

CALIFORNIA BUDGET PROJECT

Moving Forward:

What Does the Governor's Proposed 2007-08 Budget Mean for California?

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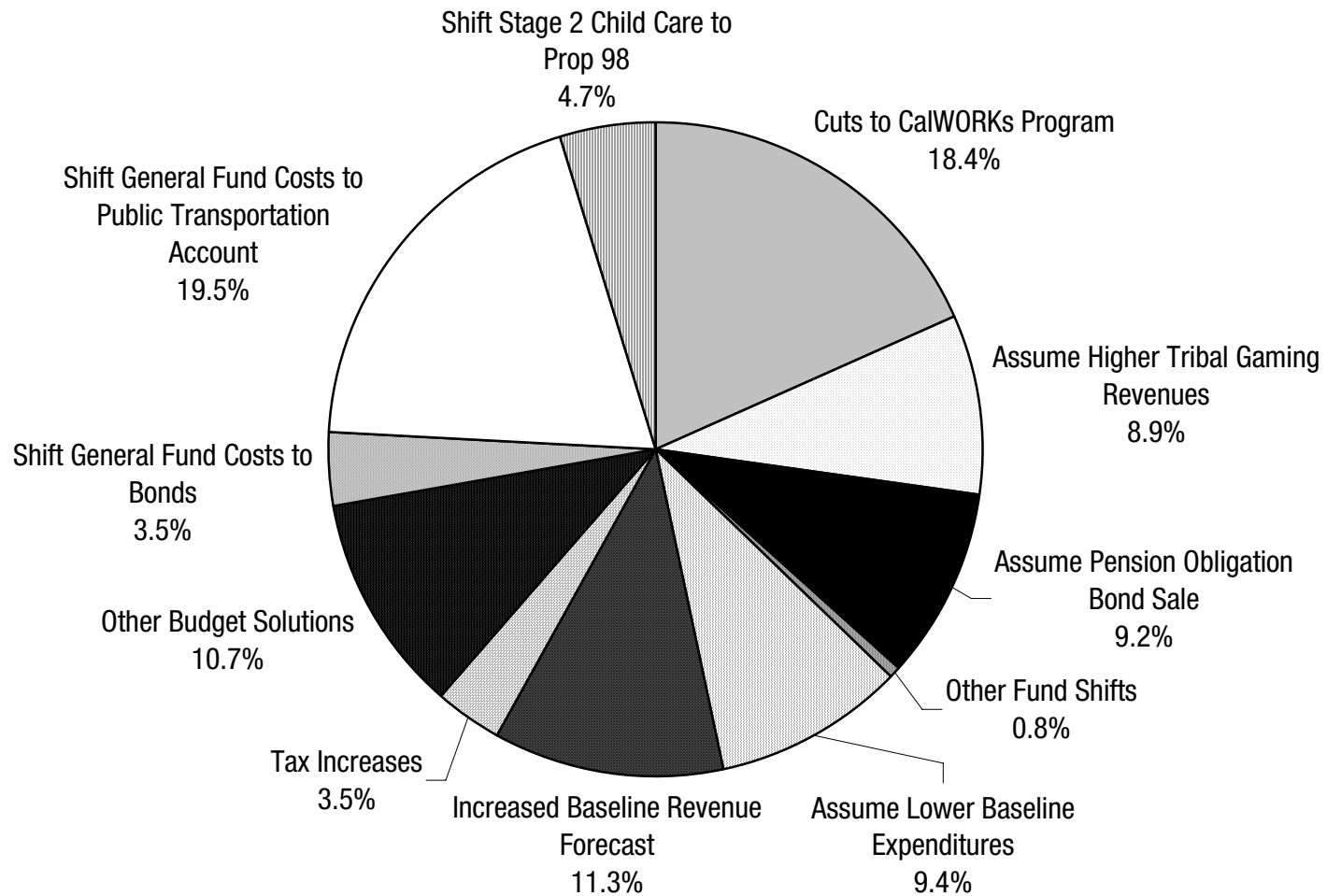
A PRESENTATION BY
THE CALIFORNIA BUDGET PROJECT
February 2007

How Does the Governor Balance the Budget?

- The Governor shifts costs to special funds and uses optimistic revenue and expenditure estimates to minimize the state's budget gap. However, the proposed spending plan still spends \$841 million more than it assumes in revenues in 2007-08.
- More than \$1 billion of the \$5.7 billion of “solutions” in the Governor's Budget come from the CalWORKs program.
- The Governor's revenue forecast assumes that courts will allow the sale of pension obligation bonds and that the Legislature will ratify previously rejected tribal gaming compacts.
- Finally, the Governor would use transportation funds to pay for over \$1 billion of costs previously supported by the state's General Fund, eliminate the teacher tax credit, and shift more of the cost of child care under the Proposition 98 school funding guarantee.

How Does the Governor Propose to Balance the Budget?

Percentage of Proposed Budget "Solutions"



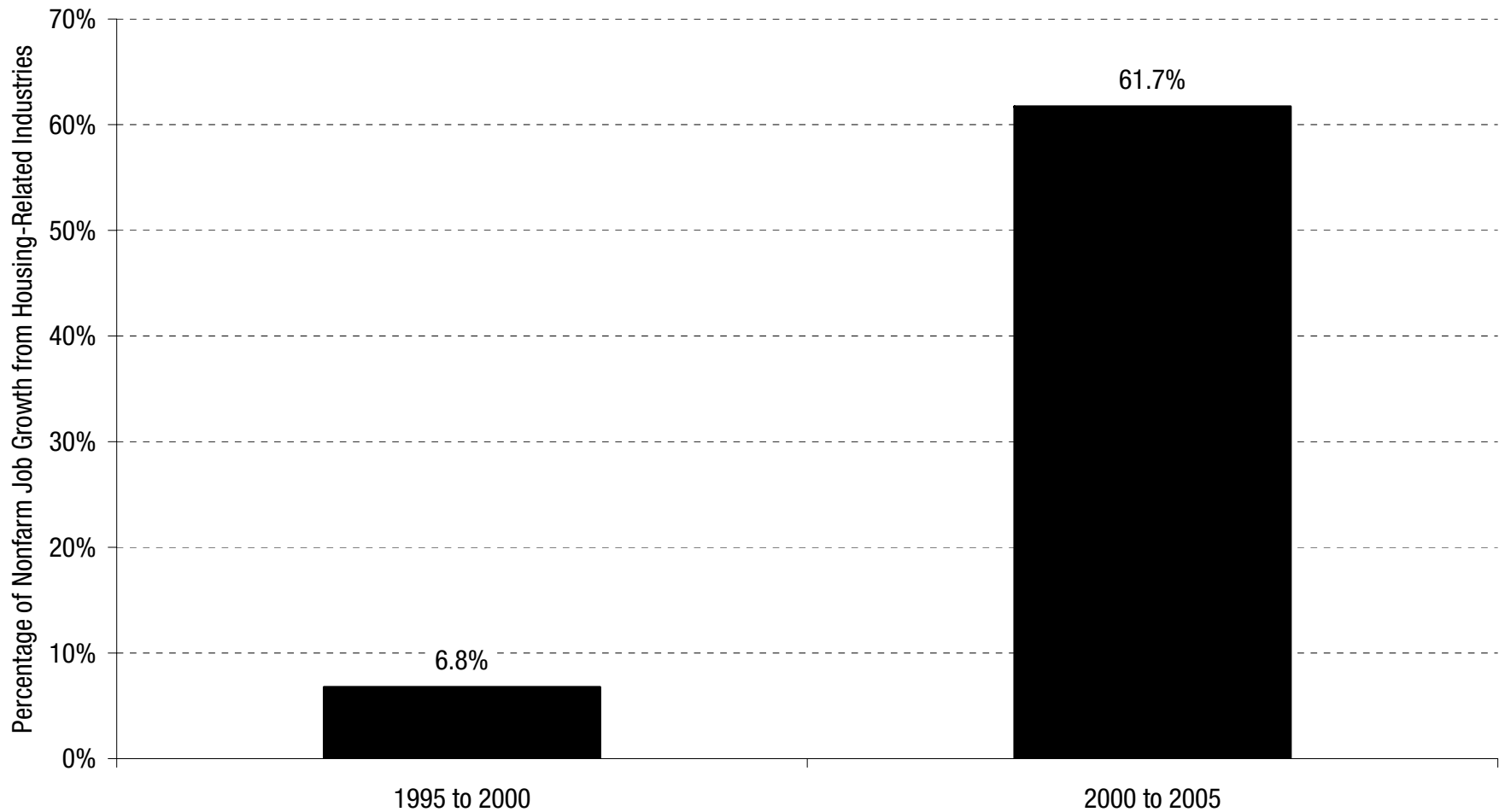
Wishful Thinking: Risky Assumptions Underlie the Budget

The Governor assumes:

- \$506 million in revenues from tribal gaming compacts previously rejected by the Legislature.
- \$525 million in revenues from issuance of pension obligation bonds in 2007-08 and savings of \$553 million from avoiding payment of a CalWORKs cost of living adjustment. Lower courts have ruled against the state on both issues.
- \$641 million in higher baseline revenues, relative to the Legislative Analyst's November estimate. Late 2006 and early 2007 personal income tax collections were below the level assumed in the Governor's Proposed Budget. While some of the lower than anticipated collections were offset by higher than projected corporate income tax collections, revenues lagged the Budget's estimate by over \$800 million as of late January.
- Strong growth in local property tax revenues, which reduces the state's share of school funding, despite a slowing housing market.

Housing-Related Industries Drove Job Growth Between 2000 and 2005

Fewer Than 4 Percent of 2000 Jobs Were Housing-Related



Note: Housing-related industries include residential construction, residential specialty trade contractors, and real estate.

Source: CBP analysis of Employment Development Department data

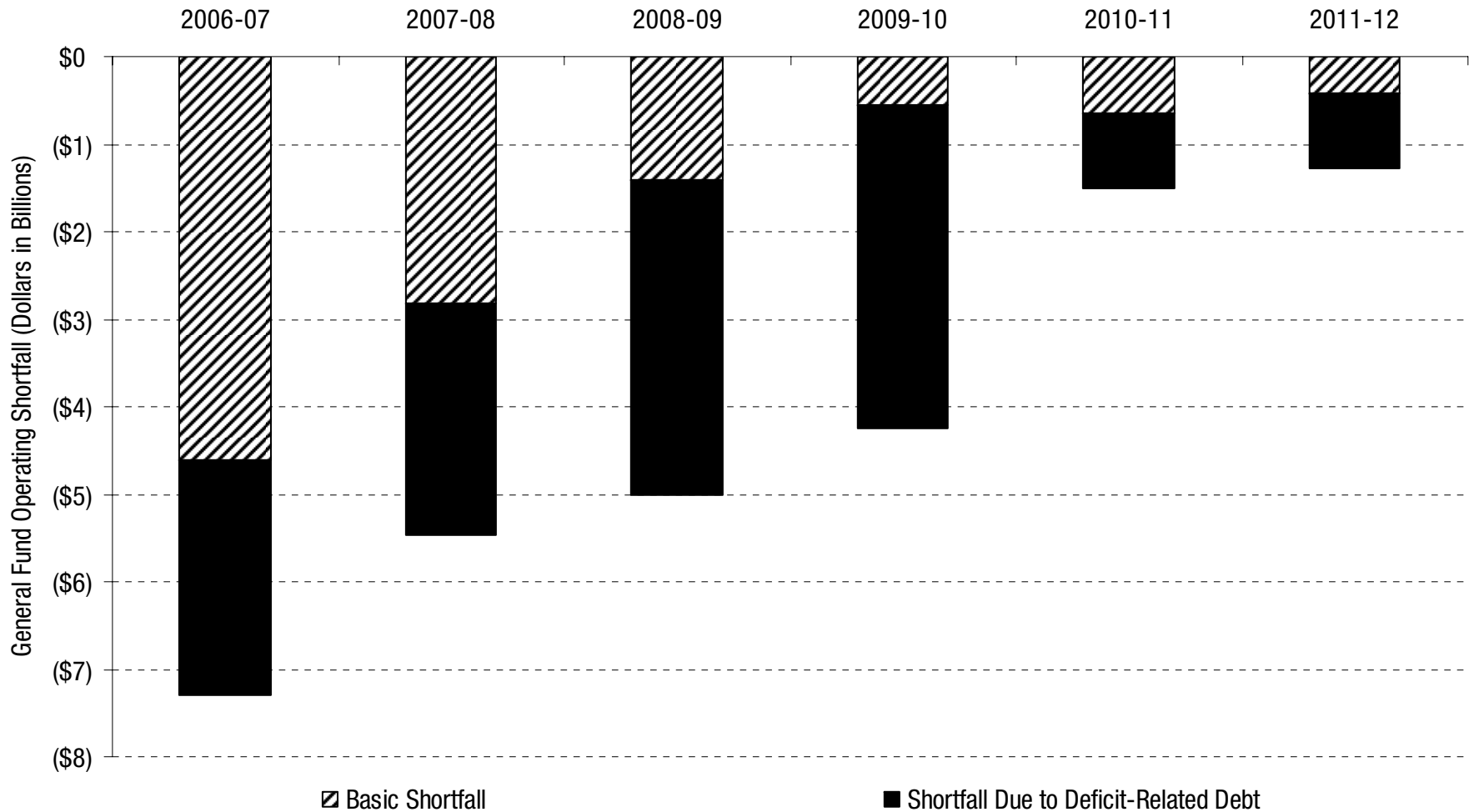
Is the Budget *Really* Balanced?

- The Legislative Analyst notes, “the budget contains a significant number of downside risks and is based on a number of optimistic assumptions. Its key proposals also raise serious policy and legal issues....Even if all the budget’s proposals were adopted, however, it is likely that the actual amount of budget savings and new revenues would fall short of the levels estimated by the administration.”
- Neither the Governor’s ambitious health reform proposal nor the bonds that would be issued as part of his new public works proposal are funded in the budget.

Deficit-Related Debt Contributes to the Ongoing Gap

- In November, the Legislative Analyst projected that over 70 percent of the projected operating shortfalls in 2007-08 through 2011-12 were related to repayment of debt used to finance prior budget shortfalls.
- The largest of these obligations is the deficit financing bonds authorized by Proposition 57 of 2004. Payment on this debt comes from a quarter-cent sales tax rate that is expected to generate \$1.5 billion in 2007-08.
- Other debts include amounts owed to special funds, including transportation, as well as to schools and local governments.

Most of the State's Projected Shortfalls Are Due to Deficit-Related Borrowing

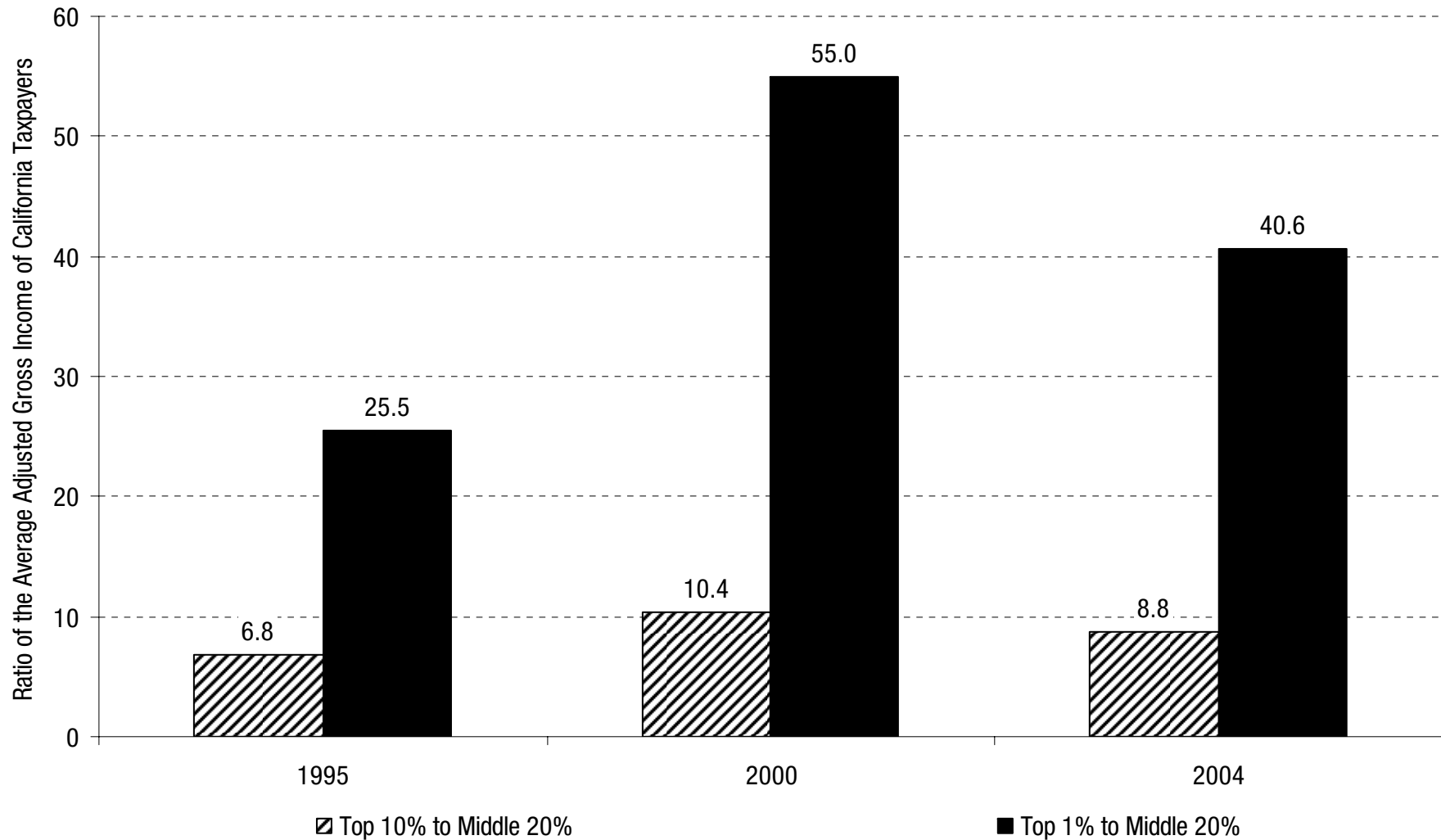


Note: Based on the Legislative Analyst's November 2006 forecast.
Source: Legislative Analyst's Office

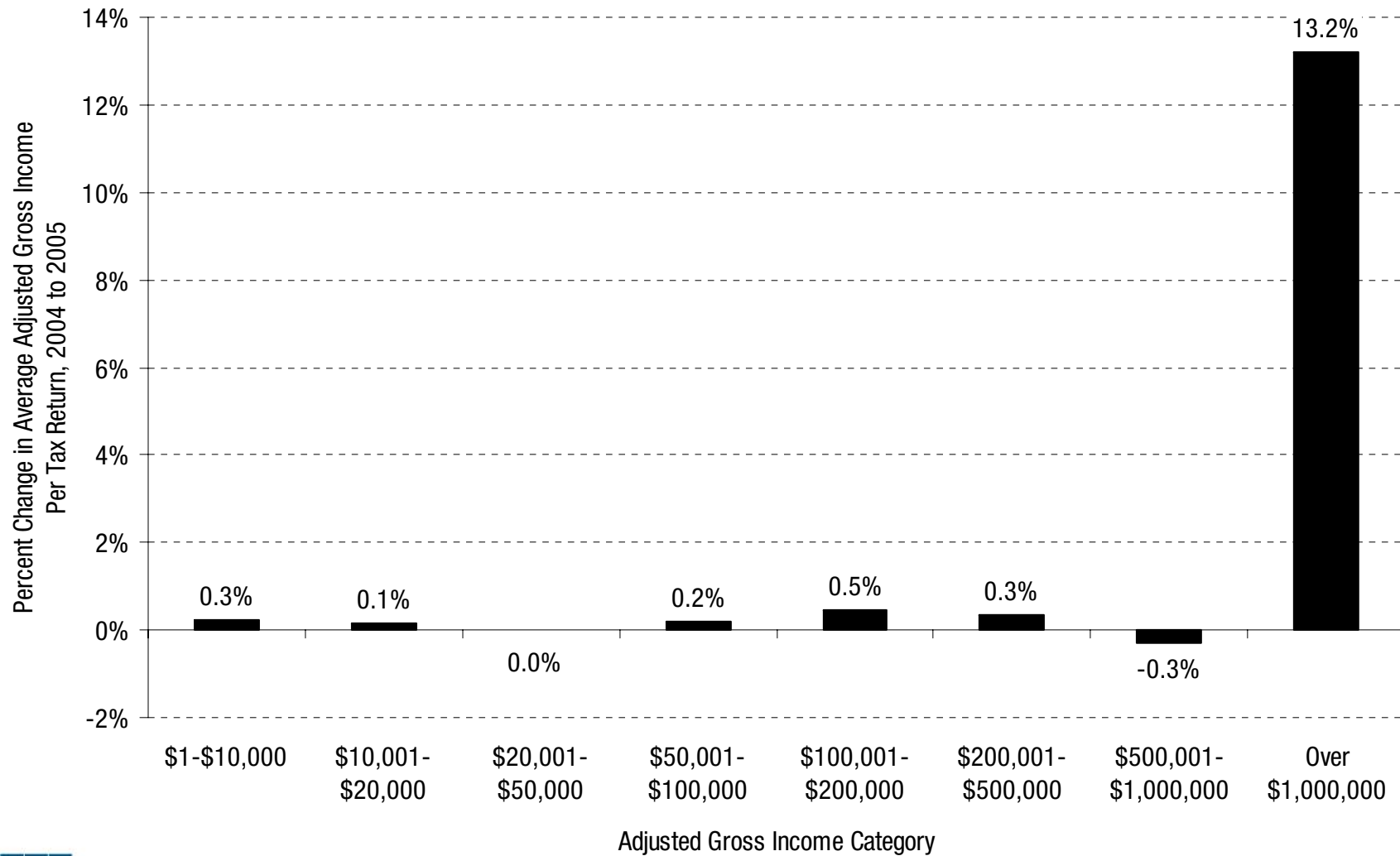
The Gap Between California's Rich and Poor Continues to Widen

- The average income of the wealthiest 1 percent of California taxpayers was more than 40 times higher than that of the middle fifth of taxpayers in 2004. In 1995, in contrast, the average income of the wealthiest 1 percent was about 25 times higher than that of middle-income taxpayers.
- This trend continued in 2005. Between 2004 and 2005, the average income of California taxpayers with incomes in excess of \$1 million rose by 13.2 percent, while that of taxpayers with incomes between \$50,000 and \$100,000 increased by just 0.2 percent.
- While some suggested that imposing a surcharge on millionaires would cause these individuals to leave California, the number of millionaire tax returns increased by 23.6 percent in 2005 – the first year of the surcharge – compared to a 1.9 percent increase in tax returns overall.

The Gap Between Middle-Income Californians and the Wealthy Widened Between 1995 and 2004

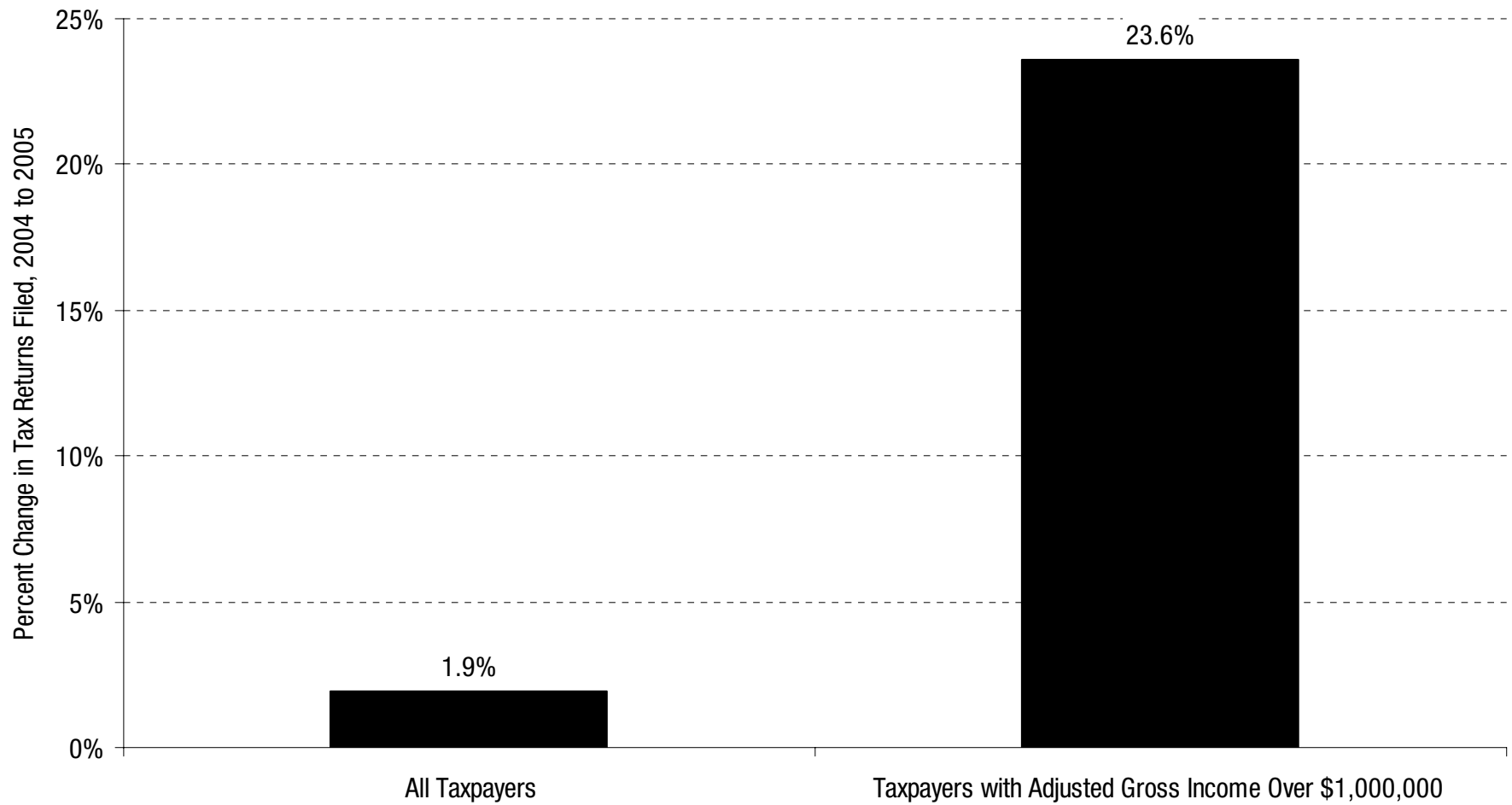


Wealthy Californians' Incomes Posted the Largest Gains in 2005



Source: Franchise Tax Board

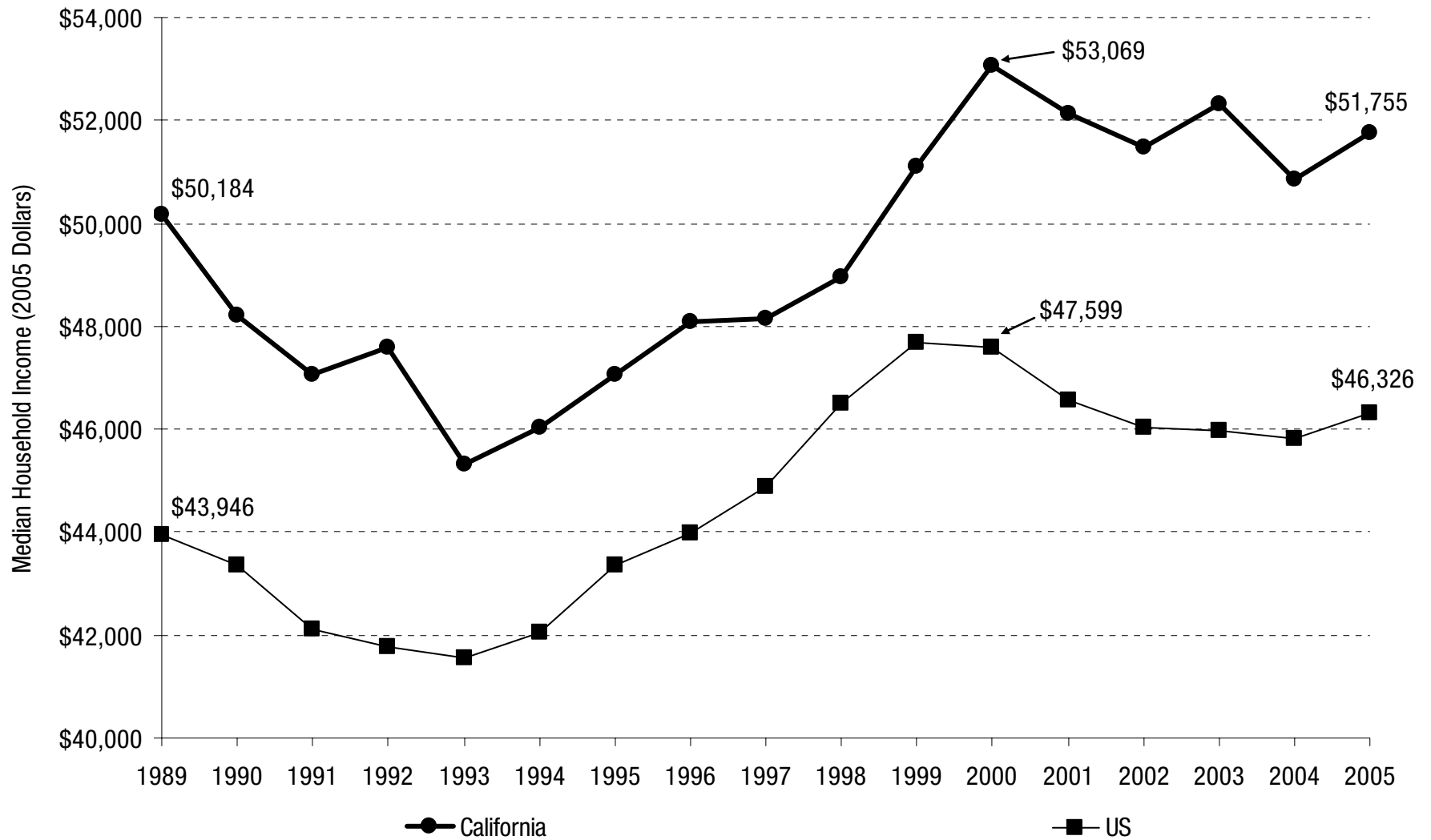
The Number of Millionaire Taxpayers Increased After the Imposition of Proposition 63's Surcharge



Many Californians Continue to Struggle to Make Ends Meet

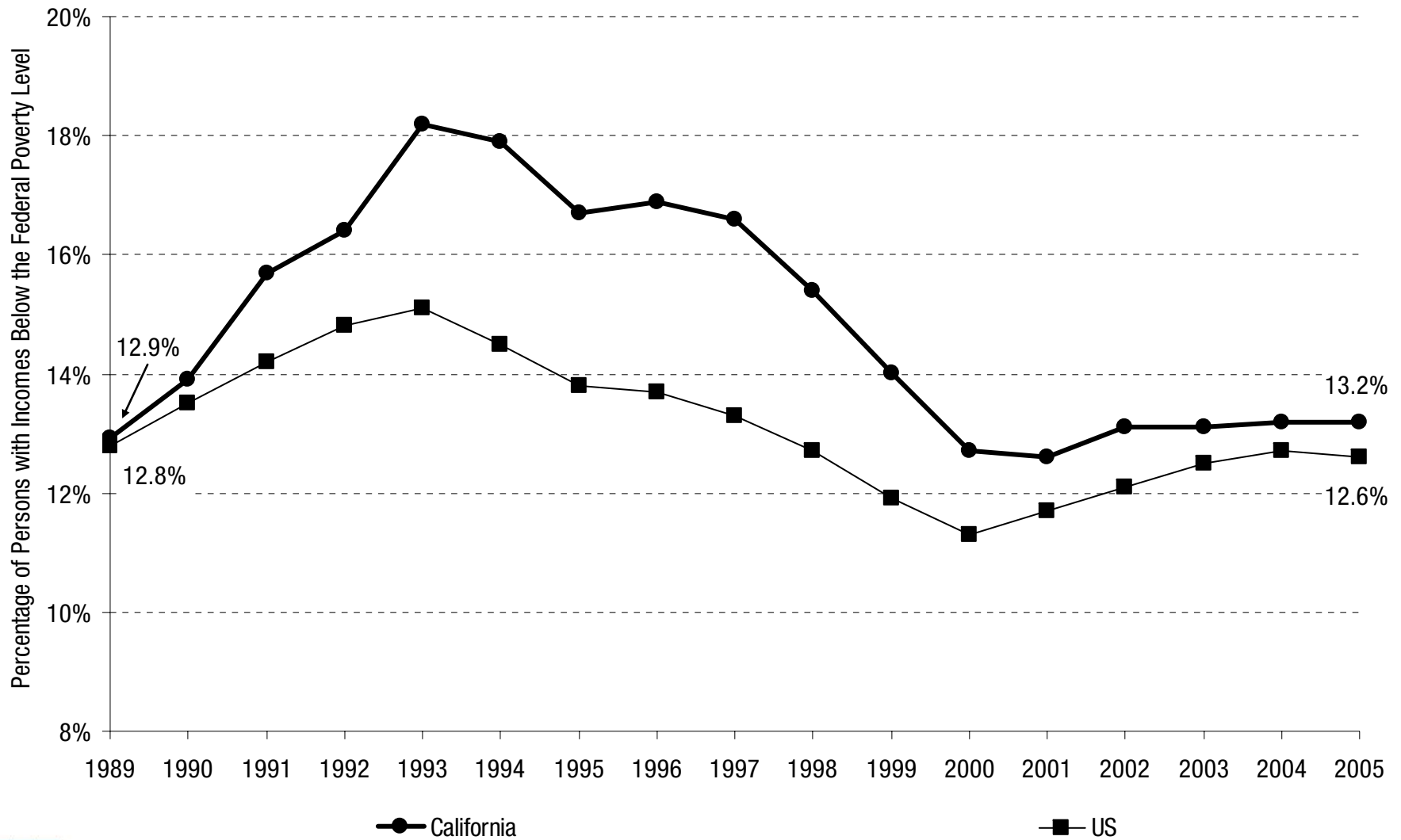
- The share of Californians in households with incomes below the federal poverty level remained constant in 2005, despite the fact that the nation was four years into an economic recovery. California's poverty rate remained higher than that of the nation as a whole.
- The income of the household at the midpoint of the income distribution was \$1,314 lower in 2005 than in 2000, after adjusting for inflation.
- These trends reflect broader shifts in the state's economy:
 - The average annual pay of sectors that lost jobs between 2000 and 2005 was substantially higher (\$51,215) than that of sectors that gained jobs (\$44,057).
 - Between 2000 and 2006, the growth in hourly earnings of California workers at the middle of the wage distribution lagged that of the nation, while that of low- and high-wage workers exceeded that of the nation.
 - Five of the 10 occupations with the largest projected job growth pay the typical worker – the worker at the midpoint of the earnings distribution – less than \$10 per hour, equivalent to an annual salary of \$20,800 for full-time, full-year work.

2005 Median Household Income Remained Below That of 2000

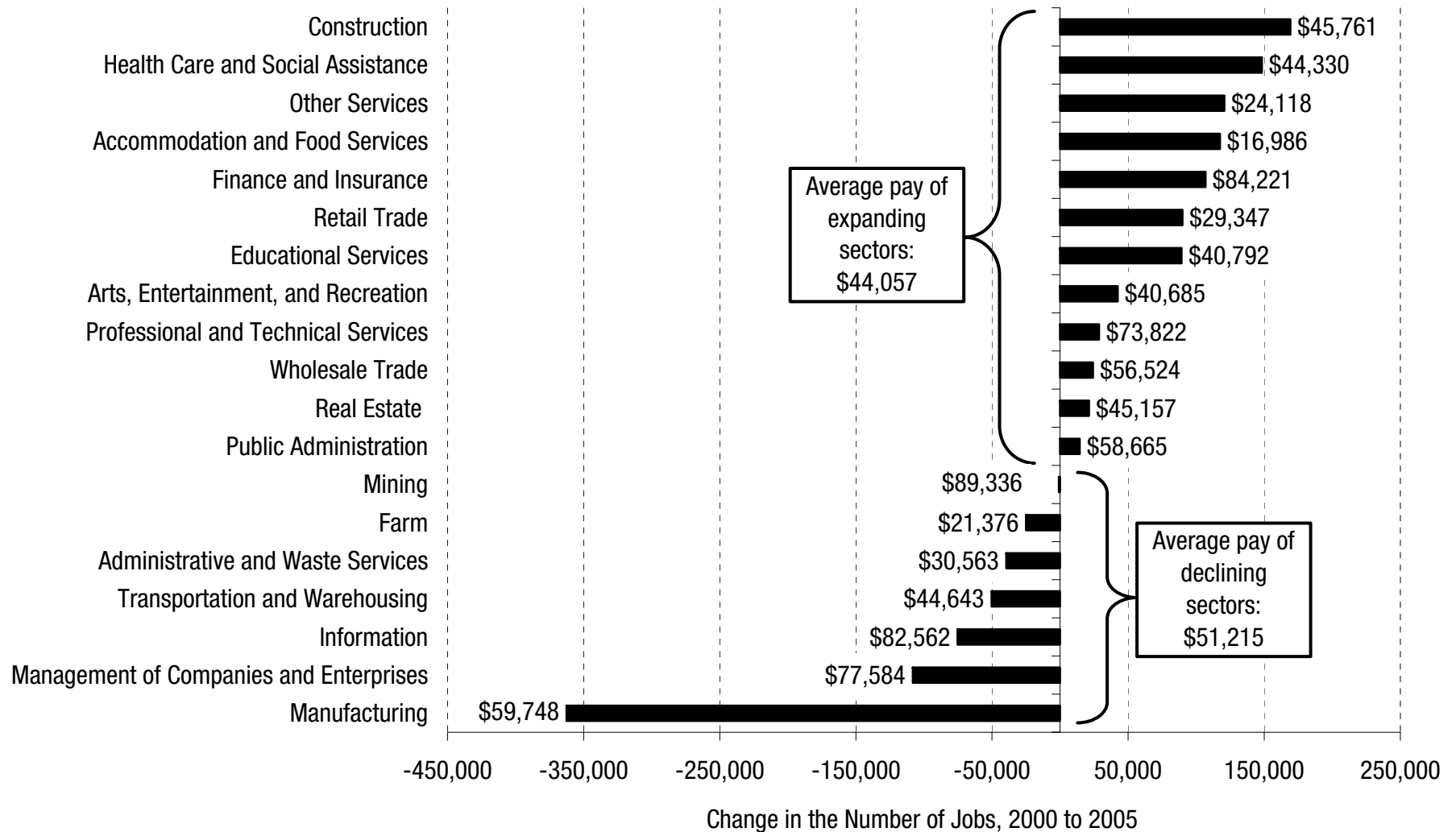


Source: US Census Bureau

The Share of Californians in Poverty Has Been Stagnant Since 2002

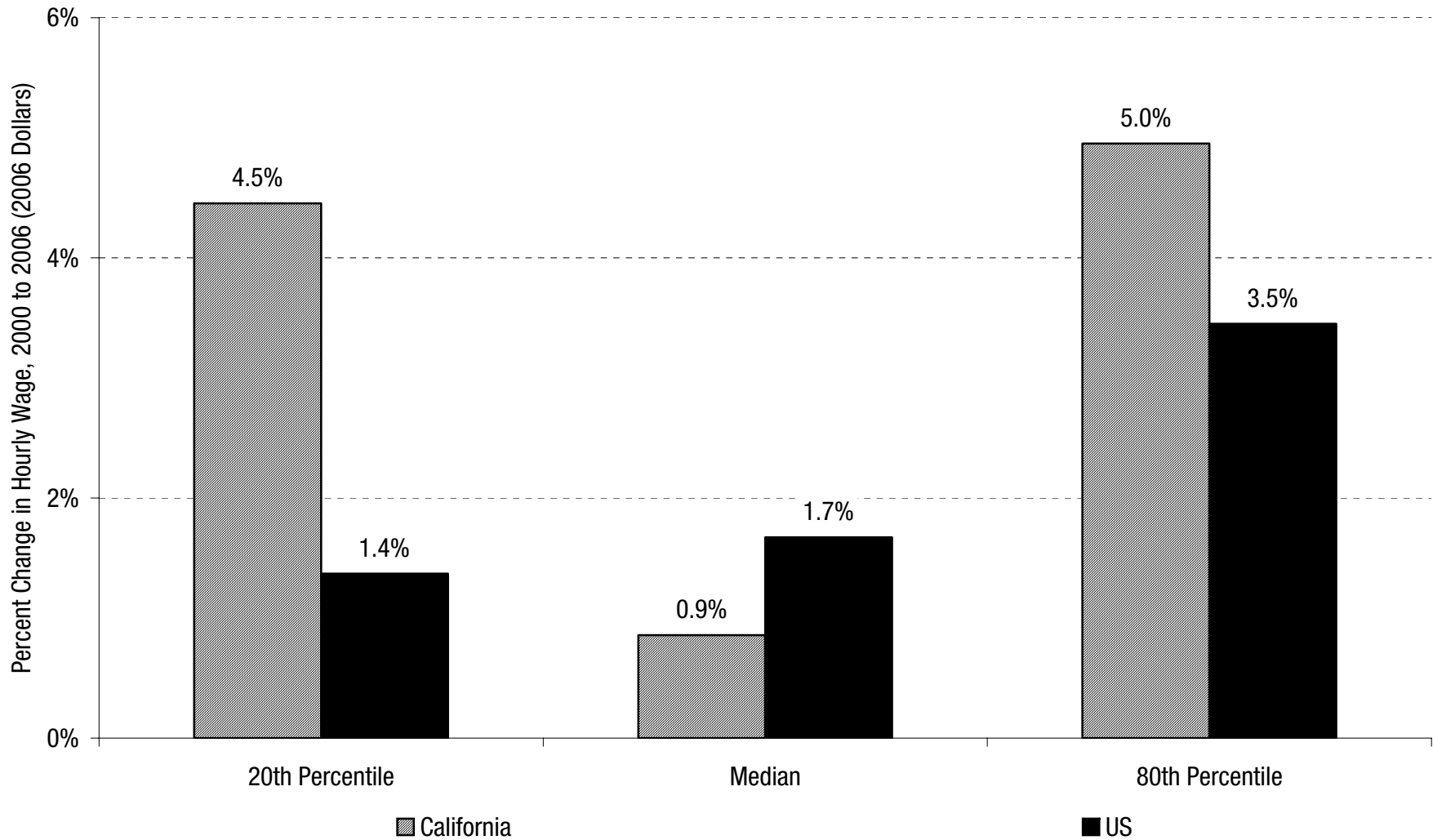


Average Pay of Expanding Sectors Was Lower Than That of Declining Sectors



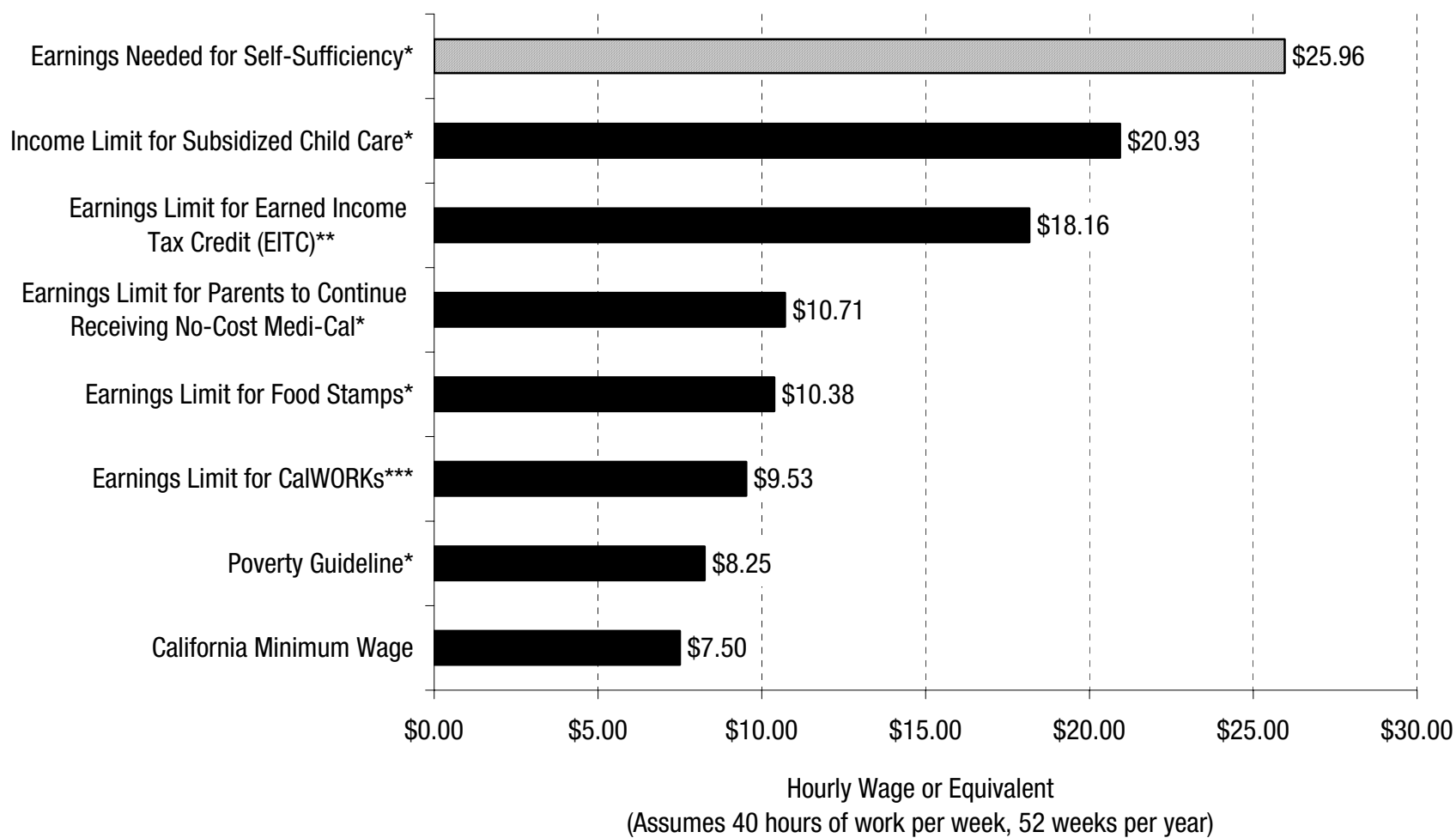
Source: CBP analysis of Employment Development Department data

The Wage Gain of the Typical California Worker Lagged That of the Typical US Worker



Source: CBP analysis of Current Population Survey data

Supports for Working Families End Before Families Reach Self-Sufficiency



* Family of three.

** One-parent family with two or more children.

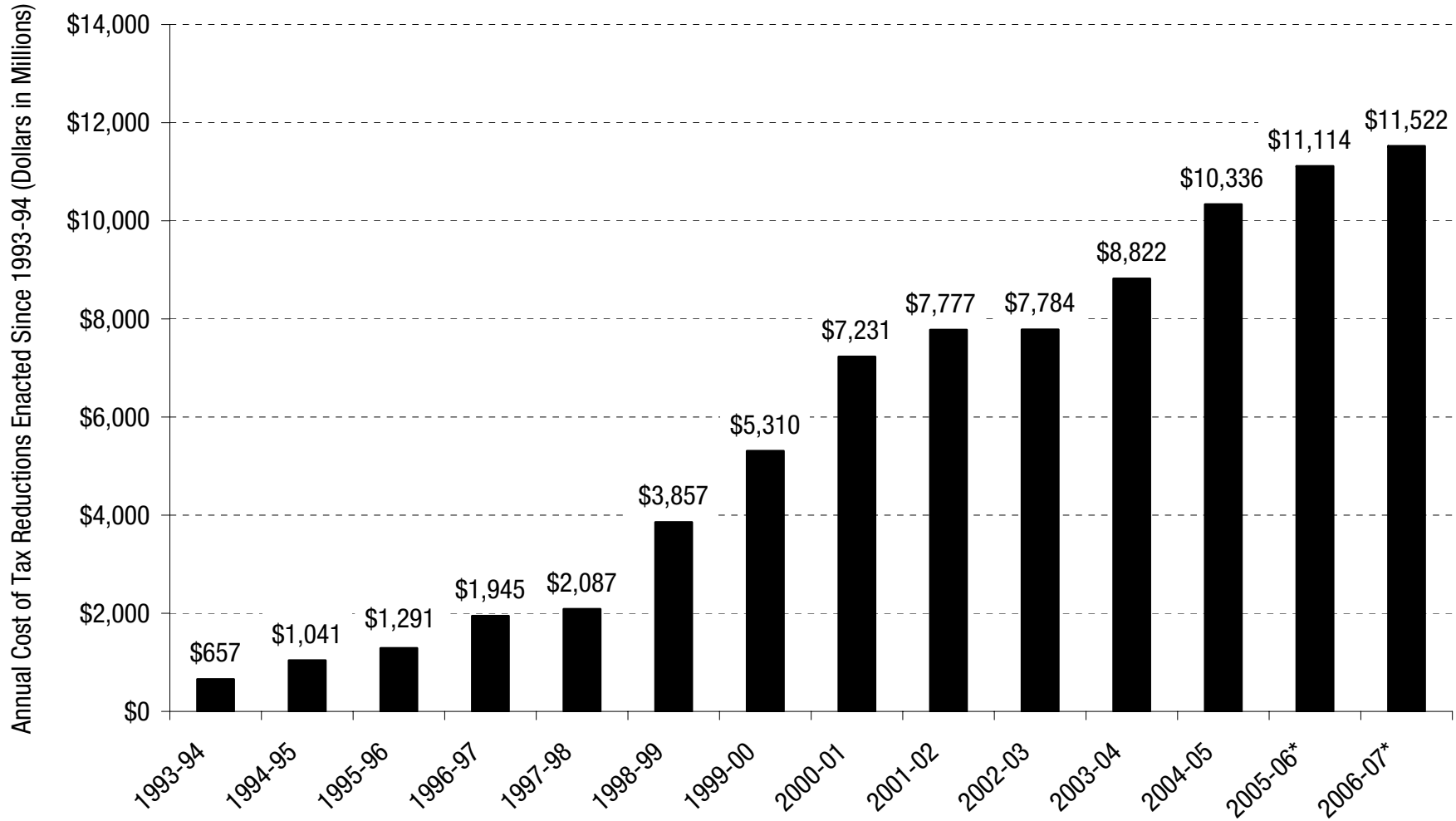
*** Family of three in a high-cost county.

California's Tax System Contributes to the Budget Gap

Tax policies and economic trends contribute to the state's budget problems:

- Tax cuts enacted between 1993 and 2006 will reduce 2006-07 revenues by an estimated \$11.5 billion. The largest reductions include the \$4.8 billion reduction in Vehicle License Fees, the \$1.0 billion expansion of the dependent tax credit, and the \$543 million 1996 corporate tax rate reduction.
- Revenues attributable to stock options and capital gains remain below 2000 levels.
- Corporate income taxes have declined over time as a share of General Fund revenues and as a share of corporate profits.
- The yield of the state's sales tax has declined over time, reflecting the shift in economic activity from goods to services and the rise of Internet and mail order sales that escape taxation. If taxable purchases accounted for the same share of personal income in 2007-08 as they did in 1966-67, the state would collect an additional \$13.3 billion in sales tax revenues.
- The phase-out of the federal estate tax will cost the state over \$1.1 billion in 2007-08. Current law reinstates the tax in 2011. However, the President proposes making the repeal permanent.

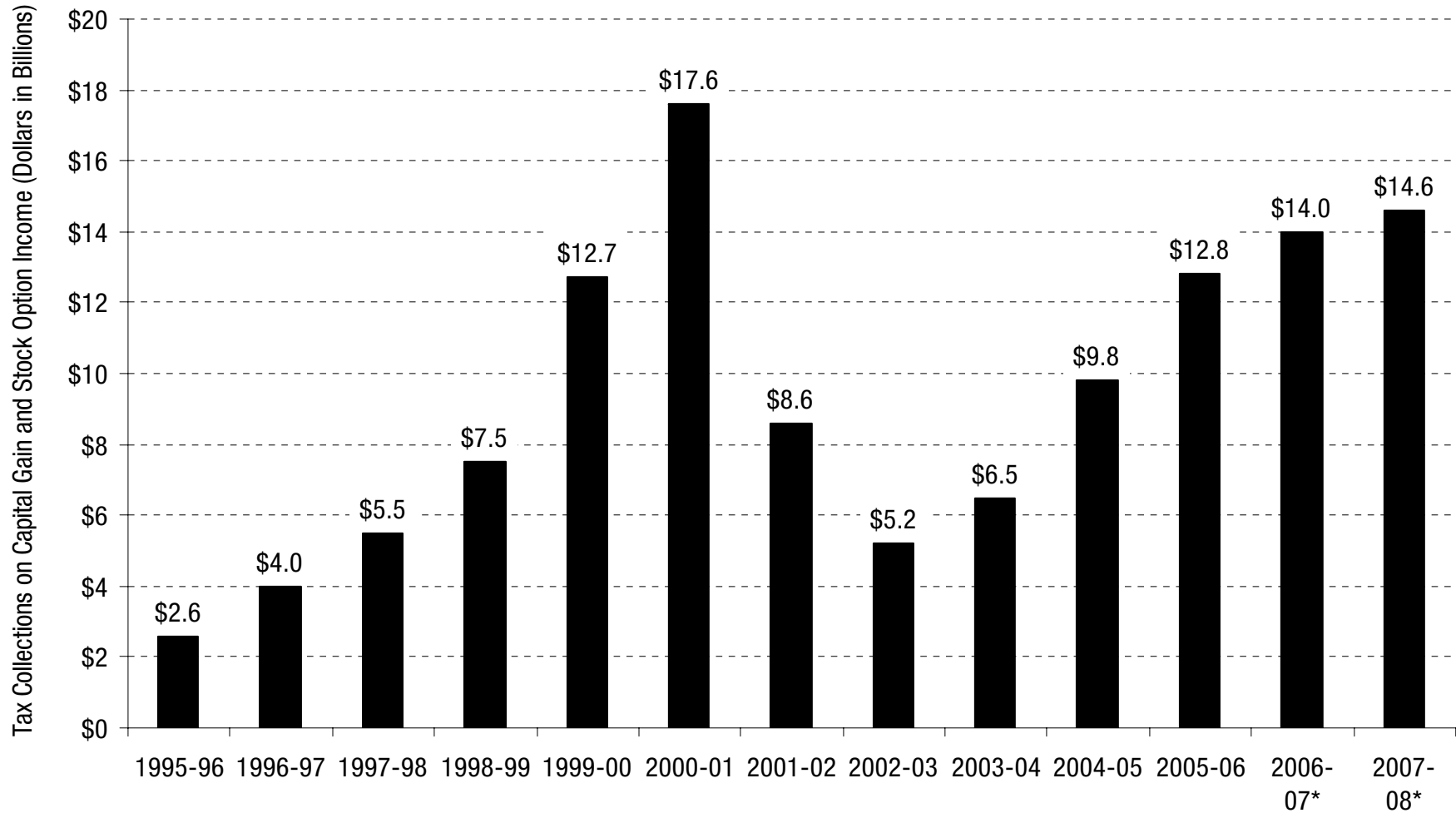
Tax Cuts Enacted Since 1993-94 Will Cost \$11.5 Billion in 2006-07



* 2005-06 and 2006-07 estimated.

Source: Franchise Tax Board, Board of Equalization, Legislative Analyst's Office, Department of Finance, and Assembly Revenue and Taxation Committee

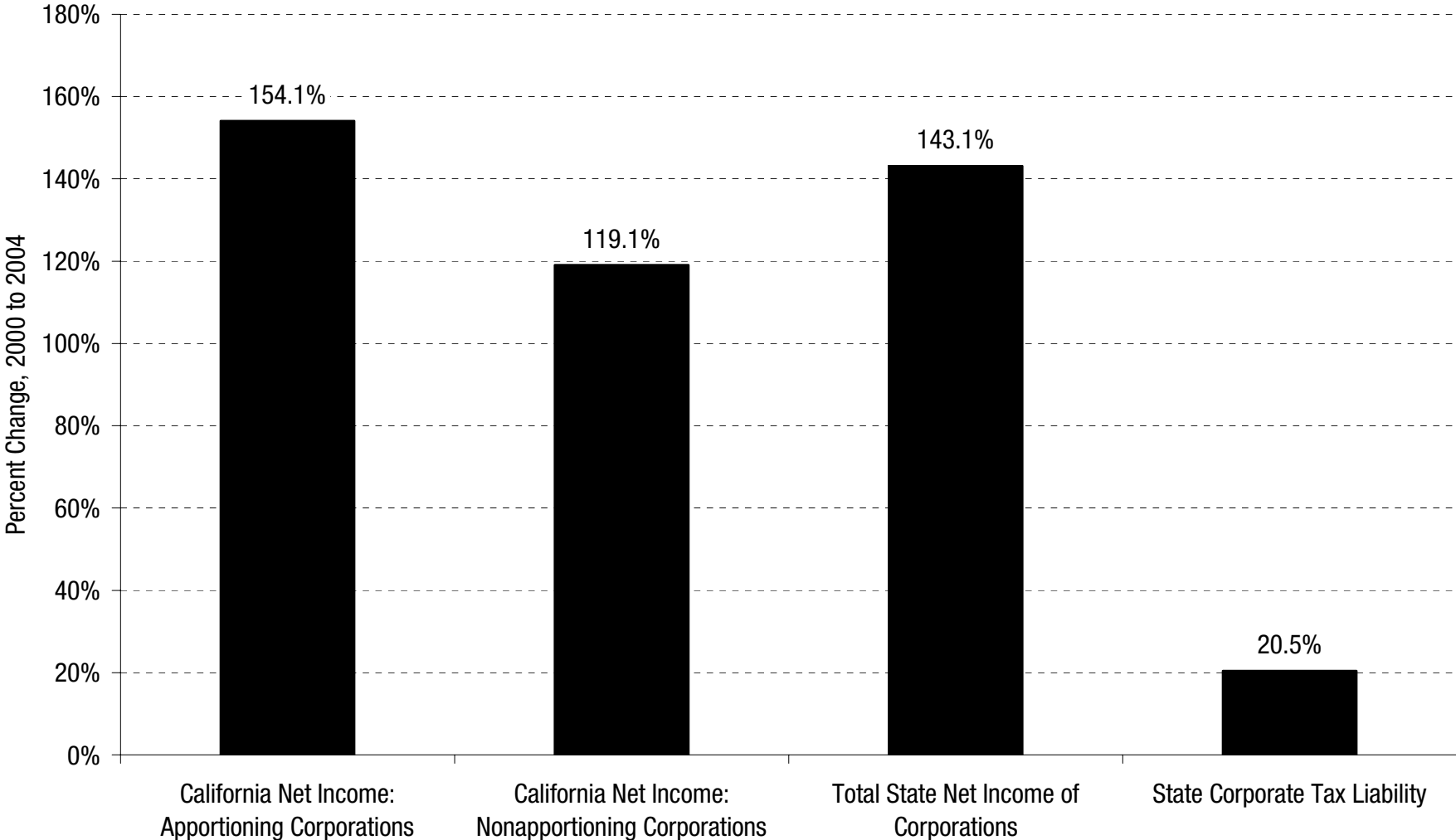
Revenues from Stock Options and Capital Gains Are Still Significantly Below Boom Levels



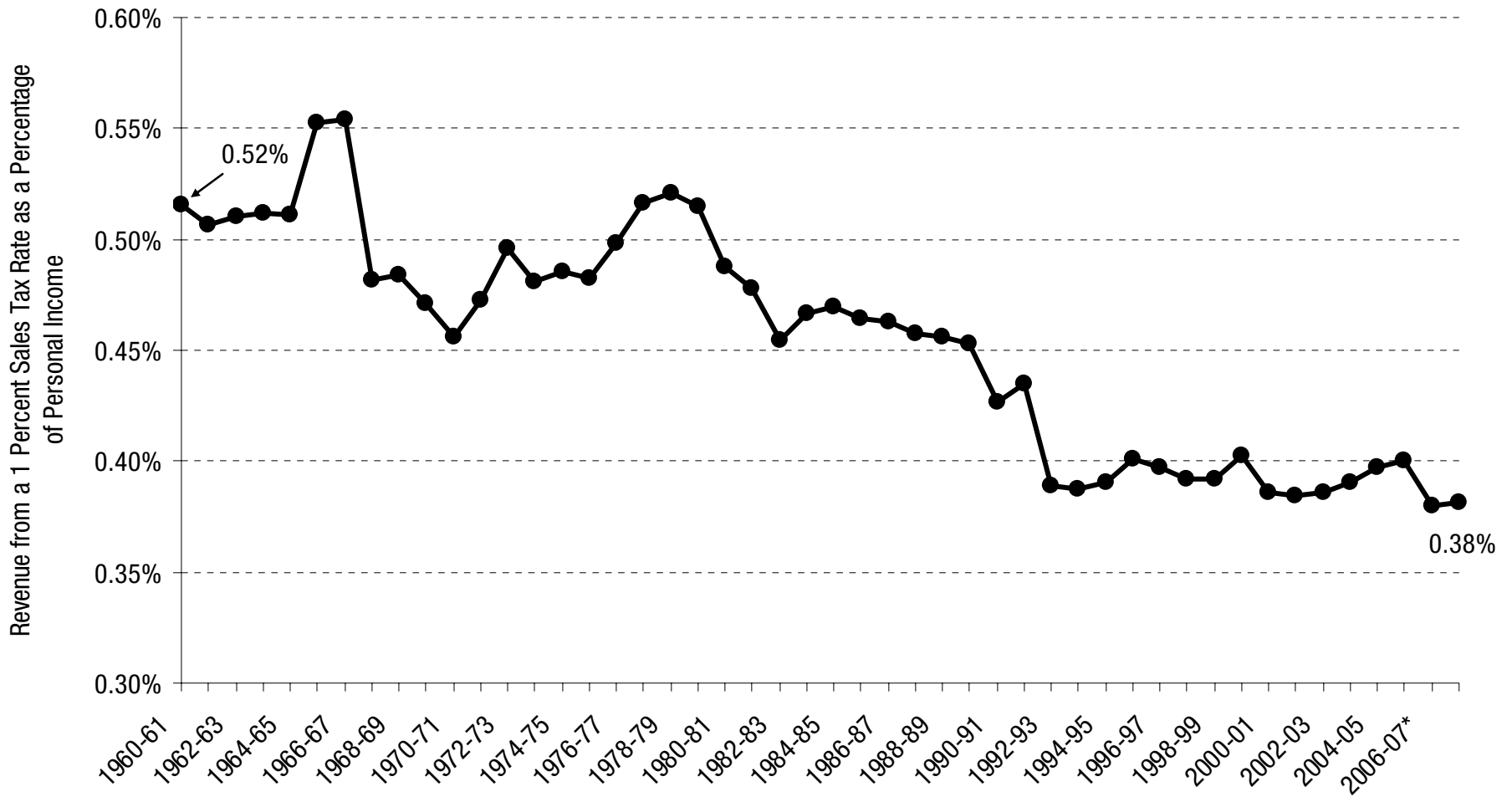
* 2006-07 estimated and 2007-08 projected.

Source: Department of Finance

Recent Growth in Corporate Profits Has Outstripped Corporate Tax Payments



Sales Tax Collections Have Declined as a Share of Personal Income



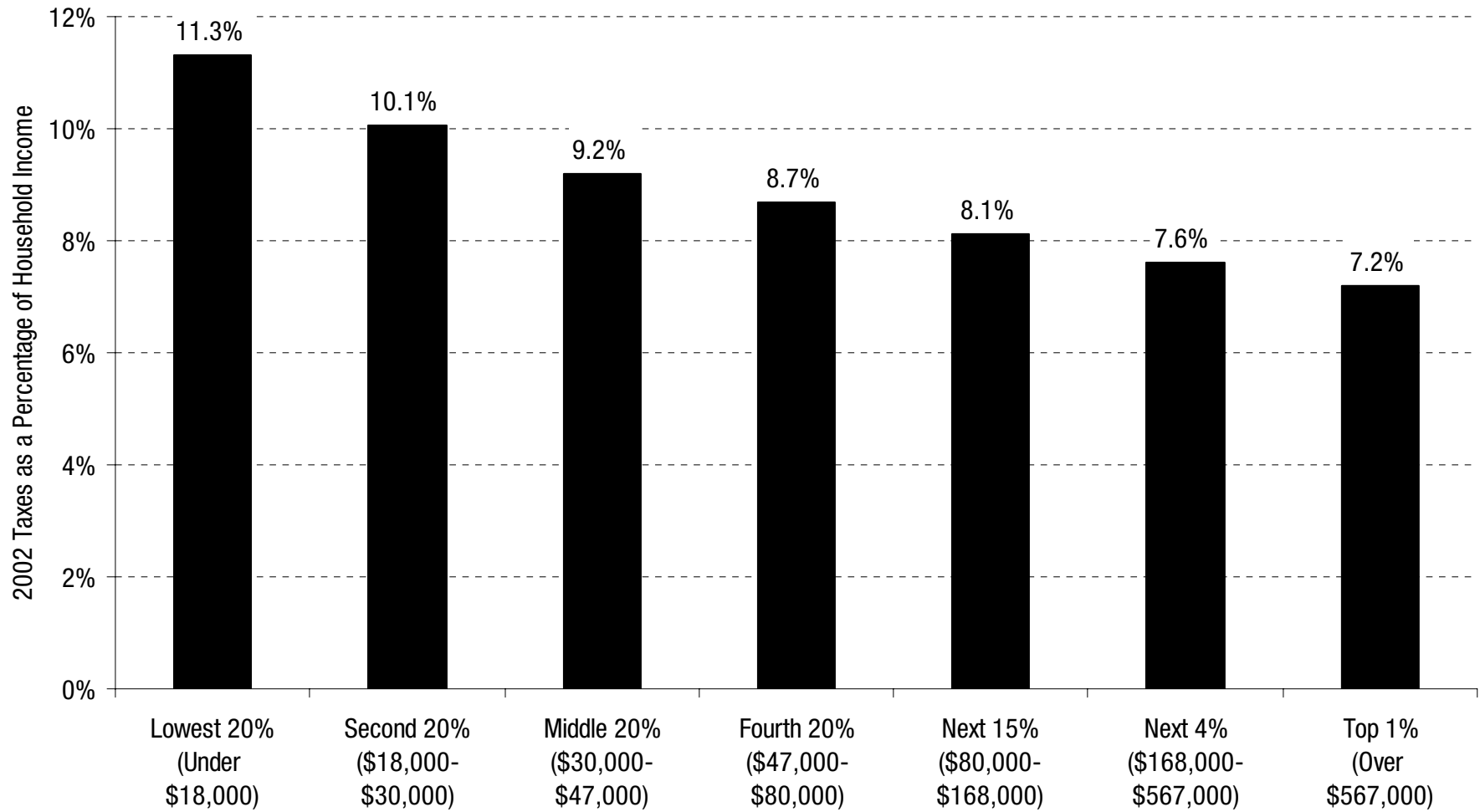
* 2006-07 estimated and 2007-08 projected.
 Source: Legislative Analyst's Office and Department of Finance

How Does California Compare?

Revenues as a Percentage of Personal Income

	California Rank	California	US
Total State and Local Own Source (2003-04)	19	16.17%	15.55%
Total State and Local Taxes (2003-04)	17	10.96%	10.72%
State Taxes (2004-05)	13	7.58%	6.50%
Local Taxes (2003-04)	30	3.94%	4.43%
State and Local General Sales Taxes (2003-04)	19	2.81%	2.60%
State and Local Property Tax (2003-04)	34	2.82%	3.38%
State General Sales Tax (2004-05)	20	2.31%	2.13%
State Motor Fuels Taxes (2004-05)	45	0.26%	0.35%
State Tobacco Tax (2004-05)	40	0.08%	0.13%
State Alcoholic Beverage Sales Taxes (2004-05)	41	0.02%	0.05%
State Individual Income Tax (2004-05)	5	3.31%	2.21%
State Corporate Income Tax (2004-05)	5	0.67%	0.39%

Lowest-Income Households Pay the Largest Share of Their Income in State and Local Taxes



Note: Calculated for non-elderly, married couples. Includes offset for federal deductibility of state taxes.
Source: Institute on Taxation and Economic Policy

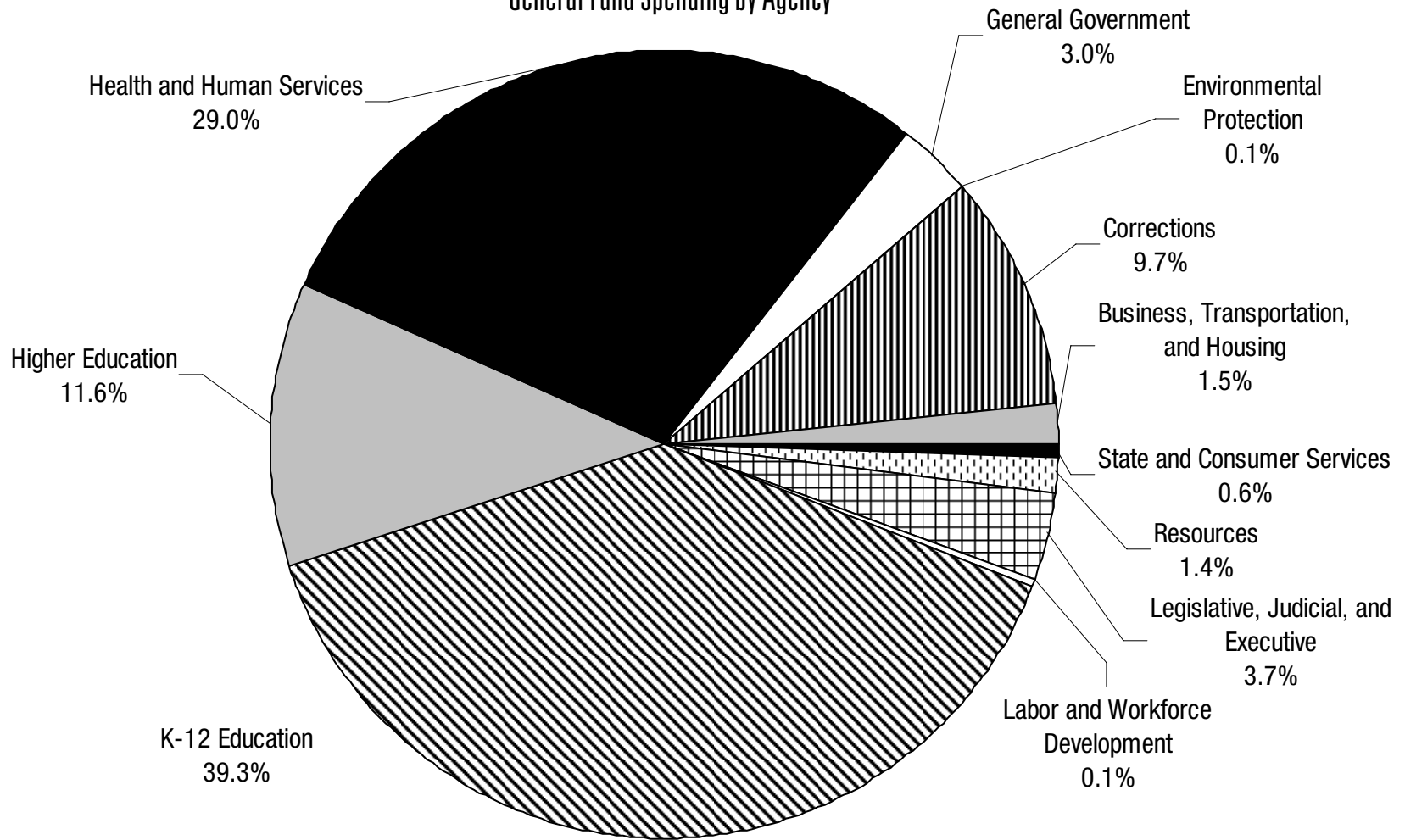
The Basics

The Governor's Proposed 2007-08 Budget:

- Would spend \$103.1 billion from the General Fund and assumes receipt of \$102.3 billion in General Fund revenues and transfers.
- Makes up the \$841 million gap from balances carried forward from the prior year.
- Assumes that \$1.023 billion would be transferred to the Budget Stabilization Account established by Proposition 58 of 2004, leaving total reserves of \$2.1 billion, down from an estimated \$2.9 billion in 2006-07.
- Proposes to increase General Fund spending by 1.0 percent and assumes 7.7 percent growth in General Fund revenues and transfers. The relatively modest growth in spending does not, however, reflect the proposed transfer of programs formerly supported by the General Fund to special funds, such as the use of Public Transportation Account funds for home-to-school transportation.

Education Accounts for the Largest Share of 2007-08 Spending

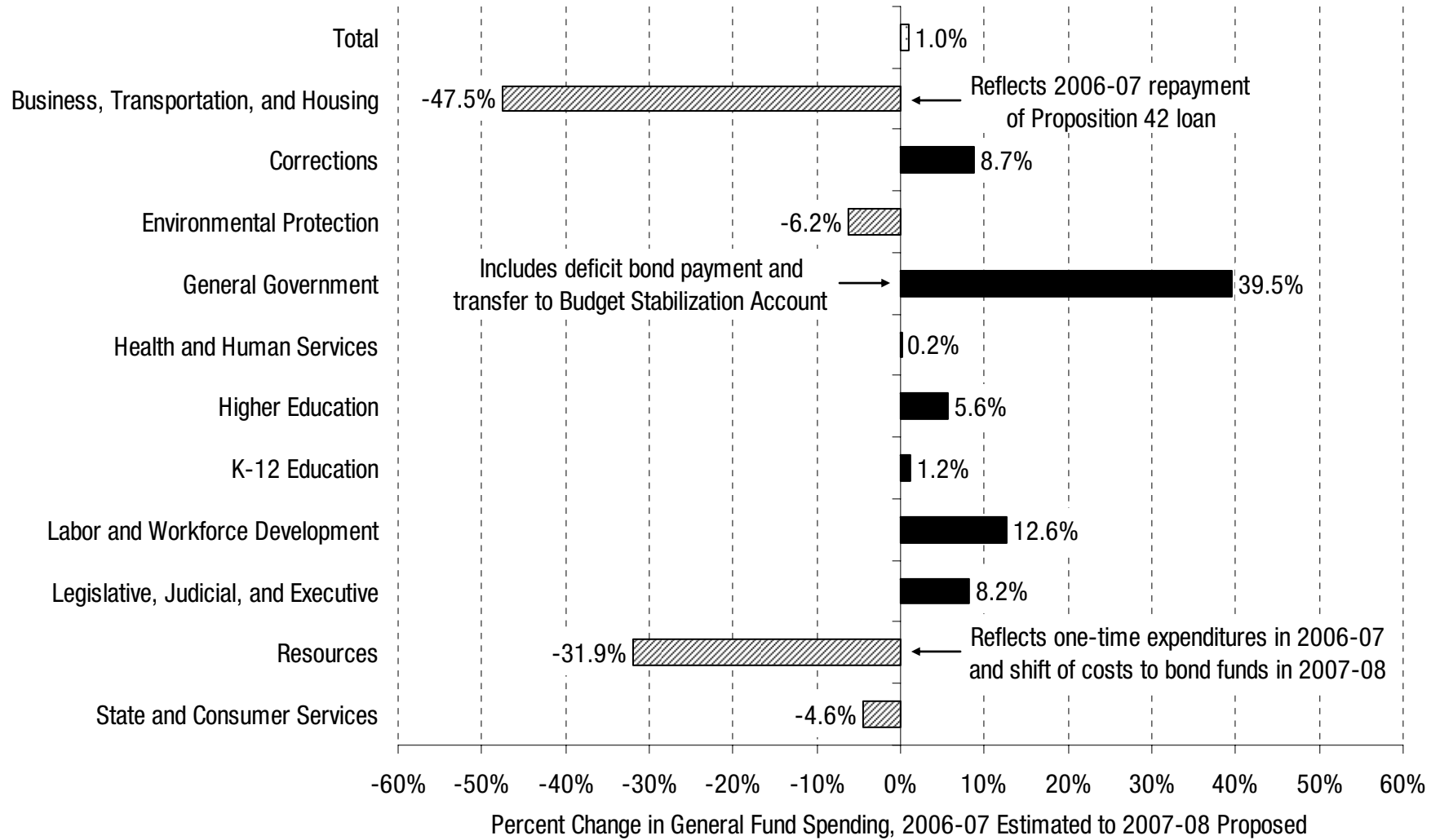
General Fund Spending by Agency



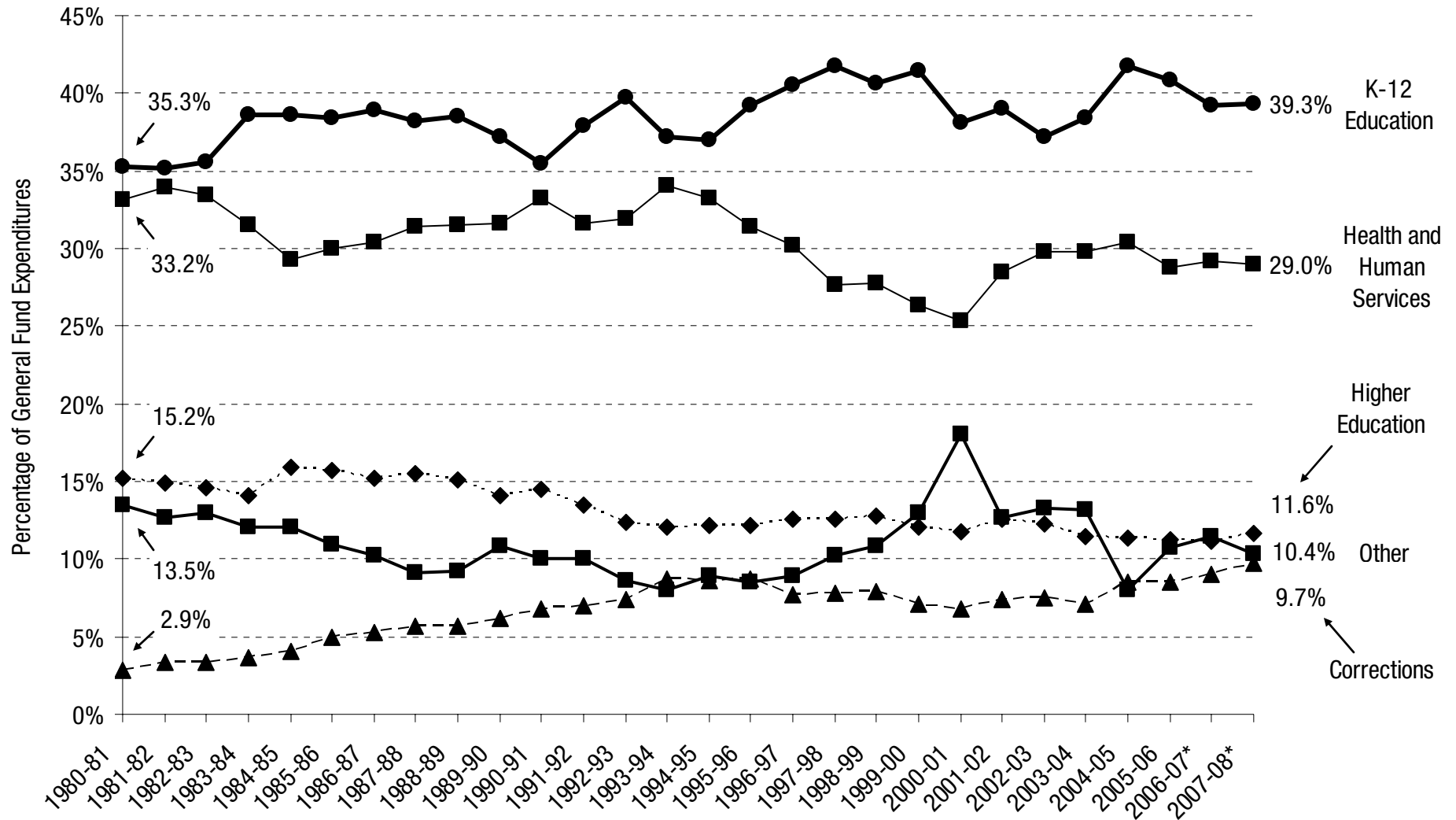
Proposed 2007-08 General Fund Expenditures = \$103.1 Billion

Source: Department of Finance

State Spending Up Modestly



K-12 Education Accounts for the Largest Share of State General Fund Spending



* 2006-07 estimated and 2007-08 proposed.

Source: Department of Finance

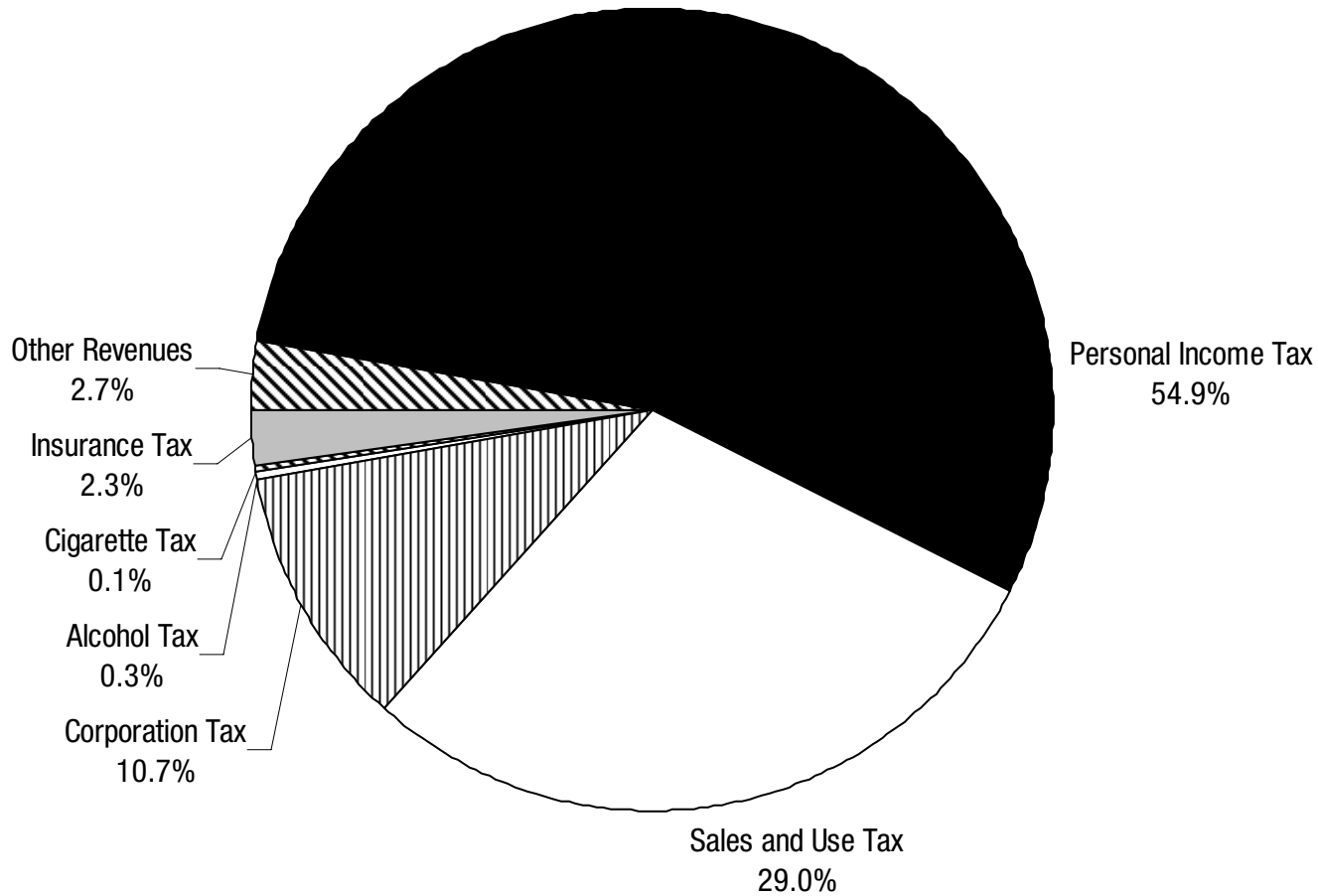
How Does California's Spending Compare to That of Other States?

Expenditures as a Percentage of State Personal Income, 2004-05

	California Rank	California	US
Total Expenditures	21	16.16%	14.76%
General Expenditures	28	13.62%	12.85%
Education	26	4.99%	4.57%
Hospitals	23	0.41%	0.43%
Health	10	0.70%	0.49%
Highways	44	0.69%	0.91%
Police Protection	38	0.10%	0.11%
Corrections	18	0.46%	0.41%
Natural Resources	25	0.22%	0.18%
Parks and Recreation	32	0.05%	0.05%

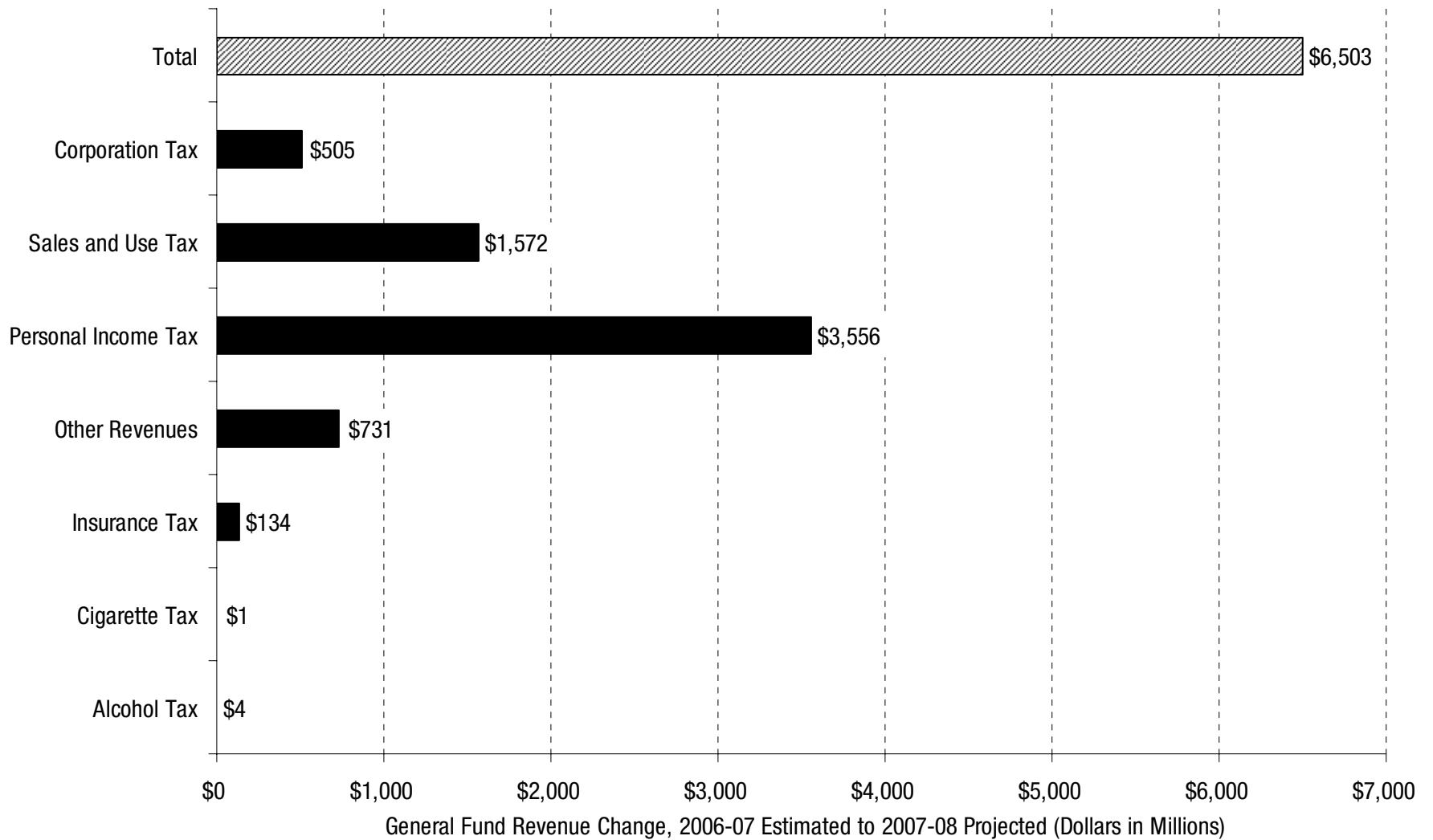
Source: US Census Bureau and US Bureau of Economic Analysis

The Personal Income Tax Provides More Than Half of 2007-08 General Fund Revenues

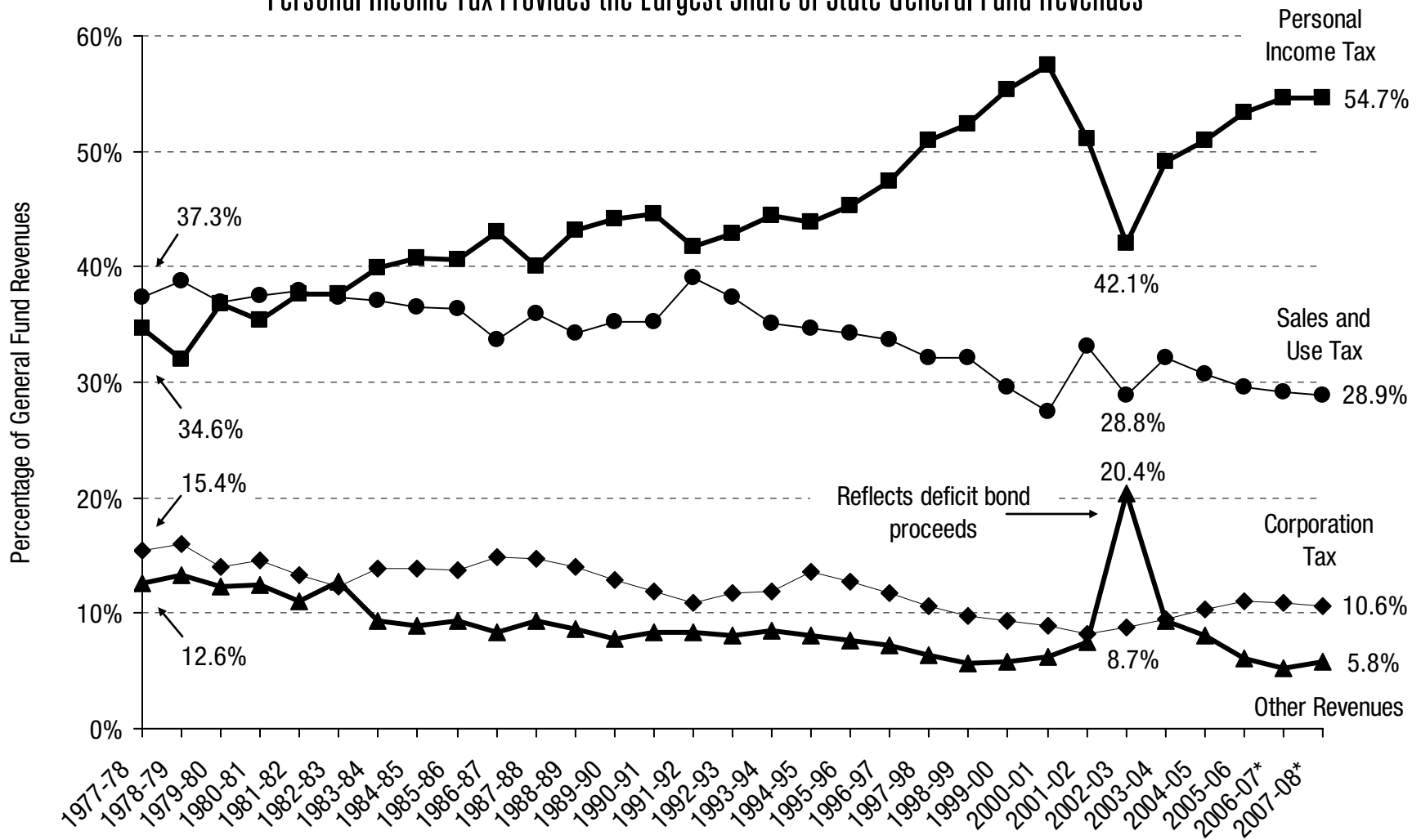


Projected 2007-08 General Fund Revenues = \$101.3 Billion

General Fund Revenues Are Expected to Increase by \$6.5 Billion



Personal Income Tax Provides the Largest Share of State General Fund Revenues



* 2006-07 estimated and 2007-08 projected.
Source: Legislative Analyst's Office

K-12 Education

The Governor's Proposed Budget:

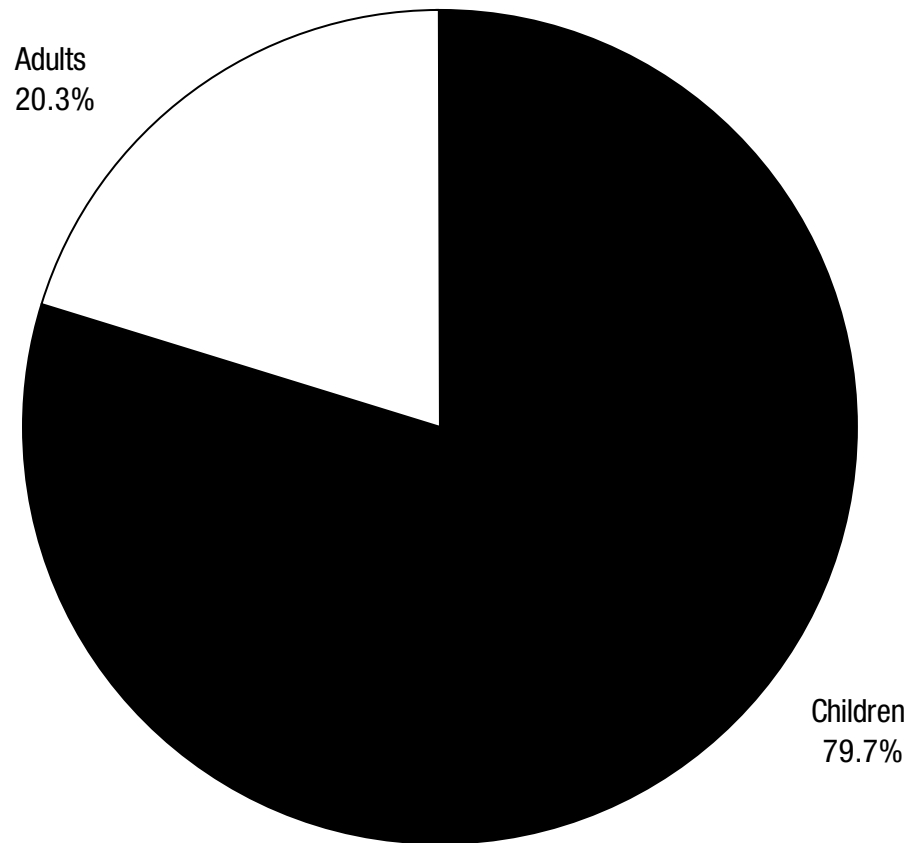
- Would fund a K-12 Proposition 98 per pupil spending level of \$8,569 in 2007-08, up from \$8,293 in 2006-07, a 3.3 percent increase.
- Includes \$300 million in Proposition 98 “settle-up” funds attributable to the 2004-05 suspension of the Proposition 98 guarantee. Of this amount, \$268 million would fund approximately 450 to 500 low-performing schools to reduce class sizes, reduce the number of students per counselor, and provide professional development.
- Uses \$627 million from the Public Transportation Account to fund home-to-school transportation, which historically has been funded from the General Fund, and reduces the Proposition 98 guarantee by an identical amount.
- Shifts \$268.9 million in additional CalWORKs Stage 2 child care costs under the Proposition 98 guarantee.
- Funds enrollment growth and a 4.04 percent cost of living adjustment for revenue limit apportionments, child care programs, class size reduction, special education, and various categorical programs. However, enrollment is anticipated to decline by 23,000 students, a drop of 0.39 percent.

CalWORKs/TANF

The Governor's Proposed Budget:

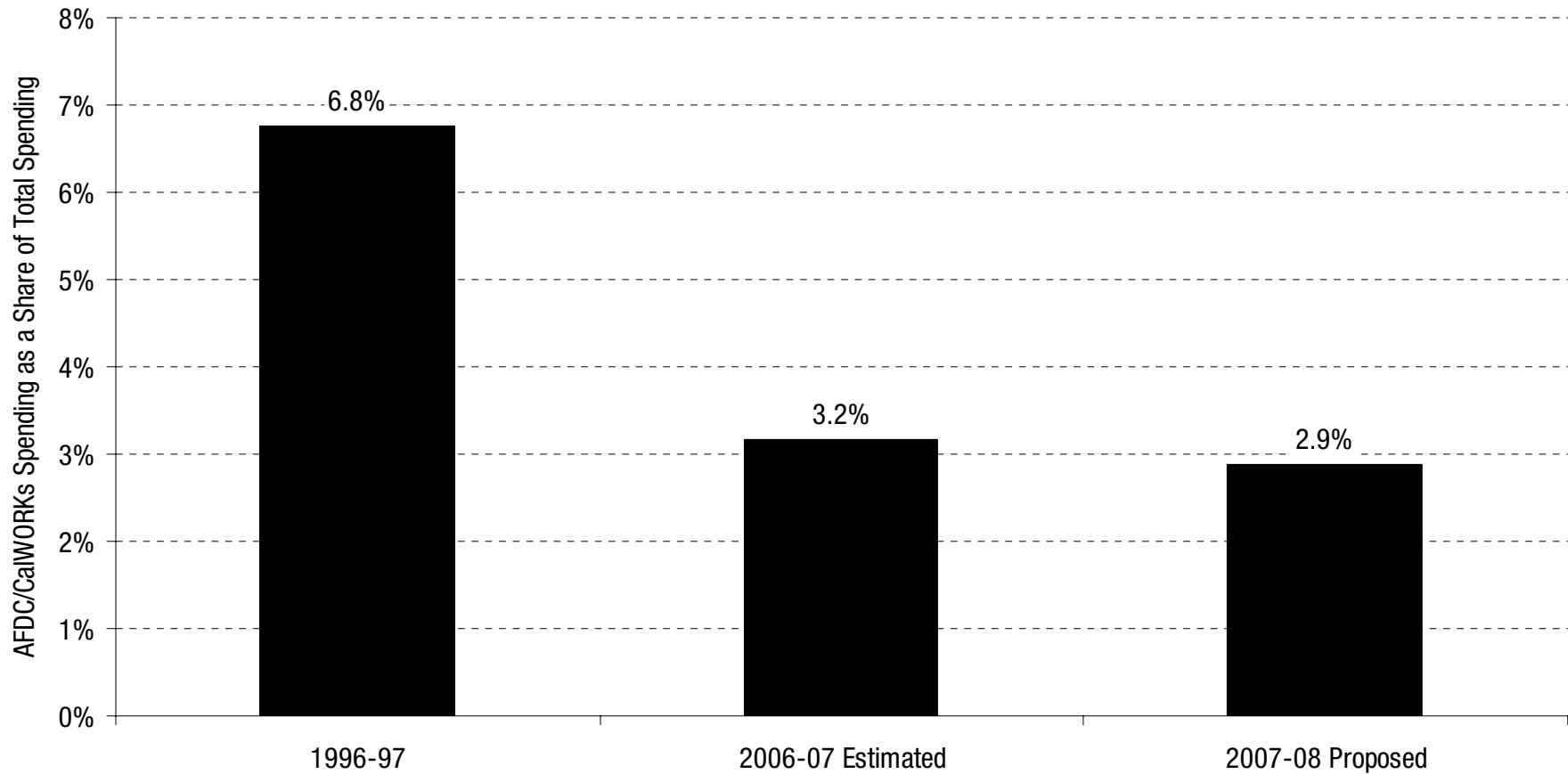
- Eliminates cash assistance for children if their parents do not meet CalWORKs requirements within 90 days.
- Eliminates “safety net” cash assistance for certain children after their parents have reached the state’s 60-month time limit.
- Eliminates cash assistance after 60 months for certain children whose parents are ineligible for CalWORKs.
- Suspends the July 2007 cost of living adjustment (COLA) for CalWORKs grants and continues to withhold the October 2003 COLA. These actions will cost CalWORKs families \$693 million in additional grant payments.

Four Out of Five CalWORKs Recipients Are Children



Number of Individuals Receiving CalWORKs Cash Assistance in September 2006 = 1.1 Million

Welfare Spending as a Share of Total Spending in California Would Drop Further Under the Governor's CalWORKs Proposals

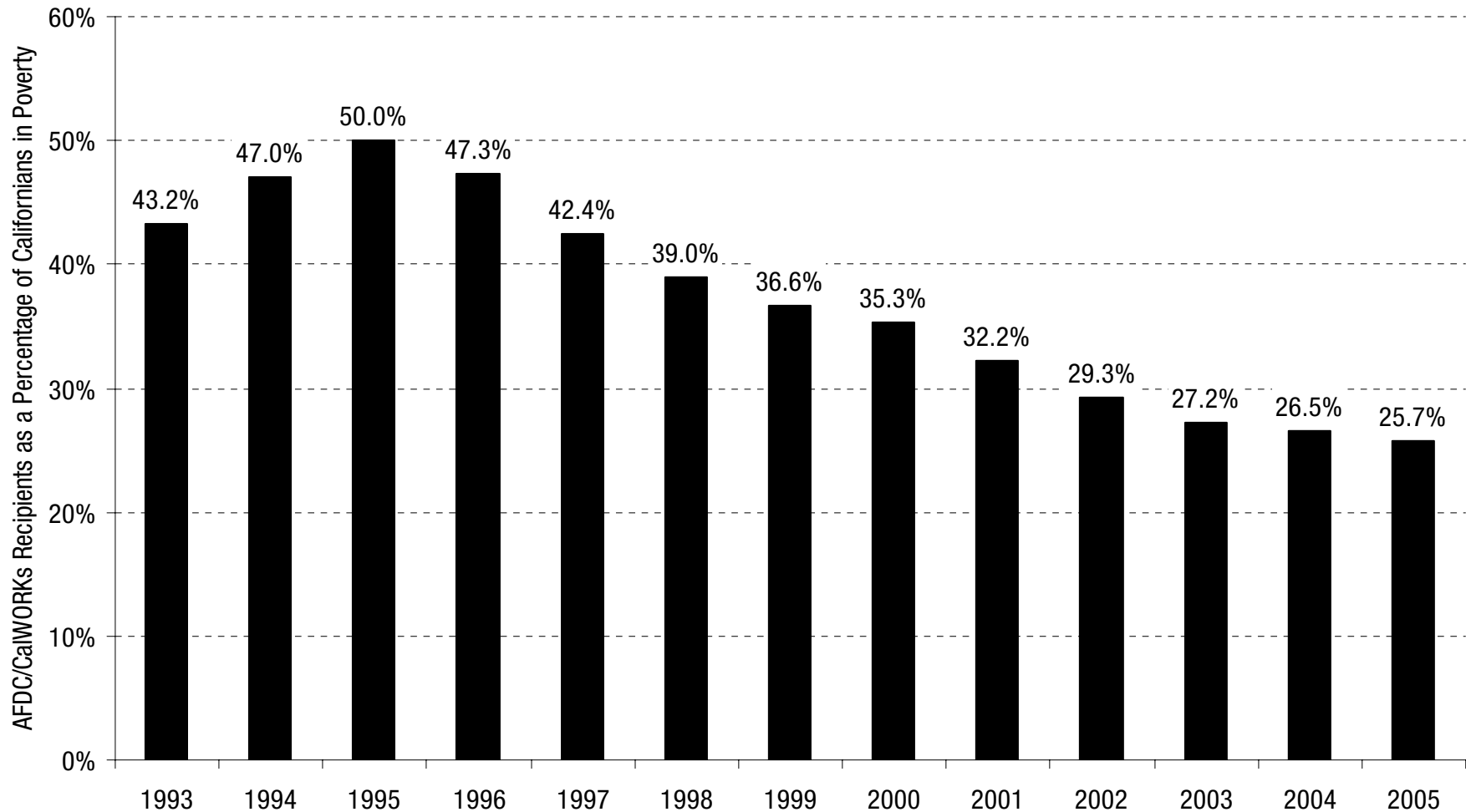


Note: AFDC/CalWORKs spending includes federal, state, and county funds.

Total spending includes federal and state funds.

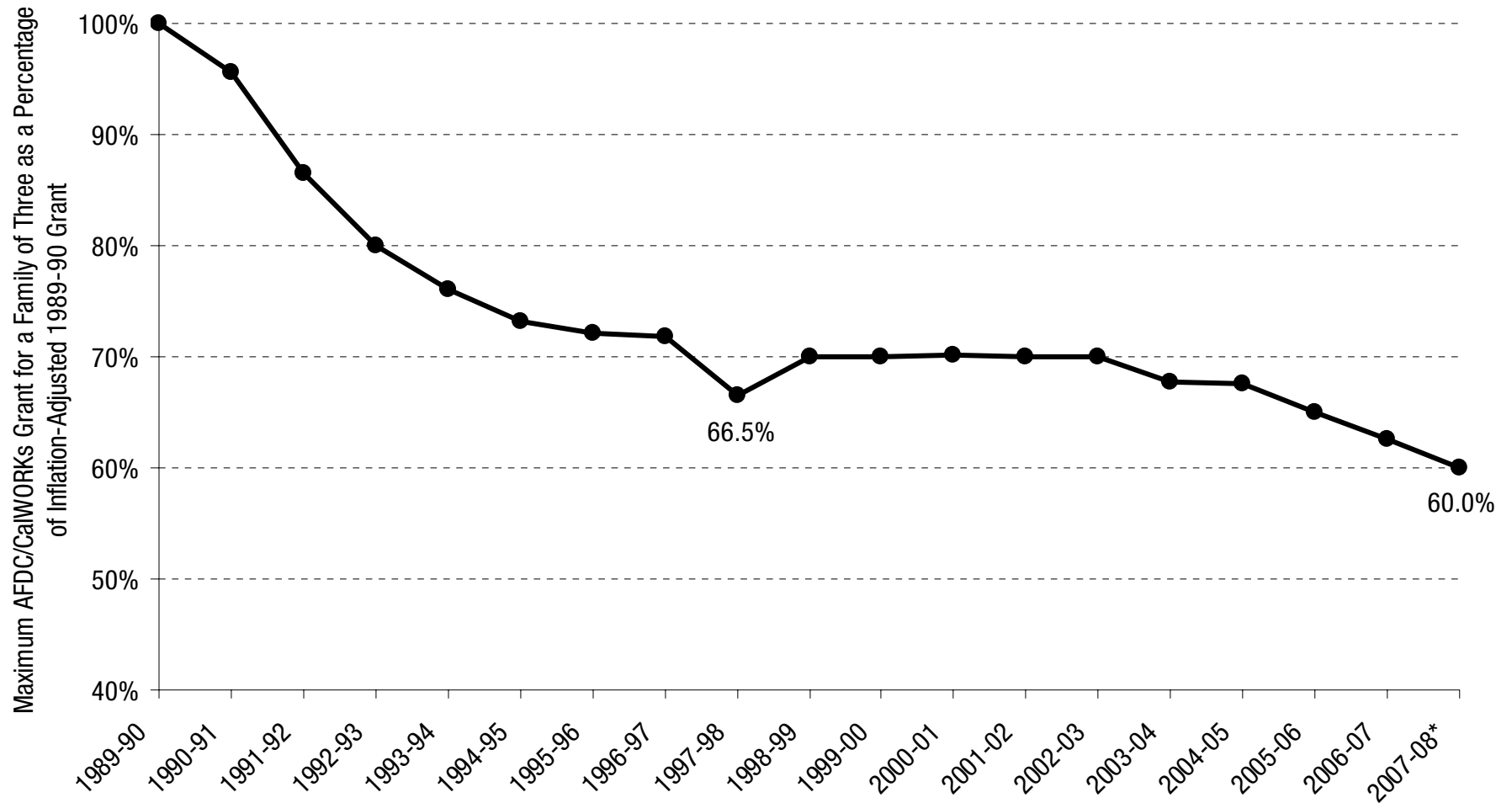
Source: Department of Education, Department of Finance, and Department of Social Services

Californians in Poverty Are Less Likely to Receive Cash Assistance



Source: US Census Bureau, Department of Social Services, and US Department of Health and Human Services

Purchasing Power of CalWORKs Grants Will Decline Further in 2007-08 if State Suspends July 2007 COLA



* 2007-08 proposed.

Source: Department of Finance and Department of Social Services

The Governor Proposes Ambitious Health Reforms

The Governor's proposal would:

- Require all Californians to carry a minimum level of health coverage.
- Expand public programs to cover all children with family incomes below 300 percent of the federal poverty level (FPL) and adults without children with incomes below 100 percent of the FPL.
- Provide subsidies to help other low-income adults purchase coverage.
- Require employers with 10 or more workers to pay a fee equal to 4 percent of payroll if they do not offer health coverage to their workers.
- Require hospitals to pay a fee of 4 percent, and physicians to pay 2 percent, of their gross revenues.
- Reduce funding that counties receive to treat the uninsured.
- Increase payments to Medi-Cal providers by \$4.0 billion.
- Require health insurance companies to insure all who apply and to spend at least 85 percent of premiums on patient care.

The Governor's Health Proposal Raises Questions

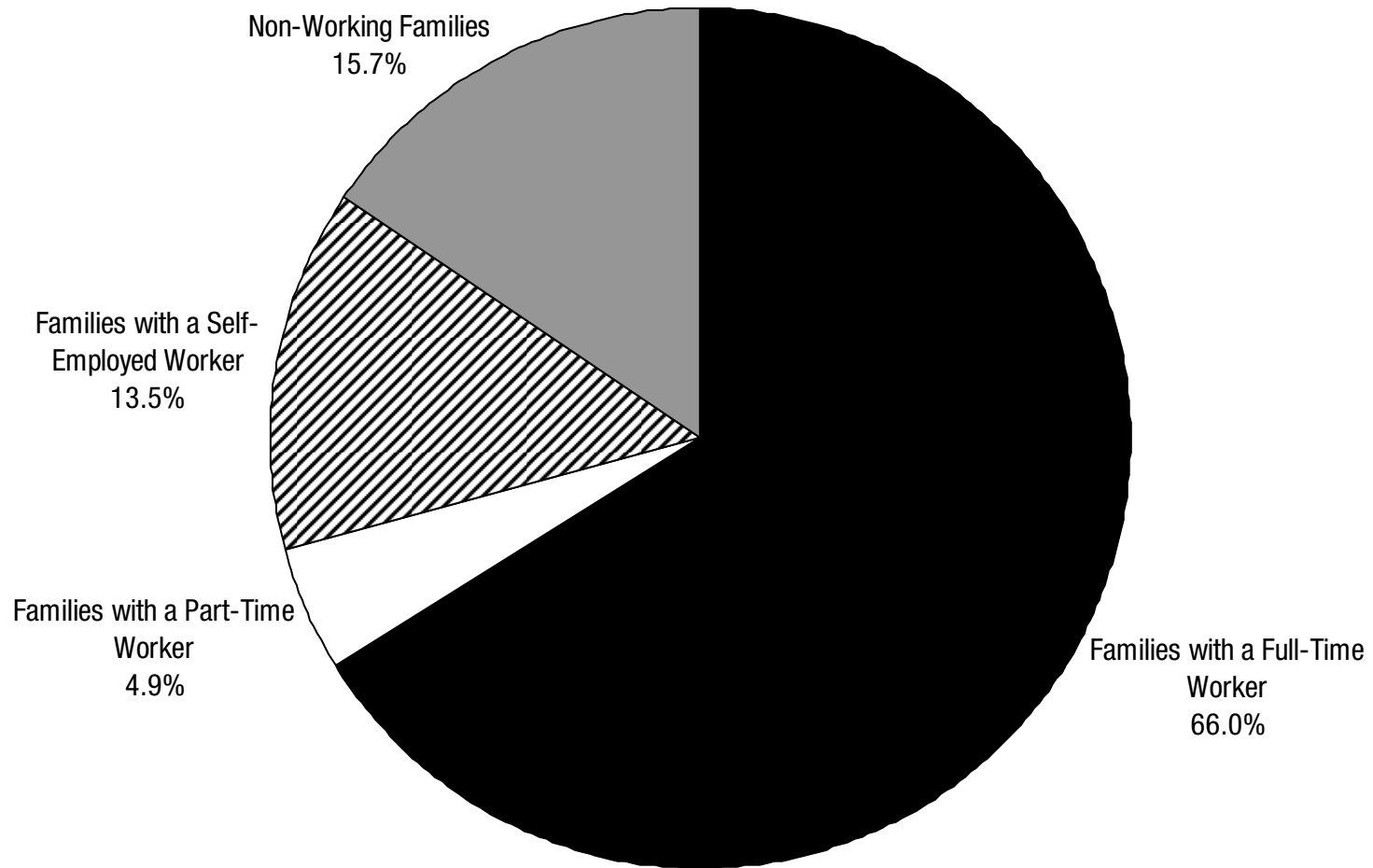
The Governor's health proposal raises a number of policy issues:

- Will the proposal extend high-quality, affordable, comprehensive coverage to all Californians?
- Does the proposal call for the “right” mix of sacrifice from individuals, employers, insurers, providers, and counties?
- Does the proposal raise sufficient revenues to support the proposed program over the long-term?
- Will counties retain enough funding to provide services to those who remain uninsured and to meet other obligations?
- Does the Governor's proposal simplify or add more complexity to the state's already complicated health care system?

Who Are California's Uninsured?

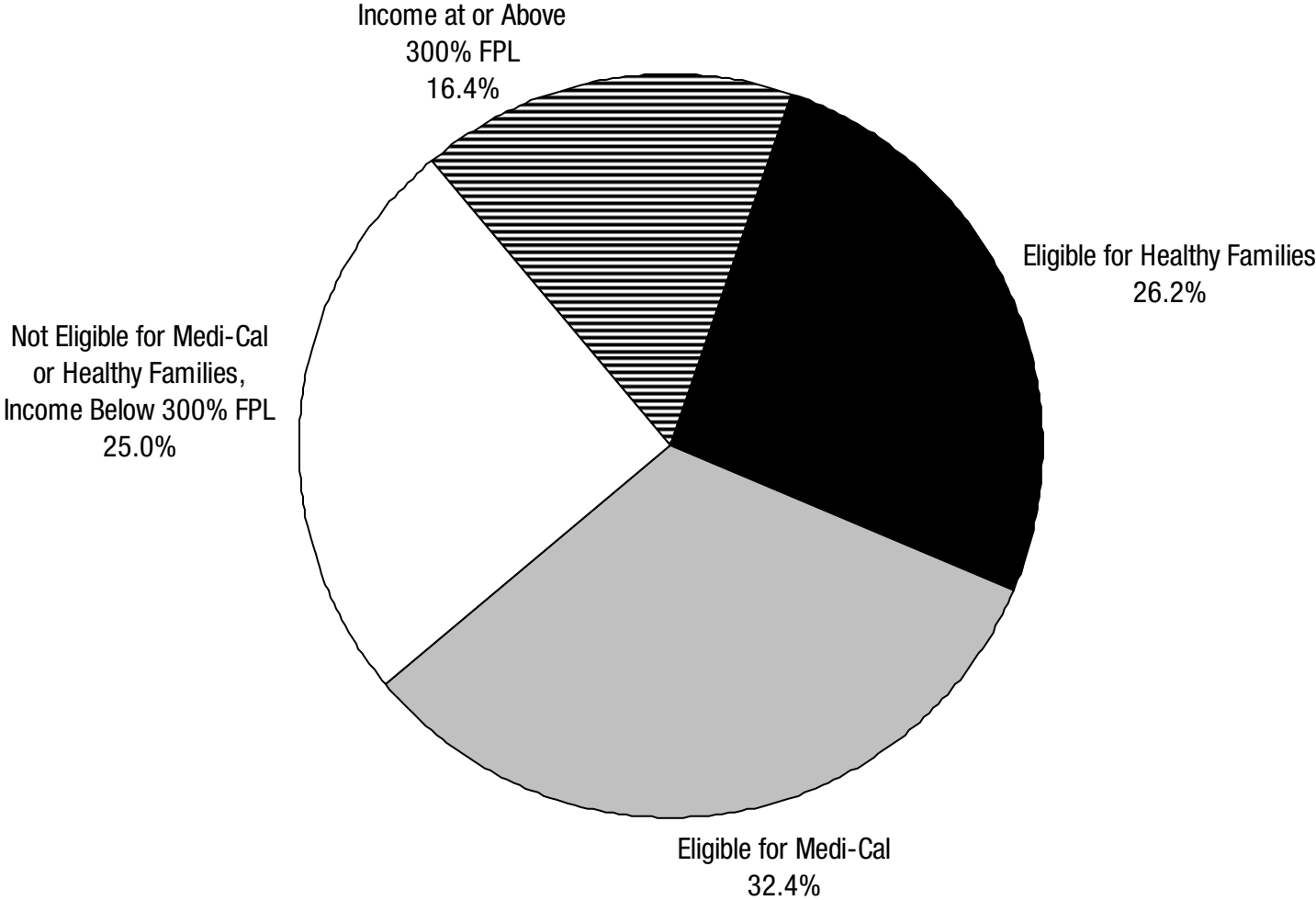
- Two-thirds of the uninsured under age 65 are in families with a full-time employee; an additional 18.4 percent are in families with either a self-employed or part-time worker.
- Over half of the state's uninsured children are eligible for coverage through Medi-Cal or Healthy Families. The remainder are ineligible, largely due to their family's income or their immigration status.
- The share of Californians with job-based health coverage declined between 2000 and 2005. A significant increase in the share of low-income children enrolled in publicly-supported programs more than offset the decline in children's coverage. However, the share of low-income adults under age 65 lacking coverage increased.

Most of the Uninsured Are in Working Families



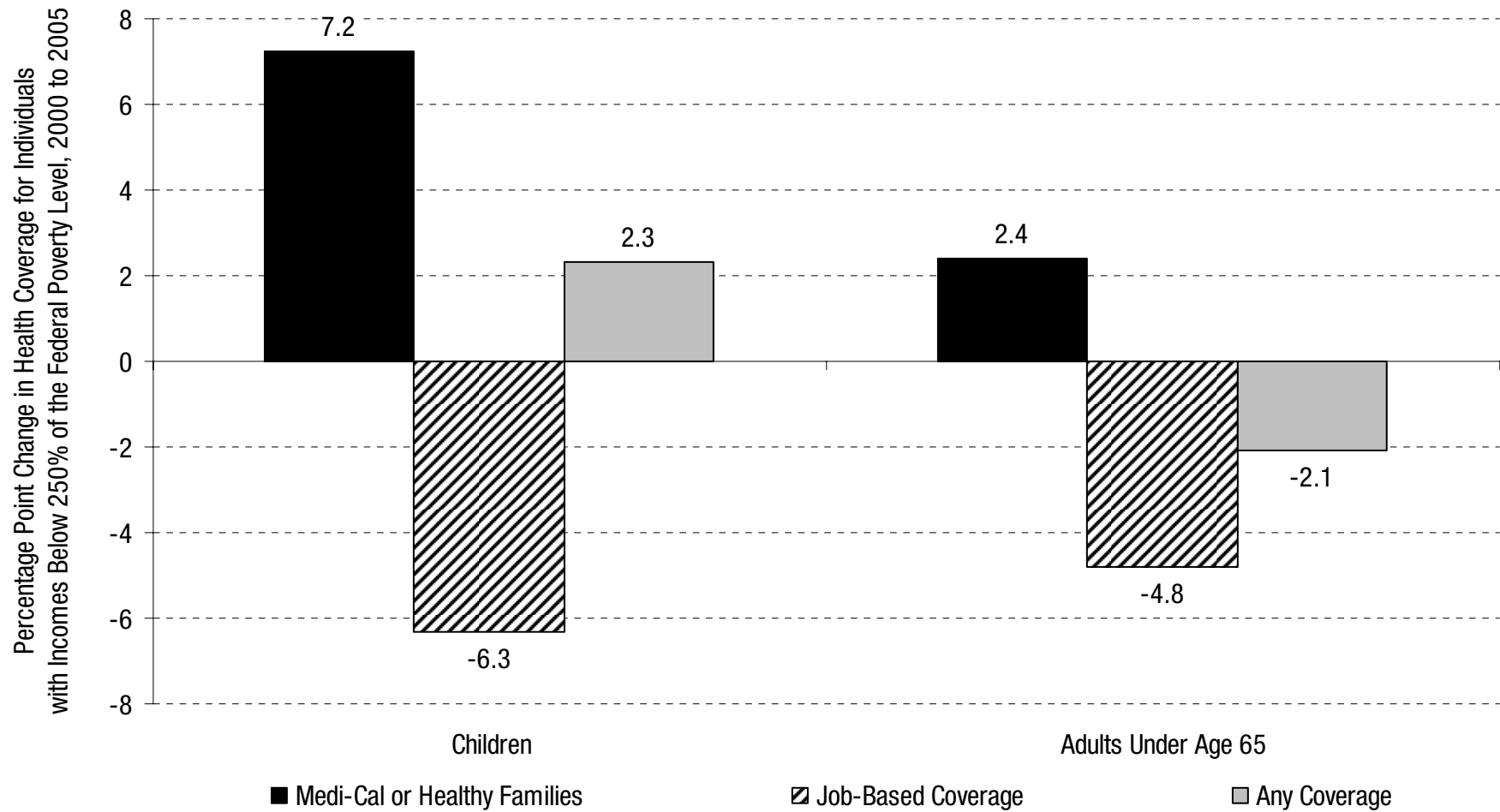
Note: Includes uninsured Californians under age 65.
Source: 2005 California Health Interview Survey

Who Are California's Uninsured Children



Note: FPL = Federal Poverty Level.
Source: 2005 California Health Interview Survey

Medi-Cal and Healthy Families Have Helped Offset the Erosion of Job-Based Coverage



Source: CBP analysis of Current Population Survey data

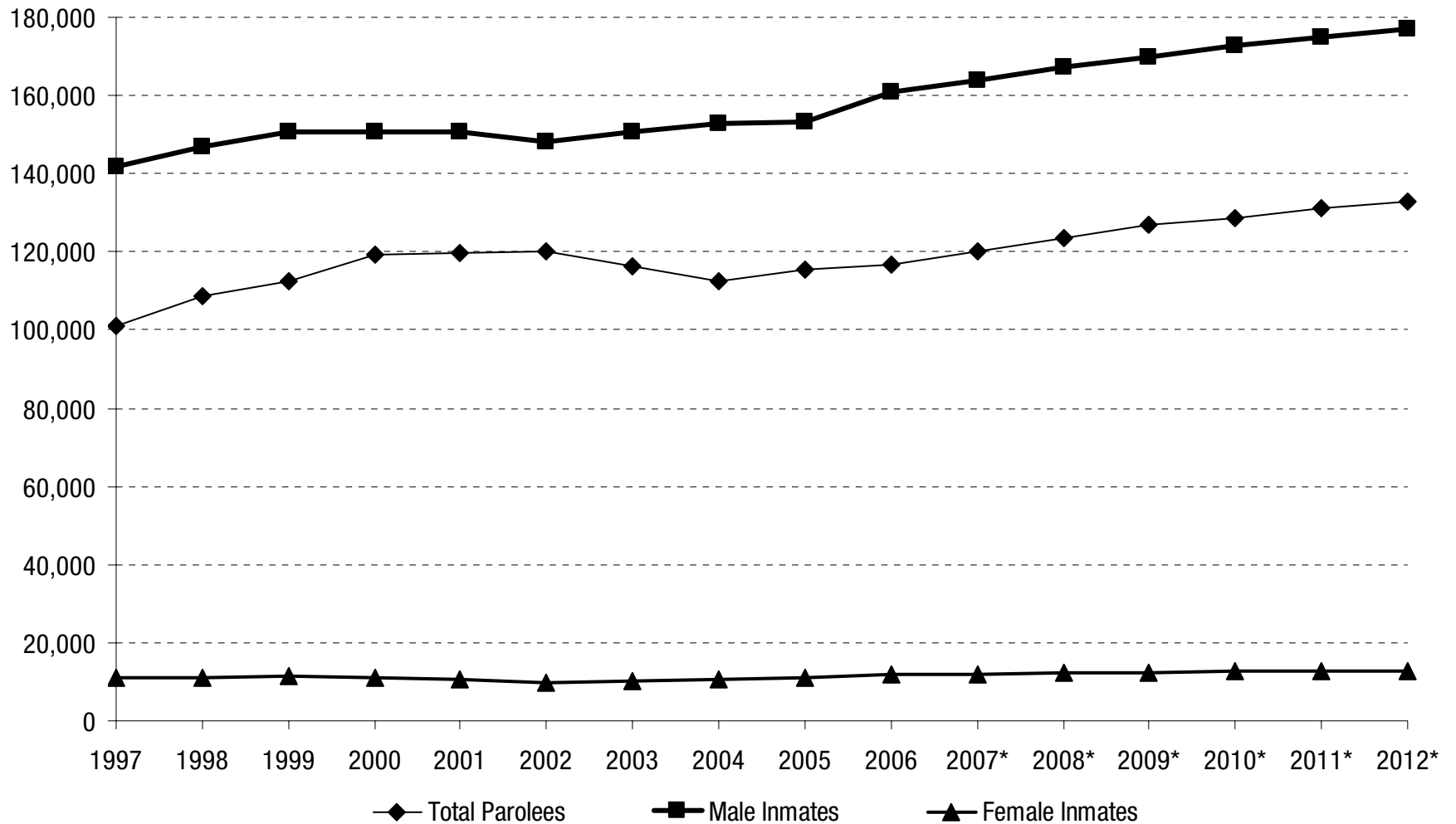
Does California Face a Corrections Crisis?

- Between 1980-81 and 2006-07, Corrections spending increased at more than three times the rate of General Fund spending overall.
- After a period of slow or no growth in the late 1990s and early years of this decade, the number of adults in the state prison system increased by 5.1 percent between June 30, 2005 and June 30, 2006. Significant growth is projected through 2012.
- The Governor claims that the state faces an overcrowding crisis and must act immediately. While most agree that current conditions are unacceptable, there is debate over whether additional capacity or sentencing reform offers the best solution.
- As a result of litigation, federal judges now oversee inmate medical, dental, and mental health care; the rights of parolees; conditions in juvenile facilities; and other aspects of the state's correctional facilities.

The Governor Proposes More Beds and Sentencing Reform

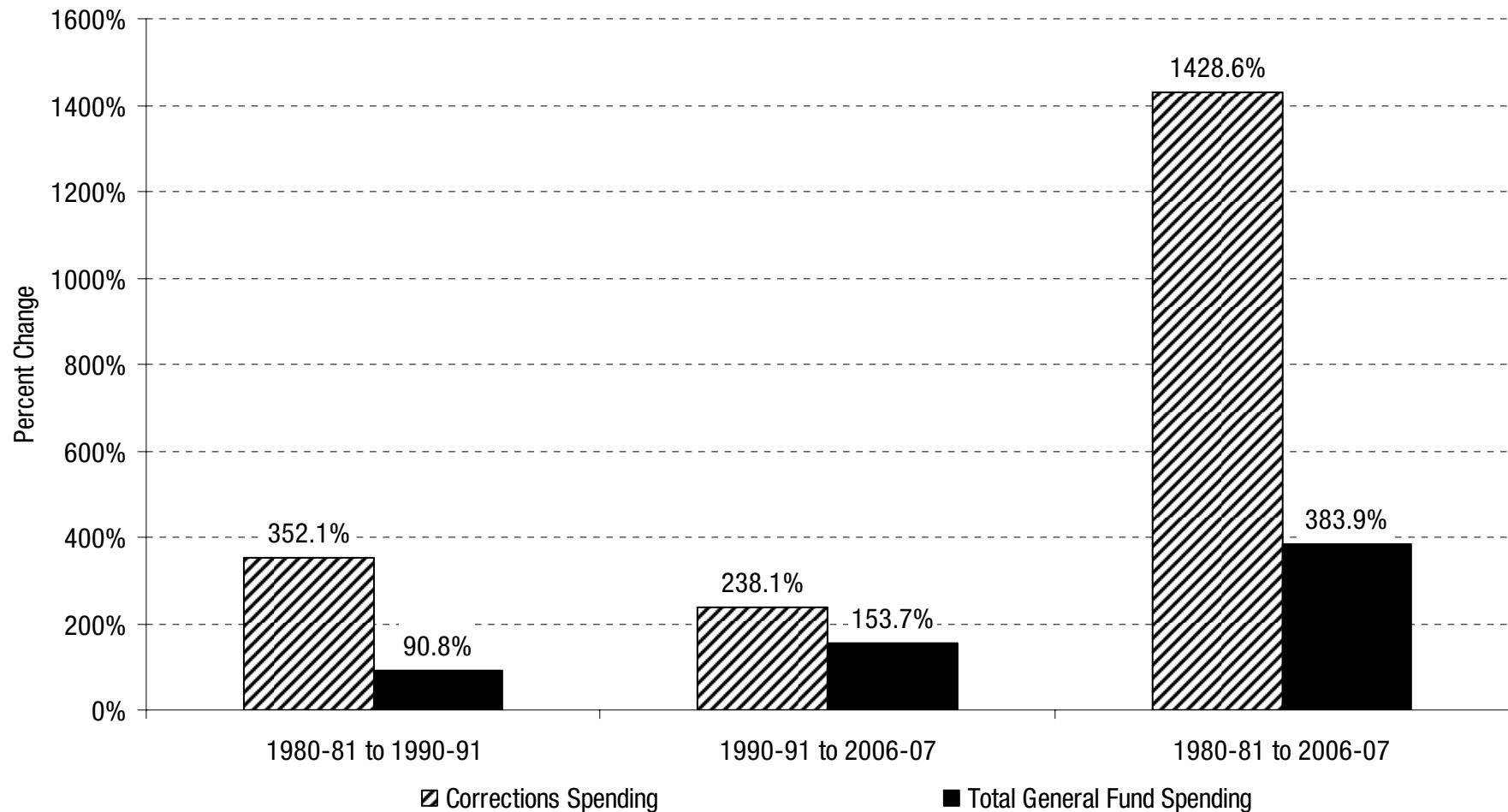
- In response to concerns with the state's correctional system, the Governor's proposals include:
 - Creating a sentencing review commission to make recommendations on sentencing guidelines.
 - Having specified non-violent felons with sentences of three years or less serve their time in county jails.
 - Allocating \$10.9 billion to expand state and local correctional facilities, primarily funded from lease-revenue bonds that do not require voter approval. The new funds would finance over 71,000 beds in existing state and local facilities, including health care facilities needed to comply with orders of the court-appointed receiver.
- On January 19, the Department of Finance announced that an arbitration award covering correctional officer salary adjustments will increase salary costs by \$199.8 million above the level assumed in the Governor's Proposed Budget, thereby widening the gap between revenues and expenditures.

The Number of Parolees and Male Inmates Is Projected to Increase



* 2007 through 2012 are projected.
Source: Department of Corrections

Corrections Spending Has Grown at More Than Three Times the Rate of General Fund Spending as a Whole



Note: 2006-07 is estimated.
Source: Department of Finance

Borrowing and Building

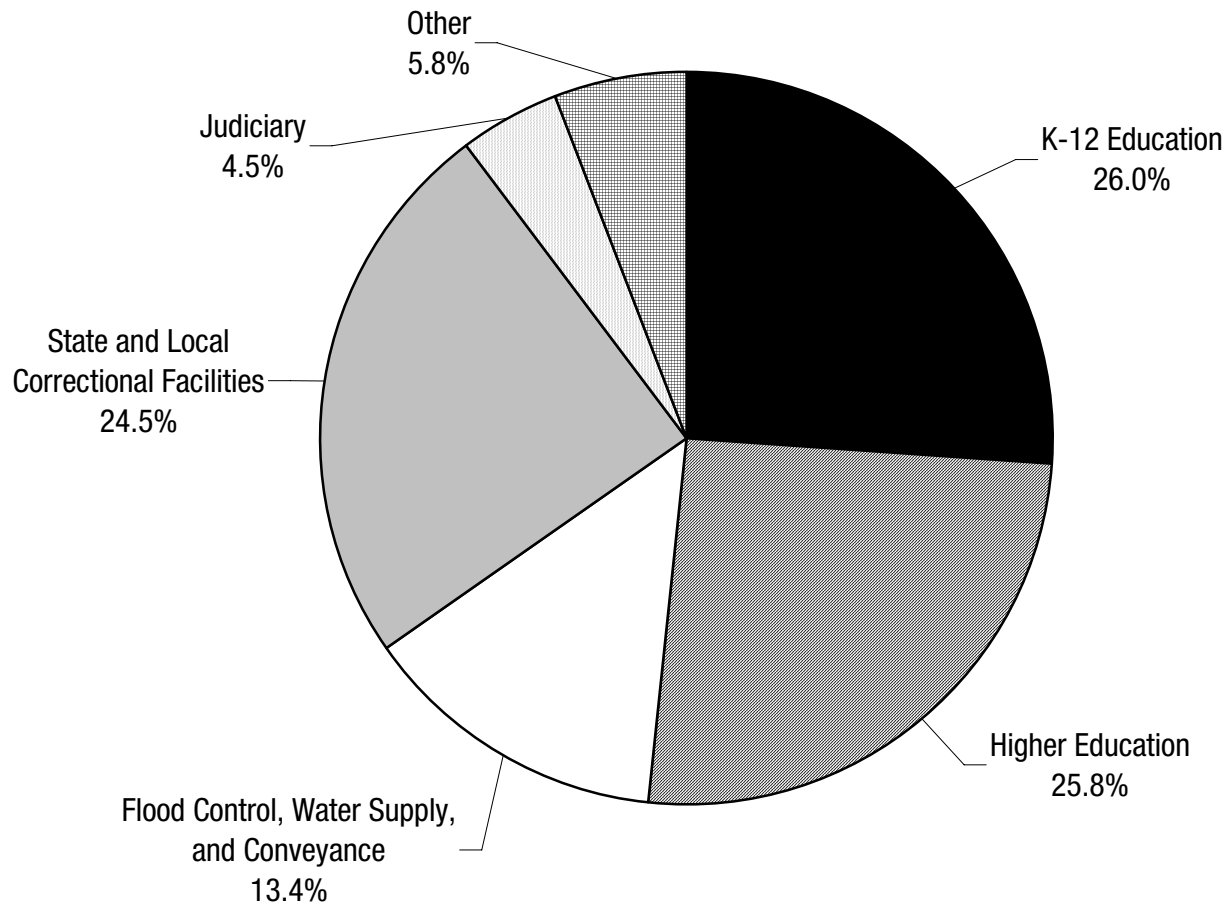
In November 2006, voters approved \$42.7 billion in bonds for a variety of public works projects, and the Governor has proposed a new “Strategic Growth Plan” as part of the budget package. The magnitude and complexity of the bond package raise important policy issues, including:

- How can the Legislature and public play an active oversight role that ensures that bond proceeds are well spent?
- How does the bond money fit into the state’s long-term infrastructure needs? The Administration failed to meet the statutory deadline for publishing the 2007 infrastructure plan.
- Can the state afford to take on more debt in light of the significant cost of the recently approved bonds and repayment of outstanding deficit-related debt? The Legislative Analyst projects that the annual debt service cost on currently authorized infrastructure-related bonds will rise from \$4.7 billion in 2007-08 to a peak of \$7.5 billion in 2014-15. If the Governor’s new plan is adopted, the Legislative Analyst estimates that debt service costs would peak at \$10.4 billion in 2017-18.

The Governor's 2007 Public Works Proposal

- The Governor proposed a new “Strategic Growth Plan” (SGP). The 2007 SGP would allocate \$11.6 billion for K-12 education; \$11.5 billion for higher education; \$10.9 billion for state and local correctional facilities; \$6.0 billion for flood control, water supply, and conveyance; \$2.6 billion for various other projects, such as seismic retrofit of state buildings; and \$2.0 billion for court facilities.
- The 2007 SGP would be funded by: \$29.3 billion in General Obligation (GO) bonds that would be placed on the 2008 and 2010 ballots; \$11.9 billion in lease-revenue bonds; \$2.0 billion in revenue bonds; \$1.1 billion in local matching funds; and \$300 million in General Fund monies.
- Debt service on the GO bonds in this proposal would cost approximately \$1.9 billion per year over a 30-year period.

Where Does the Money Go? Governor's 2007 Public Works Proposal

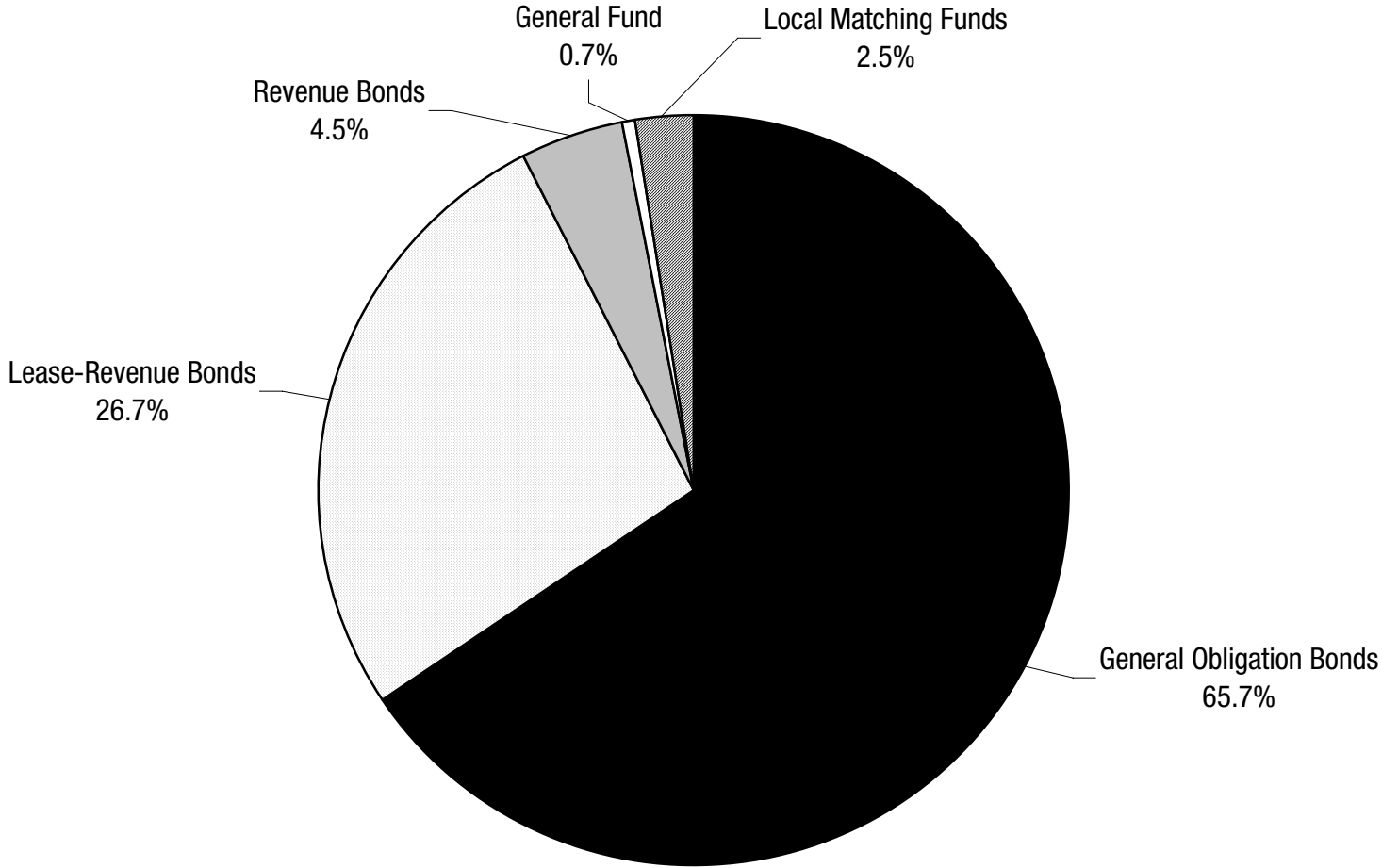


Note: Other includes funding for Department of Forestry and Fire Protection facilities, the Department of Mental Health, a new DNA laboratory, seismic retrofit of state buildings, and the School for the Blind and the School for the Deaf.

Source: Department of Finance

Where Does the Money Come From?

Governor's 2007 Public Works Proposal



California Faces Critical Choices

California is at a crossroads. While the state's fiscal condition has improved significantly, the Governor's Proposed Budget relies on optimistic forecasts and fund shifts to achieve balance. Moreover, long-term forecasts – including the Governor's own – project red ink through the end of the decade. The Governor's Proposed Budget raises important budget and policy choices that will affect California in 2007-08 and beyond:

- How should the state balance competing needs for programs and services with demands for increased spending on public works?
- What steps are needed to ensure that the state has adequate resources to balance its budget *and* pay for quality public services?
- What should the state do to prepare for a population that is growing, aging, and becoming increasingly diverse?
- How can public policies help narrow the widening gap between the state's high-income and low- and middle-income families?