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FISCAL REALITIES: BUDGET TRADEOFFS IN STATE AND LOCAL GOVERNMENT

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Fiscal Realities: Budget Tradeoffs in California Government

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Foreword

Issues of state and local governance and public finance took center stage in California's most recent election. Voters approved five bond issues worth $43 billion. Still, a recent report on California's fiscal outlook by the Legislative Analyst's Office warns of "operating shortfalls in excess of $5 billion in both FY 2007–08 and 2008–09, which will require significant actions to eliminate." California's growing population is putting considerable strain on the state's health, education, and social services programs as well as in many other areas. With the persistent shortfalls in operating budgets and the uncertainty about who and what will receive benefits from the bond issues, planning for and financing future programs and projects is increasingly difficult. "What kind of California do you want?" is a difficult question to answer when residents are not sure that there is enough money for even the most modest visions of the future.

Ten years ago, PPIC published its first study on California public finance. That study evaluated the accuracy and timeliness of the revenue data reported by more than 7,000 local government entities. Since then, the institute has published nearly two dozen reports examining a wide range of governance and fiscal policy issues, including the effects of Proposition 13, the relationship between local sales taxes and land-use decisions, the changing balance of fiscal power between state and local governments, and the challenges that future growth and changing demography present for future planning. In this volume, five research fellows analyze and compare California's revenue and spending patterns to those of several other large states and to those of the nation as a whole. Their objective is to give Californians a better sense of how they are doing compared to other states facing similar public spending challenges.

California voters have a strong say in how much they are willing to pay for services and the kind and degree of services they expect to receive in return. However, the authors find a considerable gap between the services state residents would like their government to provide and the taxes they are willing to pay to receive those services.

The authors find that California collects more taxes, fees, and miscellaneous revenues per capita than the average state in the rest of the nation. They also find that California differs markedly in its mix of tax revenues: Whereas the average state in the rest of the nation relies on property taxes for 32 percent of its tax revenues and on income taxes for 25 percent, these proportions are reversed in California as a result of its property tax restrictions and highly progressive income tax.

The authors also find that some of Californians' strongest preferences for policy change are very expensive. And although many observers believe that Proposition 13 has severely limited California's revenues and expenditures, the authors find that the state's total spending on public services per capita is higher than the average in the rest of the nation. Like all employers in California, state and local governments must pay higher wages to attract employees who can afford to live in the state. Yet, comparative analyses show that labor market conditions are responsible for only a portion of the differences in government payroll expenditures between California and other states. Nonpayroll expenditures also figure into the equation. So higher spending levels in California do not necessarily translate into more services per capita or higher staffing ratios in K–12 education or in police and fire protection. For example, California spends 50 percent more per capita on public safety than the average in all other states, but it employs proportionately fewer police and fire protection personnel.

This report provides a unique explanation of these and other factors involved in California finance—benchmarking California against other states. The authors' goal was to provide a clearer picture of where California spends its public revenues and how much it takes in. They have met this goal most effectively and have set the stage for a more informed discussion of the state's budget policies and priorities.

David W. Lyon
President and CEO
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Summary

California's recent fiscal tumult has prompted calls for a frank public discussion of state and local budget priorities. In short, what do Californians want from their governments and what are they willing to pay for? Despite exhortations from many quarters, this conversation has yet to occur. This omission may have contributed to delays in the passage of state and local budgets in recent years and to an increasing detachment of citizens from their governments.

We argue that deciding what California *should* raise in revenues and spend on services requires first understanding what it currently *does* raise and spend and why. The usual framing of state and local budget choices can be an obstacle to this understanding. For example, focusing on the state budget alone, and the General Fund within this budget, obscures the activities of other layers of government and their contributions to overall revenues, expenditures, and service delivery. More important, limiting considerations of public spending to one category at a time (such as K–12 education, health and human services, or public safety) prevents a recognition of the explicit or implicit tradeoffs California has made across spending categories or between revenues and public spending.

This report takes a different approach. It considers state and local government finances together using a common framework. This framework is comparative, evaluating California's fiscal choices against those of other states and of California in earlier periods. The purpose of these comparisons is not to make the case that California should be more like one state or another. Rather, it is to provide a benchmark of comparison. These comparisons also provide insights into the drivers of revenue and public spending. Although this framework ignores certain institutions of California budgeting—for example, the two-thirds voting requirement for enacting a budget and constitutional spending mandates

in K–12 education, transportation, and other areas—these rules are also ultimately policy choices.

Throughout the report, we compare California's fiscal choices to those of the United States excluding California and to those of other large states including New York, Illinois, Florida, and Texas. Although no set of states provides a perfect comparison group, this group shares certain features with California, such as a large and diverse population, high median incomes, and a substantial proportion of the population living in poverty. We rely on the most timely, complete, and accurate source of information on state and local budgets in all states over time. Although the most recent data available for all states at the time of our study were for fiscal year 2001–2002, we feel that this base year provides a reliable indicator of where California stands in relative terms today. Our principal findings are presented below.

Revenues

On a per capita basis, California's total revenues were $7,166 in 2002, 16 percent higher than the average in the rest of the nation. California also collected more taxes, fees, and miscellaneous revenues than the average state. In 2002, California state and local governments raised $5,099 per state resident, compared to an average of $4,530 in the United States excluding California, $6,232 in New York, $4,480 in Illinois, $4,299 in Florida, and $3,969 in Texas.[1]

These differences narrow once we adjust for higher personal incomes in this state. In 2002, California's own-source revenues represented $155 per $1,000 of personal income, 5 percent higher than the average in the rest of the nation, 7 percent higher than in Florida, 12 percent higher than in Texas, 13 percent higher than in Illinois, and 12 percent lower than in New York. California also relied on roughly the same composition of taxes, charges, miscellaneous revenues, and federal income as other states.

Where California differs more dramatically from other states is in its tax mix. The average state in the rest of the nation relies on the property

[1]In this report, we refer to fiscal years by their terminal years. For example, fiscal year 2001–2002 is referred to as 2002.

tax for 32 percent of tax revenues and on income taxes for 25 percent. In California, these proportions are reversed as a result of both limits on the property tax and the state's highly progressive personal income tax.

Spending

California's total per capita spending is higher than that of other states ($8,386 versus $6,939 for the rest of the nation in 2002). Focusing on the core activities of government (excluding public sector utilities and insurance trusts), California's general expenditures are closer to the average for the rest of the nation but still 15 percent higher.[2] Spending differences between California and the rest of the nation are particularly large in public safety ($266 per capita in 2002), social services ($222 per capita), environment and housing ($142), and government administration ($142 per capita) (Figure S.1).

What are the sources of these differences? Do California's higher per capita expenditures reflect the particular challenges California faces, such as a large and diverse population, high labor costs, and stewardship over a rich endowment of natural resources? Or do they reflect policy choices—such as decisions about what level of services to provide and who should receive these services?

K–12 Education

Contrary to perceptions that California is near the bottom in K–12 education spending, it spends more per capita than the average for all other states, at $1,592 compared to $1,489 in 2002. However, California is also home to more students. As a result, spending per pupil in California is slightly below the average for the rest of the nation, at $7,391 compared to $7,523 per student in 2002.

Another difference between California and other states is that California pays higher salaries to school district and state education employees. In 2002, California teachers earned an average of $54,348,

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[2]Throughout this report, we include mass transit in the transportation category, which is part of the U.S. Census Bureau's general government sector. In contrast, the bureau considers transit part of the utility sector along with water, gas, and electricity supply. Our concept of general expenditures therefore differs slightly from theirs.

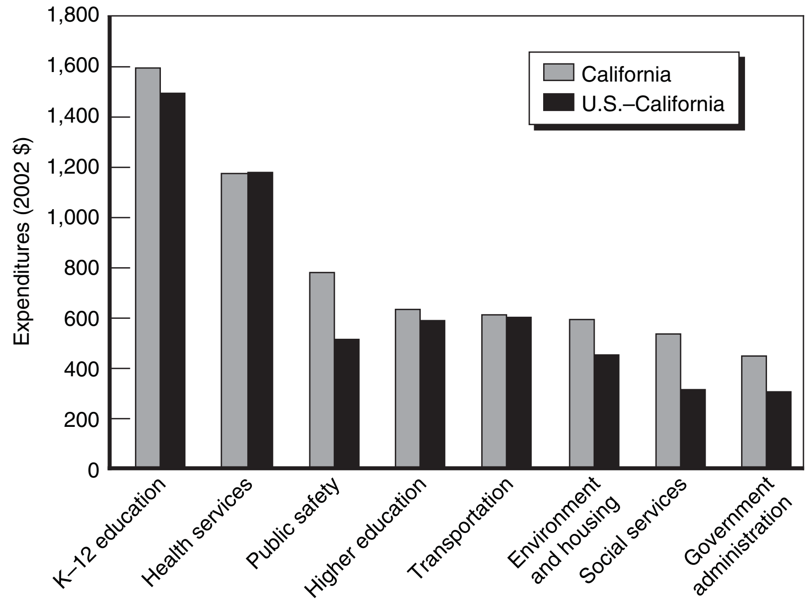

Figure S.1—General Expenditures per Capita, 2002

the highest salary for any state in the country according to the National Center for Education Statistics (2003). These salaries partly reflect the premium that all California employers must pay to attract college-educated workers from other states. However, about half of the compensation difference between California and other states is not explained by labor market conditions.

Higher compensation for public school employees and more K–12 students per capita imply lower staffing ratios per student in California than in other states, all else being equal, and this is the case in California. In 2002, there were 49 teachers per 1,000 students in California, compared to 65 per 1,000 in the rest of the nation. Lower staffing ratios were also evident for other types of school employees, including instructional aides, librarians, principals, and administrative assistants.

It is also true that California's student achievement scores lag those of other states. These differences persist even after taking into account differences in English language proficiency, race or ethnicity, and family characteristics, such as income and parental education (Carroll et al., 2005). Although the link between resources and outcomes is not straightforward (see, for example, Hanushek, 1997, and Krueger, 2003), California's recent focus on accountability standards raises the question of whether schools have adequate resources to meet these goals.

Higher Education

California spends about 8 percent more per capita than the average for all other states on its public colleges and universities, including the University of California, California State University, and California Community College systems ($634 compared to $586). Moreover, California has a tradition of low tuition and fees and a tendency to collect less in revenue from auxiliary services, such as dormitories, cafeterias, and bookstores. As a result, its expenditures net of revenues exceeded the average for other states by an even greater margin (15%) in 2002.

As in the case of elementary and secondary education, California has more college and university students per capita than other states. As a result of higher enrollments, net support per full-time-equivalent student (FTES) is lower in California than in other states. In 2002, California spent 7 percent less per student than the average for all other states ($11,329 versus $12,177). Compared to other large states, California was similar to Florida in net support per FTES but lagged Texas by 10 percent, Illinois by 13 percent, and New York by 21 percent.

California's broad participation in higher education stems from its lower tuition and fees as well as its reliance on the California Community College system, which enrolls approximately two million full-time-equivalent students. In fact, California is one of only a handful of states where a majority of higher education students (60%) are enrolled in two-year institutions. Lower costs per FTES in community colleges could bring down average spending for all students.

However, California also lags other states in a key measure of productivity in higher education—the number of degrees conferred per student. In 2002, California's colleges and universities as a group conferred fewer degrees per student than other states did (an average of 0.15 compared to 0.19 degree per FTES). The gap relative to the rest of the nation was particularly large (38%) for associate degrees granted relative to enrollment in two-year institutions.

Health Services

California spends virtually the same amount per capita as the rest of the nation on health services, including medical care for low-income residents, publicly administered hospitals, and public health ($1,173 versus $1,175 per capita). However, California spends less per capita on the largest individual program in this category, Medicaid (known as Medi-Cal in California), and even less per Medicaid recipient relative to the rest of the nation ($3,113 compared to $4,878).

California's lower Medicaid expenditures stem in part from its younger population. California enrolls more nonelderly adults and children in its Medicaid program than other states do and health care costs for these enrollees are generally about one-fifth of those for the elderly and disabled. California also enrolls a higher proportion of Medi-Cal beneficiaries in managed care plans; and it reimburses these and other health care providers at relatively low rates, despite the higher costs of practicing medicine in this state.

As in any public program, high enrollment rates can reflect demographics, eligibility rules, or the rate at which individuals apply for and receive benefits (also referred to as the "take-up" rate). A review of these factors suggests that both generous eligibility rules and high take-up rates are at work. For all groups—nonelderly adults, elderly and disabled individuals, and children—California's income criteria for receiving Medi-Cal benefits were higher than those of other states in 2002. California also extended Medicaid eligibility to groups for whom the federal government did not mandate coverage, such as working parents.

Social Services

Beyond medical care, state and local governments provide direct cash payments and other subsidized services to low-income individuals. California spent $533 per capita on these services in 2002, roughly 70 percent more than the average for all other states although only a modest share (6%) of total state and local government spending.

The largest of California's social services programs is Temporary Assistance for Needy Families (TANF), more commonly known as welfare, or CalWORKs in California. CalWORKs is more generous than TANF programs in other states along several dimensions, including higher maximum allowable benefits per family, milder sanctions for noncompliance, and longer time limits before termination of benefits (MaCurdy, Mancuso, and O'Brien-Strain, 2002). Nevertheless, actual expenditures per individual recipient were lower in California than in other states in 2002 ($4,718 compared to $5,105). This discrepancy may be due to shorter average welfare spells, larger family sizes, or a different allocation of cash assistance versus in-kind benefits in California than in other states.

Apart from CalWORKs, state and local governments in California support a variety of community-based services, such as child care, child welfare (including foster care and adoption assistance), and programs geared toward low-income elderly and disabled adults. These services are often characterized by low caseloads and high costs per recipient. For example, California spent roughly $15,000 and $29,000 per case for foster care and adoptions, respectively, in 2002. Although exceeding the average for the rest of the nation, these expenditures were not out of line with those of New York or Illinois. In contrast, California's expenditures on other community services apart from child care and child welfare were $6,690 per case in 2002, much higher than the average for the rest of the nation or for any of our comparison states.

Finally, California spends much more than the average state on supplements to the federal Supplemental Security Income (SSI) program, although the per capita amount ($79) is low in absolute terms. California also has higher-than-average caseloads in this program. These caseloads do not stem from a greater concentration of low-income elderly and disabled individuals in the state but rather from a higher rate of participation within this target group.

Transportation

In 2002, California's per capita spending on transportation was roughly the same as the average for all other states. However, in every other year since 1977, California's spending lagged that of the rest of the nation. California is also distinctive in the way it allocates transportation expenditures, with less money going toward highway construction ($154 versus $240 in 2002) and more toward mass transit ($181 compared to $117 in 2002). Mass transit use is higher in California than in many other states, comparable to levels in Illinois. However, automobile use is also high, rivaling that of Texas or Florida. This intensive highway use, coupled with lower capacity, contributes to road congestion and delays.

Public Safety

California's third-largest area of government spending is public safety. Although California spends 50 percent more per capita on this function than the average for all other states, it employs fewer police and fire protection personnel. California lags even further behind other large states in police protection (with 72 employees per 1,000 crimes in 2002, compared to 89 and 165 per 1,000 in Illinois and New York, respectively) and fire protection (with 0.9 staff per 1,000 residents in 2002, compared to 1.4 per 1,000 in Florida).

As in K–12 education, low staffing ratios in public safety go hand in hand with high operating costs, including payroll. Payroll cost differences are only partly explained by the salary premium that all employers in California must pay. Differences in nonpayroll expenses were even wider, perhaps due to more supplemental services provided in California or to different practices of contracting out for services.

Higher payroll costs may reflect differences in quality or other personnel attributes. For example, crime rates have fallen more rapidly in California than in the rest of the nation since the mid-1990s. This trend may be due to the effectiveness of law enforcement in this state as well as to the improving economy, changing demographics, and stricter sentencing policies. On the other hand, falling crime rates and relatively low numbers of inmates per capita may also signal an opportunity to reexamine resource allocation in this area.

Housing and Community Development

In 2002, California spent roughly 50 percent more on housing and community development than the average for all other states. The majority of these expenditures were pass-throughs of federal funds for programs administered by local public housing authorities on behalf of the U.S. Department of Housing and Urban Development. Despite these higher expenditures per capita, fewer households report receiving direct housing aid in California. This result may be due to higher costs per recipient or a greater emphasis on redevelopment in California than in other states. Waiting lists for housing assistance are also longer in California than in other states.

Environment

California's per capita expenditures on natural resources were 80 percent higher than the average for all other states in 2002. However, they were less than those of other western states or Florida, which face similar water management issues. Water supply is the largest component of natural resources spending in California.

Government Administration

In 2002, nearly 5 percent of California's state and local government expenditures went toward administration. At $447 per capita, California's spending on administration exceeded the average for all other states in that year and even surpassed that of New York, which spent $390 per capita.

Part of the explanation for California's high administrative costs is that these functions are labor-intensive and labor costs are high in this state. However, as in other areas we have considered, only part of the difference between California and other states is attributable to labor market conditions. Nonpayroll expenditures are also part of the explanation. Unfortunately, it is unclear what these expenditures include and whether they are excessive in the absence of appropriate performance measures.

Alternative Tradeoffs

The final chapter of this report draws these findings together and identifies the implicit or explicit choices California has made over time, either between revenues and public spending or across spending categories. It also compares California's budget tradeoffs to the expressed preferences of its residents and, where actual choices deviate from public opinion, it poses some alternative scenarios.

These alternative tradeoffs are intended not as policy prescriptions but as illustrations of the kinds of changes necessary to achieve desired policy goals. Perhaps the most important theme of this chapter is that some of Californians' most desired policy goals are costly. For example, increasing K–12 staffing levels to national levels (129 employees per 1,000 students versus 92 per 1,000) would cost five times as much as reducing corrections costs per inmate to the average for all other states and twice as much as raising property taxes per $1,000 of personal income to the average for all other states. These and other tradeoffs provide an analytical foundation for a far-reaching public conversation on what kind of state California should be.