

## Thoughts on California's Budget Crisis

Typically in crisis, there are unparalleled opportunities for those leaders with foresight and political courage to act. Unfortunately election years are not often conducive to acts of political courage, but we have to assume that term limits, whatever their deficiencies, and the magnitude of the budget deficit will allow for acts of leadership and statesmanship. Crisis is not a time for maintenance of the status quo we should all be pushing for financing reforms coupled to better, more cost effective program performance.

California's budget crisis with a \$16 billion deficit, as projected by the Legislative Analyst's Office, is extra-ordinarily large.<sup>1</sup> It cannot be solved with new revenues alone, or with budget cuts only.<sup>2</sup> Before discussing solutions, it is worth reflecting on genesis. The budget deficit is a result of a recession, wildly gyrating tax revenues, the state's structural budget deficit and the increased need for public spending in recessions. It is unclear as yet whether we are entering a severe long term recession or a short and mild one; while the forecasters think it will be short and mild, they may be wrong, as the financial markets' turmoil is a very serious threat.<sup>3</sup> California tax revenues gyrate more widely than most states in part due to our reliance on progressive income taxes, which tank when declines in the stock market and housing market produce large losses as opposed to large capital gains.<sup>4</sup> California has a structural budget deficit as well; this is due to large tax cuts, substantial growth in spending and improvements in programs for

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<sup>1</sup> To put it in context, California's State Gross Domestic Product is roughly \$1.9 trillion and California's State Government Budget is \$141 billion and California's General Fund is \$101 billion. So our state budget deficit is less than 1% of GDP, but more than 16% of the State General Fund. The projected deficit is more than the state spends on higher education (\$14.5 billion), and more than one third of what the state spends on K-12 education (\$44 billion).

<sup>2</sup> The legislature passed and Governor signed budget cuts totaling \$8 billion in February to halve the deficit.

<sup>3</sup> California Business Minute, Headed for a Recession or is it the Chicken Little Syndrome (December 2007) available at [www.CaliforniaBusinessMinute.com](http://www.CaliforniaBusinessMinute.com). "Bernanke Says Economy May Slip into Recession" (April 2, 2008) available at [www.Bloomberg.com](http://www.Bloomberg.com). Recent reports added large job losses in construction and manufacturing to the financial turmoil that had dominated the headlines. See Louis Uchitelle, 80,000 Jobs Lost, New York Times (April 5, 2008). Economists are projecting job losses as high as 2 million in the recession. More Job Losses Expected. Associated Press (April 7, 2008) at [www.woi-tv.com/Global/story.asp](http://www.woi-tv.com/Global/story.asp). Projections of a long and deep recession are not at this point in the budget estimates of either the Governor or the California Legislative Analyst, but rather they are assuming a mild slow down, consistent with the hopes of many economic forecasters. The May revise will give a clearer picture as to how deep the economic slowdown and fall in revenues truly is.

<sup>4</sup> For example, the state's personal income tax revenues fell by \$11 billion between 2001 and 2002 and grew by over \$8 billion between 2006 and 2007 while this year's budget assumes a \$4 billion increase. See Schedule 8 at <http://www.ebudget.ca.gov/BudgetSummary/REV/1249563.html>. California tax revenue relies heavily on the wealthiest 1% of Californian tax payers – last year, the state took in approximately \$1 billion in tax revenue in one day from a Google executive who had just paid taxes on sold stock. Source: Presentation by Senator Denise Ducheny at the California Budget Project Conference 3/20/08 These wild swings in revenue argue for some form of multi-year budgeting with sequestered rainy day funds as proposed by the Governor and the Legislative Analyst and/or for tax reform to balance out the dependence on volatile capital gains with more stable revenue streams.

schools and health care and large reduction in the state's vehicle license fees, enacted when revenues were good.<sup>5</sup>

New revenues could come in the form of unanticipated economic growth (if the recession is mild and short-lived), tax increases, fee increases, or increased federal funds. First, there is certainly no harm in asking Congress for a temporary increase in the federal Medicaid match to ward off the state's need otherwise to cut provider and plan reimbursement rates by 10%.<sup>6</sup> This is an election year for Congress as well. Federal law allows for an unbalanced federal budget, whereas California's Constitution requires a balanced state budget, and it is a federal responsibility to restore economic growth with tax, spending and monetary policies. Second, fees do not require a two-thirds vote and opportunities to increase fees should be carefully evaluated.<sup>7</sup> Fees cannot exceed the cost of the state service in question. Fee options can only help to a limited degree, as fees are not permitted or appropriate for most of state spending. Fee increases could help keep state parks open or pay for more of the rising costs of public higher education. However fees cannot constitutionally be charged for public K-12 education – the biggest single component of the state budget; nor are participation fees particularly wise or appropriate for the state's health programs (the second largest component of the state budget) that serve low income families already pressed hard by the rising costs of necessities such as gas, food, shelter and medical care.

Tax increases, unlike fees, require a two-thirds vote. They can come in the form of an increase in income taxes, sales taxes, corporate taxes, or sin taxes or in the elimination of specific deductions, tax credits or exemptions.<sup>8</sup> The Legislative Analyst's Office has

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<sup>5</sup> For example, the state phased out and eliminated the estate and gift tax for a revenue loss of \$1 billion annually and reduced vehicle license fees for a revenue loss of over \$1.5 billion annually. See Schedule 3 at <http://www.ebudget.ca.gov/BudgetSummary/REV/1249563.html>. The state expanded eligibility for health care to children from 100% of the Federal Poverty Level to 250% of FPL now covering over 900,000 children annually at a projected cost of \$400 million in state General Fund costs and \$800 million in Federal matching funds in 2008-09.

<sup>6</sup> The FMAP (Federal Medical Assistance Percentage) ranges from 50 to 83% of a state's Medicaid program's expenditures, depending on the state's income and poverty. Congress has in the past temporarily lowered state matching requirements during an economic downturn to stimulate the economy, protect state fiscal solvency and preserve Medicaid eligibility.

<sup>7</sup> Fees and fines make up less than \$1 billion of the state General Funds as compared to taxes that account for \$100 billion. See Schedule 8 at <http://www.ebudget.ca.gov/BudgetSummary/REV/1249563.html>. On the other hand they account for nearly \$7 billion in revenues for Special Fund programs as compared to \$18 billion in taxes. Special Fund programs include major spending such as roads and highways, realignment to counties, and smaller spending such as Prop 99 and Prop 10 cigarette tax supported programs. For example the state vehicle license fees can be increased to pay for roads with a simple majority vote, but if the new vehicle license fee revenues are dedicated to schools, that would no longer be a fee. Vehicle license fees could be altered so that cars with high miles per gallon pay less, and cars with low MPG pay more. Revenue swaps between fees and taxes are permissible unless precluded by state ballot initiatives.

<sup>8</sup> Estimated tax revenues in 2008-09 are: sales and use (\$33 billion), personal income tax (\$58 billion), corporate taxes (\$11.9 billion), tobacco taxes (\$1 billion), insurance gross premiums tax (\$2.2 billion), alcohol taxes (\$0.3 billion), motor vehicle fuel taxes (\$3.5 billion) and vehicle registration and license fees (\$5.9 billion). See Schedule 3 at <http://www.ebudget.ca.gov/BudgetSummary/REV/1249563.html>

suggested reviewing the range of tax credits, deductions and exemptions to assess which ones could be modified or repealed, to the extent they are not achieving their stated legislative objectives.<sup>9</sup> The Governor has indicated that some enhanced tax revenues could be on the table; however the Senate and Assembly Republicans have not.<sup>10</sup> Senate and Assembly Democrats have begun to explore Republicans' resolve with test votes to close loopholes for private yachts and planes and oil severance taxes for the highly profitable oil and gas industry.<sup>11</sup> California's Republican lawmakers will eventually need to evaluate whether public spending on a child's education or health care for working families or repair and replacement of deteriorated and outdated infrastructure in roads, bridges, ports and terminals are "wasteful" expenditures of state financial resources or whether increases in alcohol or cigarette taxes are an acceptable way to pay for these services. Or should we decline further in public school spending and public health spending?<sup>12</sup>

I would suggest we also take a careful look at tax equity. What does this mean? One example of tax equity is the state sales tax, which applies to goods but not to services. Over half of consumption is now on services, not on goods – a steady shift in expenditure patterns. California could apply a small sales tax of one or two percent to all services, or it could increase the already large sales tax (5% is dedicated to the state General Fund, the remaining 2.25% is dedicated to local government) on goods.<sup>13</sup> A new sales tax on services could be applied to reduce the budget deficit in the immediate term and then to lower the sales tax on goods over the longer term, The rap on sales taxes is that they are regressive, which is true to a certain degree, but they are less regressive than typically thought, as shelter, food and health care are exempt. Sales taxes on services could be applied selectively. Is a sales tax on accountant or lawyer services, country club dues or massage services regressive? Another example of tax equity is the wide gap in property taxes due to Proposition 13.<sup>14</sup> If you have recently bought a home (and can still pay your

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<sup>9</sup> The Legislative Analyst recommended that the legislature consider modifying or eliminating \$2.6 billion in tax deductions or tax exclusions: \$1.5 billion in personal income tax deductions, \$800 million in corporate tax deductions and \$355 million in sales tax exemptions. See LAO Alternative Budget, Perspectives and Issues and Analysis of the Budget Bill 2008-09 at [www.lao.ca.gov](http://www.lao.ca.gov). The largest is a modification in dependent credits for a revenue increase of \$1.3 billion. The smallest is closing the private yacht and airplane loophole to evade sales taxes that generates \$21 million in new revenues.

<sup>10</sup> Judy Lin, California Budget Cutters Look at Tax Breaks, Sacramento Bee March 23, 2008

<sup>11</sup> California ranks 29<sup>th</sup> in public school spending per capita and last in school staff to student ratios. [www.californiaschoolfinance.org/budgetandfunding](http://www.californiaschoolfinance.org/budgetandfunding) California ranks 24<sup>th</sup> in Medicaid spending per capita and last in spending per Medicaid enrollee. See [www.ppiny.org/reports/jtf/medicaid](http://www.ppiny.org/reports/jtf/medicaid) and [www.statehealthfacts.org/comparetable.jsp](http://www.statehealthfacts.org/comparetable.jsp)

<sup>12</sup> See ITUP, State Tax Revenues (April 15, 2003) at [www.itup.org/reports](http://www.itup.org/reports)

<sup>13</sup> Assembly Revenue and Tax Committee, Overview of California Taxes, Sales and Use Tax Chapter 2E. See Publications at [www.assembly.ca.gov/acs/newcomframeset.asp?committee=21](http://www.assembly.ca.gov/acs/newcomframeset.asp?committee=21) Local governments may and do increase sales taxes within their jurisdictions for specific local purposes.

<sup>14</sup> Assembly Revenue and Tax Committee, Overview of California Taxes, Sales and Use Tax Chapter 4. Local property taxes raise over \$40 billion in tax revenues. Pursuant to Prop 13, property taxes are capped at 1% of purchase price with a 2% permissible increase each year; valuations were rolled back to their 1976 levels. The policy is occasionally referred to as "welcome stranger" due to its differential impacts on long

mortgage), you are likely paying up to ten times as much in property taxes as your neighbor who bought his home back in 1976. Are you receiving ten times as much in public services or does your neighbor receive exactly the same fire and police protection and send her children to the same public schools and colleges as you do? One place to start in reforming the property tax inequities is adjusting the rates on commercial property (this issue is referred to as the “split roll”).<sup>15</sup> Equalizing tax rates between newly acquired and pre-Prop 13 acquired real property could stimulate new business formation and job growth. A third example of tax equity is the differential rates at which for profit hospitals and health insurers are taxed vs. their non-profit counterparts.<sup>16</sup> It is unclear whether there is much difference in terms of lower prices, better care or improved access for low-income populations in non-profit as opposed to “for profit” plans and facilities.<sup>17</sup> A fourth revenue raising approach is to add a temporary surcharge to income taxes that would expire after one year in order to balance the 2008-09 budget; the surcharge could be applied to those individuals with incomes above a certain income level.<sup>18</sup> In general, higher income individuals have benefited disproportionately under President Bush’s proposed and enacted tax cuts and general economic policies.<sup>19</sup> Fifth, corporate taxes

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time residents as opposed to new arrivals. Changes to Prop 13 require a constitutional ballot initiative. Another change that could be considered would be a higher rate on ‘McMansions’ above a certain size and cost that are consuming disproportionate shares of scarce space, water, energy and other natural resources. Property taxes could be equalized between newly acquired and older properties based on market assessments; provisions could be made for relief of seniors and low and moderate income homeowners adversely impacted. The state could get out of the business of subsidizing local governments impacted by Proposition 13 with realignment and other funds.

<sup>15</sup> Split roll refers to a different rate for commercial (higher rate) and residential (lower rate) property.

<sup>16</sup> The tax rate is 2.35% of gross premiums for health insurers; however non-profit insurers and health plans regulated by the Department of Managed Health Care are exempt from the tax. The tax raises \$2.2 billion. Assembly Revenue and Tax Committee, Overview of California Taxes, Insurance Gross Premiums Tax Chapter 3C

<sup>17</sup> There does not appear to be much of a community benefit being provided by non-profit vs. for profit hospitals. OSHPD data reports that for profit hospitals provide 2.6% of expenses for bad debt and charity care while non-profit facilities provide 3.0 of expenses for bad debt and charity care; each type of facility receives roughly 68% of patient revenues from the better paid Medicare and privately insured and the remainder for care to Medi-Cal, county indigent patients, other patients and the uninsured. See Botelho and Wulsin, A Summary of Health Care Financing for Low-Income Individuals 1998-2007 (August, 2007) available at [www.itup.org/reports](http://www.itup.org/reports) We have observed little difference in the prices and coverage of for profit and non-profit plans in the individual and small employer markets in the course of research for our regional workgroup reports; however non-profit plans and foundations have funded local efforts to cover uninsured children. See [www.itup.org/regional-workgroups](http://www.itup.org/regional-workgroups) and Mannanal, Directory of Local Efforts to Expand Health Care Access for the Uninsured (Insure the Uninsured Project, January 2007) available at [www.itup.org/reports](http://www.itup.org/reports)

<sup>18</sup> California Personal Income tax rates start at 1% and increase to 9.3%. They account for the largest share of the state General Fund -- over \$50 billion in revenues; over 16 million individuals file returns. There is a 1% surtax on individual incomes in excess of one million annually that is devoted to mental health services. This surcharge for example applies to roughly 30,000 individuals and raises over a billion in revenue. Under federal but not California state law, capital gains are taxed at lower rates than ordinary income. Assembly Revenue and Tax Committee, Overview of California Taxes, Personal Income Tax Chapter 2B

<sup>19</sup> Between 2001 and 2006, low-income employees fared particularly poorly nationally, but in California they made substantial wage gains. See California Budget Project, A Generation of Widening Inequality 1978-2008, Chapter 4, The Long Road to Recovery (August 2008) at [www.cbp.org](http://www.cbp.org) See also D. Leonhard.

have represented steadily smaller shares of the state's revenues. They could be increased by re-adjusting certain deductions, rules, treatments and exemptions most favorable to particular industries or businesses.<sup>20</sup>

Where and how should we cut? As Republicans are going to need to look at taxes, Democrats are going to need to look at program spending reductions. The Governor made the right call in placing a high priority on preserving eligibility for health programs -- now at 100% of Federal Poverty Level (FPL) for families, 133% for the aged and disabled, 250% for children and 300% of FPL for pregnant women.<sup>21</sup> There is no reason to add to the state's already high numbers of uninsured. Expenses of health programs are essentially price of care multiplied by the quantity of services. The Governor proposed and the Legislature agreed to cut the already low prices we pay for Medi-Cal covered services by 10%. I suggest that utilization (quantity) is the more appropriate place for California to seek reductions in health spending.<sup>22</sup> Health plans are better situated and have better tools to assure that utilization is reduced in a medically appropriate manner than does the state's fee for service system. However Medi-Cal does have pre and post-treatment utilization reviews, TARs (Treatment Authorization Requests), edits and audits

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For Many, A Boom that Wasn't, New York Times (April 9, 2008) describing the stagnant wages of the middle class 2000-2007 and the concentration of income gains among the top 5% of income households for the past thirty years while at the same time the federal tax code has become ever more favorable for the highest income strata.

<sup>20</sup> Corporations pay at a rate of 8.84% of net income or \$800 (the Corporate Franchise Tax) whichever is greater. Roughly a million corporations pay taxes totaling \$11 billion. Assembly Revenue and Tax Committee, Overview of California Taxes, Corporations Tax Chapter 2C Corporate taxes are projected to comprise 11.5% of the total of personal income, sales and use and corporate taxes in 2009 as compared to 14.8% in 1971. See Schedule 3 at [www.ebudget.ca.gov](http://www.ebudget.ca.gov). The Legislative Analyst recommends some modest changes in corporate income deductions and exemptions. See [www.lao.ca.gov](http://www.lao.ca.gov).

<sup>21</sup> California's Medi-Cal eligibility levels are much lower than most of the leading reform states such as Massachusetts, Vermont, Minnesota, Wisconsin, Washington, New York and New Jersey. In addition California does not cover low-income adults without children living at home, unlike Arizona, Oregon, Maine, Massachusetts, Vermont, Minnesota, Washington, and New York who do so. Re-imposition of quarterly status reporting obviously adds red tape barriers to coverage, it will decrease low income family enrollment in Medi-Cal, but with little real cost savings to the state as those with serious medical conditions and costs will likely persevere and or re-enroll.

<sup>22</sup> See Institute of Medicine, Knowing What Works in Health Care: a Road Map for the Nation (January 2008) available at [www.iom.edu](http://www.iom.edu) The issue is that an estimated 30% of health care in America is of limited or no medical efficacy. This is manifested in wide and unexplainable variations in provider practice patterns. It is difficult for both patients and providers to know which services are of limited medical efficacy. IOM suggests a national institute of clinical effectiveness as a way to compile the informational data base on which providers, patients and payors can rely in assessing what treatments work for what conditions and under what circumstances. This is a long-term effort and would do little to help resolve the immediacy of California's budget deficit. However the state could use the tools that it does have to stop paying for care of little or no benefit as opposed to either reducing eligibility or cutting reimbursement rates. An increase in the transparency of data on provider practice patterns as proposed as part of state health reform would help with this effort. Medi-Cal is a low price and low utilization program, so the potential for savings in Medi-Cal is not as great as in other states' programs.

as tools at its disposal to reduce payments for the less vital medical services.<sup>23</sup> Since most Medi-Cal spending is for the aged and disabled who are not in managed care, Medi-Cal could use these techniques to reduce utilization, or we could shift the disabled and aged into Medi-Cal managed care plans.<sup>24</sup> If there is a perceived need to combine utilization reductions with some reimbursement rate reductions, the appropriate targets should be those providers whose rate increases have been more frequent and extensive as opposed to physicians whose increases in their reimbursement rates have been few and far between.<sup>25</sup> We agree with the LAO that it is time to incorporate pay for performance in Medi-Cal so that those hospitals and doctors providing superior quality services are better compensated than those delivering sub-optimal care; this concept could be extended to plans providing superior community service as well.<sup>26</sup>

It may be the right time to dust off the proposed expansion of Medi-Cal managed care for the disabled and aged. Medi-Cal managed care now appears to be providing superior care to the Medi-Cal fee for service system.<sup>27</sup> There are savings of up to 5% of existing

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<sup>23</sup> A recent report found that the costs of care to the terminally ill in highly respected academic medical centers varied twofold (due to utilization not price differentials) with no differences in patient outcomes. See Robert Pear, Researchers Find Huge Variations in End of Life Treatment, New York Times (April, 7, 2008). California may also wish to beef up its programs to better manage care, costs and treatments for the chronically ill – another important aspect of the state's health reform proposal.

<sup>24</sup> See Primary Care Research Center, University of California at San Francisco, Preventing Unnecessary Hospitalizations in Medi-Cal: Comparing Fee for Service with Medi-Cal (February 2004) and Preventable Hospitalizations Among Medi-Cal Beneficiaries and the Uninsured (December 2007), and Mathematica Policy Research, Access to Physicians in California's Public Insurance Programs (May 2004) at [www.chcf.org](http://www.chcf.org) Medi-Cal managed care provides better access to physicians and lower rates of unnecessary hospitalizations than does fee for service medicine. The projected statewide savings if all the disabled were in managed care for this single issue of preventable hospitalizations is \$46 million. While the evidence concludes that managed care works better than fee for service for Medi-Cal patients, it is a large undertaking, and there is insufficient time to implement it effectively and achieve savings in this budget year.

<sup>25</sup> The administration proposes a 10% rate reductions, equaling \$561 million. Nearly half that amount is cut from managed care plans. Public hospitals pay their own match for inpatient services, so their inpatient reimbursements would not be affected. Community and county clinics with FQHC or FQHC look-alike status would also be protected from the cut. Physician and hospital providers delivering care to the Medi-Medi's, seniors and the disabled with joint Medicare and Medi-Cal coverage, are insulated from much impact by their patients Medicare coverage. Hospital rates would be cut by \$88 million, including \$34 million in safety net pool funding for public hospitals, \$30 million for non-contract hospitals and \$24 million for private hospital DSH payments. Non-contracting hospitals and pharmacy have built in cost escalators in their Medi-Cal reimbursement formulas and thus receive rate increases with some regularity; physicians do not. Hospitals also benefited from significant increases in reimbursement under the recent federal Medi-Cal hospital waiver. See Legislative Analyst's Office, Analysis of the 2008-09 Budget at [www.lao.ca.gov](http://www.lao.ca.gov)

<sup>26</sup> See Legislative Analyst's Office, Analysis of the 2008-09 Budget at [www.lao.ca.gov](http://www.lao.ca.gov) LAO notes that some Medi-Cal managed care plan, some commercial plans and some Medicare pilots are implementing pay for performance reimbursement. The LAO projects an \$88 million General Fund savings if P4P is well implemented. We would suggest that pay for performance apply to health plans as well so those plans providing superior service to the community are better compensated than those whose efforts are below average.

<sup>27</sup> See n. 24.

spending that could be built into the expansion of managed care for the disabled and/or aged. The federal government offered financial incentives of \$180 million annually over two years to smooth this transition (which California declined due to consumer and provider opposition to mandatory managed care for the disabled and aged), and we could seek to recover that lost federal funding opportunity.

Other health program savings worthy of investigation would be competitively bid bulk purchasing for medical supplies and equipment and a statewide pharmacy benefits manager for prescription drugs.<sup>28</sup> The pharmacy benefits manager could be the best approach to appropriate pricing and use of prescription drugs.<sup>29</sup>

Looking beyond the state health budget, state policy makers should re-assess their decisions to incarcerate individuals for victimless crimes such as drug abuse and to mandate long prison terms for non-violent offenders and to stint rehabilitation programs that prevent recidivism.<sup>30</sup> We have become a nation with one of the highest percentages of its citizens in prison and a state with above average incarceration rates in the country.<sup>31</sup> Are we indeed such a violent and law breaking society, or should we look afresh at the priorities and performance of our criminal justice, penal and rehabilitation systems?

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<sup>28</sup> Federal law permits competitive bidding and sole source contracting for such services as medical supplies.

<sup>29</sup> Pharmacy costs are rising due to price increases; utilization increases and the substitution of more expensive for less expensive drugs. A pharmacy benefits manager can address all three aspects of cost increases.

<sup>30</sup> See John Irwin et al. America's One Million Non-Violent Prisoners (Justice Policy Institute) available at [www.cjci.org/jpi](http://www.cjci.org/jpi) Incarceration of drug offenders increased 700% over a twenty-year period (1978-1996). EU (European Union) incarcerates 300,000 prisoners out of its 370 million population, while US incarcerates 2 million out of a 300 million population. See also Timothy Egan, Fresh Ideas for a Tired Crusade, New York Times (April 1, 2008)

California Department of Corrections reports that only 20% of its 172,000 inmates are in jail for drug offenses and only 2,000 to 3,000 inmates are incarcerated for "technical" parole violations as opposed to committing another crime or absconding. California ranks 17<sup>th</sup> out of 50 states in its incarceration rates. California Department of Coorections Presentation to the Senate Select Committee on Prison Population Mangement (August 15, 2006)

<sup>31</sup> See Michael Tonry, Why are US Incarceration Rates So High, Crime and Delinquency vol. 45 #4 419-432 (Sage Journals 1999); and Allen Beck, Prison and Jail Inmates, Bureau of Justice Statistics Bulletin (April 2000)