care to prison inmates. Although the budget for this program is under the Legislature's discretion, the federal courts could require additional funding. In fact, the receiver has requested $8 billion in funding for additional medical facilities. The amount to be provided by the State is still uncertain, but costs for Corrections' health care services may rise in the near future as a result of this request.

The costs associated with the state and federally required duties just described account for about 73 percent of Corrections' General Fund budget. The remaining budget supports 10 smaller programs, including adult parole operations; juvenile operations; adult education, vocational, and offender programs; and Corrections' administration. Although these programs are provided at the Legislature's discretion, they provide support for Corrections' central, state mandated mission of incarcerating and rehabilitating felons. Budget reductions could potentially be made in these areas; however, increases in medical costs might offset any such reductions.

Some Budget Issues and Areas Need Further Exploration

Based on the information presented in this report, the Bureau of State Audits (bureau) believes the current fiscal crisis is part of a long-term, structural imbalance between the General Fund revenues and expenditures. Consequently, the bureau has designated the state budget as a high-risk area because it will likely continue to affect the State's ability to effectively provide and pay for needed services. Because we have designated the state budget as high risk, we will continue to monitor developments in this area, clarify issues when needed, and attempt to help decision makers find areas to streamline government or enhance revenues. In the following sections, we outline areas for public and legislative consideration and describe particular areas related to the budget that the bureau may examine in the future as part of its high-risk program.

California May Want to Consider Whether the Constitutional Provisions Requiring a Two-Thirds Vote in the Legislature for Passage of State Tax Increases and the Budget Are Viable

The description in this report of the constraints on the expenditure side of the State's budget is not exhaustive, but it does explain why, on the whole, it is not easy for decision makers to balance the budget each year simply by reducing expenditures to the level of estimated revenues. Furthermore, the growth in the particular populations discussed earlier, plus the additional debt service payments required by the projects and programs approved by voters in the last 10 years, lend support to the notion that the current level of General Fund expenditures does not dramatically exceed existing need. Consequently, given the long-term imbalance between General Fund revenues and expenditures that the State has experienced, it is apparent that decision makers will need to consider some form of broad-based tax increase to bring revenues in line with expenditures. Given that proposals have been made in this area but none have garnered the necessary support—namely, two-thirds of the members of both houses of the Legislature—lawmakers and the public may want to consider whether this constitutional requirement still serves as a viable benchmark for raising state taxes.

Because of the trend toward increasingly late budgets, an additional consideration would be whether to keep the requirement to pass a budget by a two-thirds vote of the Legislature, as is currently specified in the California Constitution. Other options could include a majority vote or some other form of super-majority vote, such as a 55 percent requirement.

A Larger General Fund Reserve Would Be Ideal

Because of the volatility of the State's revenue structure, creating a substantial reserve during good economic times would seem to be an imperative. A substantial reserve would allow the State to regularly earn interest, rather than continually paying interest on debt instruments used to close budget shortfalls. In fact, a proposition has qualified for the June 2010 election that aims to create a larger reserve fund and limit those times when contributions to the fund can be suspended or reduced. Regardless of the outcome of this proposal, increasing the State's financial reserves should be seriously considered.

California Should Consider Whether Appropriations That Exceed the Proposition 98 Minimum Guarantee Ought to Increase the Minimum Guarantee in Future Years

The minimum guarantee under Proposition 98 is designed to grow over time based on the prior year's funding level, adjusted for the growth in K-12 attendance and the growth in per capita personal income. Further, appropriations in excess of the minimum in one year increase the subsequent year's minimum guarantee—even if these additions cause the minimum guarantee to outpace the growth in K-12 attendance and per capita personal income. As was mentioned earlier, the Legislature appropriated a total of $9 billion in excess of the minimum guarantee between fiscal years 1997–98 and 2001–02 and, according to calculations provided to us by the legislative analyst, the cumulative effect of these additional appropriations was more than $40 billion up to fiscal year 2008–09. California voters may want to consider a modification to Proposition 98 requirements to allow legislators to provide additional funding to schools without permanently increasing the State's obligations under Proposition 98.

The Bureau May Explore Other Areas of the Budget in the Future

In this initial report on the budget condition, the bureau has covered a number of areas at a summary level. In subsequent reports on this high-risk area, the bureau will continue to monitor high-level developments concerning the budget and, as resources allow, will delve deeper into specific budget issues to aid decision makers in finding areas in which to streamline government or enhance revenues. Examples of the types of issues the bureau could review include the following:

- ***State fees:*** The bureau may review state government activities that are primarily supported by the General Fund but that disproportionately serve populations that do not pay any or sufficient fees to cover the cost of such services. A review of this nature would examine the potential positive and negative impacts of fee increases. The governor's proposed 2009–10 budget provides an example of a fee increase to driver's annual vehicle registrations to support the Department of Motor Vehicles.

- ***Costs of higher education:*** In recent years, the bureau has conducted reviews of UC and CSU compensation of executives and other highly paid staff. In light of the State's current fiscal crisis and the tough economic conditions Californians are facing, further reviews of how UC and CSU spend their resources—including follow-up reviews of executive compensation—may be worthwhile.

- ***Increases in persons eligible for Medi-Cal:*** As was shown in Table 4 on page 22, the number of individuals who are eligible for Medi-Cal has increased by 90 percent over the last two decades, while the general population has increased by only 28 percent. Examining why this number has increased so dramatically appears to be warranted.

- ***Optional health care service programs:*** As was discussed previously, California exceeds minimum federal requirements in providing additional services for underprivileged portions of the population. Although they represent a small portion of the General Fund expenditures in this area, some of these programs receive no matching federal funds. An in-depth review of the cost and corresponding benefits of these and other optional programs may identify areas in which to streamline state government.

- ***Increases in the inmate population:*** As was also shown in Table 4 on page 22, the inmate population has increased by 82 percent over the last two decades, while the general population has increased by only 28 percent. The bureau may explore the cause of this dramatic increase and examine the viability of potential solutions to this problem. For example, in view of the potential rise in medical costs occurring within Corrections' prisons, the expanded use of an early-release program for elderly inmates may be a financially prudent option to explore.

- ***Procurement practices:*** As state departments are expected to leverage limited resources, it would likely be of interest to lawmakers to know whether they are securing goods and services at the best possible prices. In past audit reports related to procurement, the bureau has found that state departments do not always exercise due diligence in making purchases, often resorting to noncompetitive alternatives that provide the specific products or services that state departments want but do not always represent the best available price.

- ***Effective budget practices from other states:*** Our report has generally focused on the condition of the state budget and, except for the two-thirds requirements previously described, not on the budget process itself. In future reports, the bureau may choose to explore topics related to the budget process and compare California's practices to those of other states. Topics could include two-year budgets, performance and zero-based budgeting, and long-range planning. This inquiry may yield some best practices that result in recommendations for changes in the State's budget process.

We prepared this report under the authority vested in the California State Auditor by Section 8546.5 of the California Government Code.

Respectfully submitted,

Elaine M. Howle

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Date: February 3, 2009

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