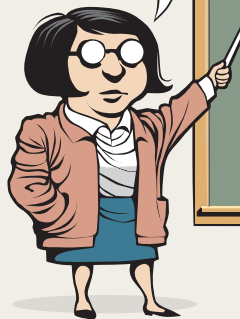


Good morning. I'm Professor Budget. Welcome to...



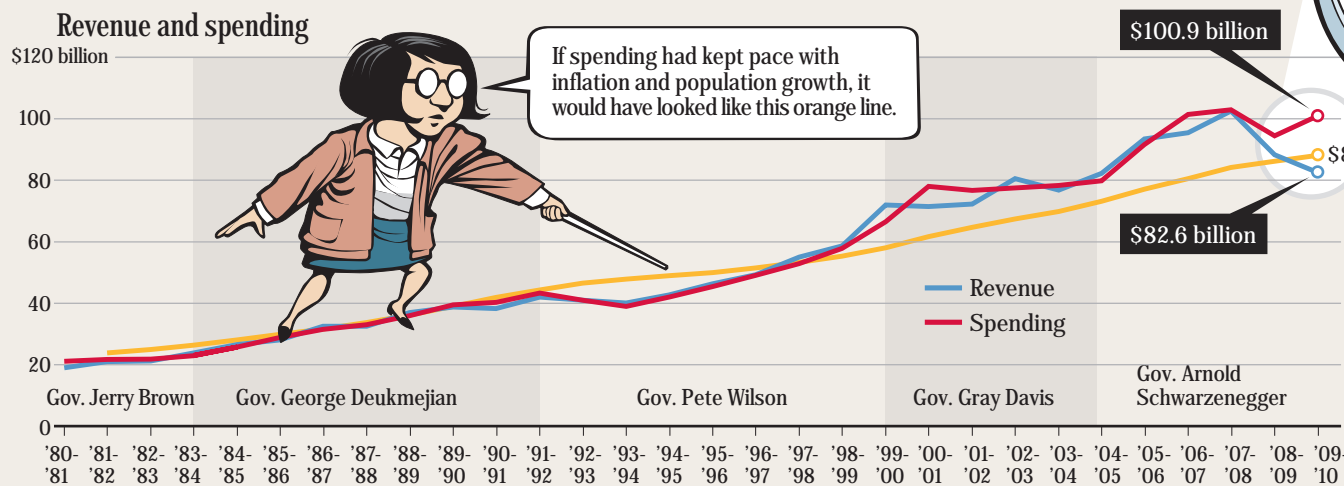
STATE BUDGET 101

MAKING SENSE OF CALIFORNIA'S BUDGET MELTDOWN

OK, first things first: How did we get into this mess?

There's no single answer to that, but here are a few main culprits: When times were good, tax revenue surged. But Gov. Arnold Schwarzenegger and his predecessor, Gray Davis, and the Legislature spent almost all the money that poured into state coffers as if it would continue indefinitely.

Note that the state is required by law to have a balanced budget, so the "deficit" is merely a projection of the gap legislators must close between estimated revenue and estimated spending.

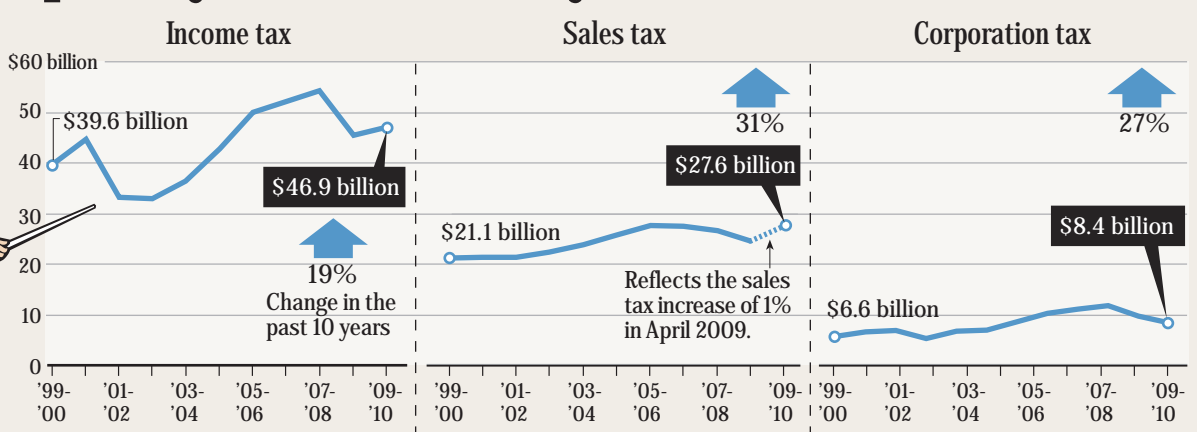
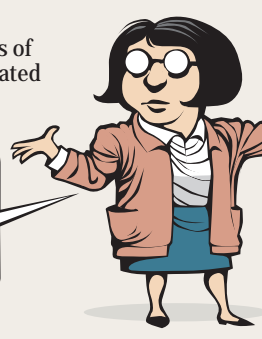


Doesn't the state take in plenty of tax money?

Sure, but the ups and downs have caused trouble. Imagine a spendthrift who earns \$80,000 one year, \$100,000 the next year and \$80,000 the third. That third year feels tight by comparison.

Here's a look at the main components of state revenue and how they've fluctuated over the past decade:

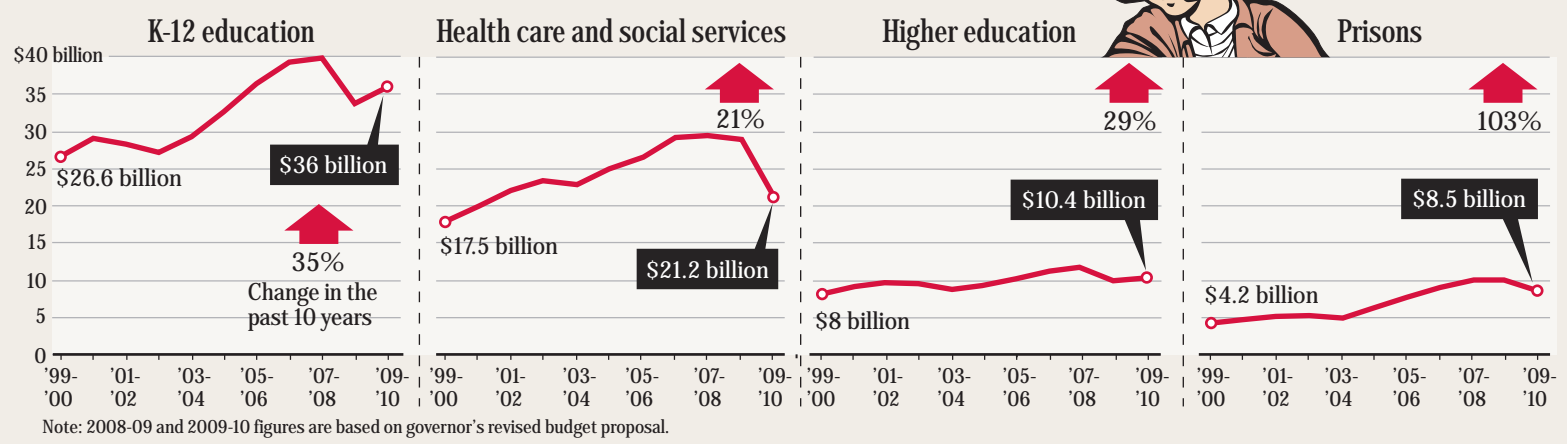
Every category of state tax revenue has declined during the recession, but income taxes have seen the biggest dollar loss.



So where does all that money go?

Overwhelmingly, the state spends its money on things people want: education, prisons and a social safety net for the poor. Driven by a host of tough-on-crime laws, prison spending has increased by the largest percentage, but it's much smaller than spending on schools and health care.

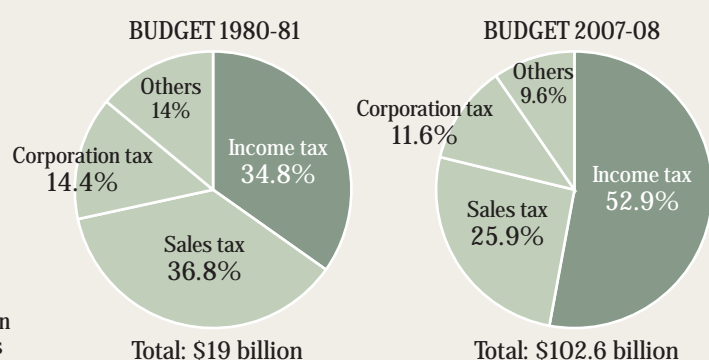
Here's a look at the big categories of state spending and how they've grown over the past decade:



Why do we keep going through this feast-or-famine budget cycle?

The biggest reason is that California's budget depends so heavily on its most erratic revenue source: income taxes on the wealthy. According to the Legislative Analyst's Office, residents with incomes over \$500,000 make up less than 2 percent of tax returns but generate nearly 40 percent of the state's personal income tax revenue. When the rich are making money, especially in the stock market, tax revenue spikes. But when the economy sputters, revenue plummets. That's what's happening now.

Three decades ago, income taxes made up about a third of state revenue, but sales tax and corporation tax have dropped as a percentage of the pie. That's largely because the stock market has become an increasingly important part of many families' financial well-being — and by extension, the state's.

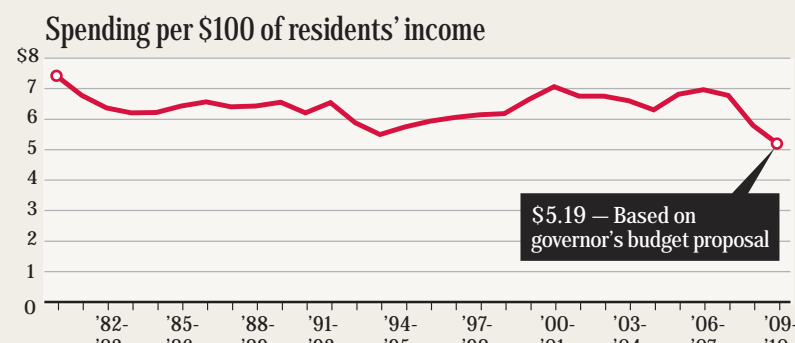


Also, various ballot measures over the past 30-plus years have limited the ability of the governor and legislators to manage the state's finances, such as:

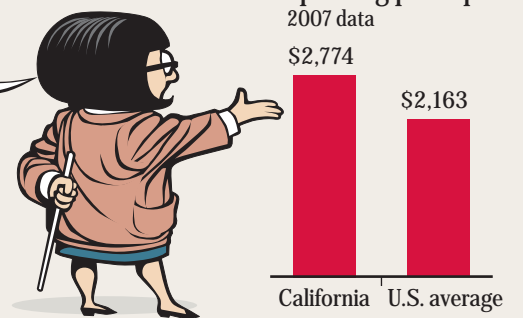
- Prop. 13 (1978): Limits property tax rates, the primary source of revenue for school districts and local governments, to 1 percent. That has led the state to "backfill" billions of dollars, primarily to schools, over the years. The initiative also raised the threshold for raising taxes from a simple majority vote to two-thirds, a constant source of gridlock in the Legislature.
- Prop. 98 (1988): Sets aside a portion of the general fund, currently about 40 percent, for public schools and community colleges.
- Prop. 42 (2002): Earmarks about \$1.4 billion in gasoline sales taxes for transportation; the money had previously gone to the general fund.
- Prop. 49 (2002): Requires the state to set aside hundreds of millions of dollars for after-school programs.
- Prop. 1A (2004): Restricts state's ability to take certain tax revenue from local governments.

Isn't the state simply spending too much money?

Clearly, California has spent more in recent years than it can sustain. But another way to judge a state's spending is to compare it to the total income of that state's residents. And in California, spending relative to residents' income has stayed pretty stable over the last three decades and has dropped in recent years.



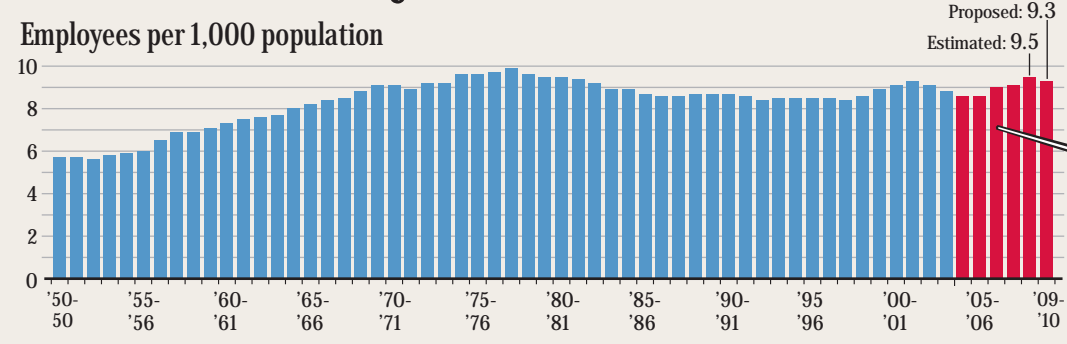
California ranked 12th-highest among the 50 states in government spending per capita in 2007.



Isn't a bloated state bureaucracy also to blame?

It's true that the number of state workers has shot to a 28-year high under Schwarzenegger; that's due in part to a spike in new prison employees.

California has the highest number of employees compared with other states (479,594 people in 2007) and the second-highest average pay, behind New Jersey. But it also has the third-lowest ratio of employees per 1,000 population, trailing only Illinois and Florida.



These red bars represent Schwarzenegger's administration.

Why can't we just...

- Slash legislators' salaries in half? That would save just \$9 million, a drop in the bucket.
- Raise alcohol and tobacco taxes? Two recent legislative proposals would do just that. But they would raise only an estimated \$3 billion combined.
- Cut the state bureaucracy by 20 percent? That would net about \$2 billion — less than 10 percent of the total shortfall. That's because so much of the state budget goes to public school employees, who are employed by school districts, not the state.
- Force teachers to accept the same temporary pay cuts state workers are taking? The problem there is the state's 310,000 teachers are governed by contracts that are negotiated at the local level by more than 1,000 school districts; the state has no direct authority over their pay.
- Stop providing services to illegal immigrants and their children? That's another big chunk of money — at least \$5 billion, according to one recent estimate — but again, it's just a piece of the overall puzzle. And figuring out just which residents are here illegally presents challenges.