Governor's Budget

August 2008-09 Update Proposed Compromise

Introduction

California's budget problem has reached crisis proportions. After months of negotiation, the Administration and the Legislature have yet to agree on a plan for solving the state's budget shortfall this year, eliminating its long-term structural deficit, and reforming the budget process to prevent such a crisis from recurring.

The Governor believes that to solve the budget crisis and move forward, the state needs to do all of the following:

- Make major reductions in programs to bring spending in line with a realistic long-term revenue projection.
- Provide for a temporary increase in revenues to see the state through the next several years of anticipated slow economic growth.
- Modernize the state's lottery and securitize expected increased revenues to pay off General Fund debts or contribute to the "rainy day fund" (Budget Stabilization Account) to help see the state through the next three years.
- Enact major budget reform that will prevent future legislatures and governors from committing temporary surges in revenues to ongoing program expansions or tax cuts, and that will provide a rainy day fund and mid-year cut authority to address future downturns in revenues.

The last two components of this plan both must be enacted by the people. Budget reform can only be achieved with a constitutional amendment, and lottery reform requires amending both the Constitution and an initiative enacted by the people in 1984.

In the absence of these two components, the only alternatives to solving the state's budget problems will be massive program cuts and/or major tax increases. The Compromise reflects lessons learned after months of negotiation with legislative leaders of both parties. It is a plan that has components that are objectionable to all parties—including the Governor.

Downside Risks to Economic and Revenue Forecasts

Since the May Revision, the economic news has worsened and many forecasters are predicting a slower return to normal growth rates. If, in fact, the economy does not grow at the rates forecast in the May Revision, revenues could decline significantly in 2008-09 and 2009-10, possibly on the order of $5 billion over the two years. This downside risk to the forecast is all the more reason to enact a balanced budget that does not rely on borrowing from local governments or transportation funds.

Outline of the Plan

Figure INT-01 represents the Governor's proposed Compromise which includes General Fund spending of $103.4 billion in 2008-09. This reflects virtually no increase from the previous year and only a 2-percent increase as compared to 2006-07. However, as compared to a workload budget, that is the projected costs of maintaining state programs at their current levels, it reflects a reduction of $9.9 billion, or 9 percent.

The figure also shows that the Compromise is balanced, not only in 2008-09, but into 2009-10 as well. In fact, the Compromise would allow the state to begin rebuilding its rainy day fund in 2009-10, thus setting the stage for achieving structural balance in the future.

Figure INT-01
2008-09 Proposed Compromise
General Fund Budget Summary
(Dollars in Millions)

	2007-08	2008-09	2009-10
Prior Year Balance	$4,277	$3,893	$1,943
Revenues and Transfers	$102,967	$101,475	$106,501
Total Resources Available	**$107,243**	**$105,369**	**$108,444**
Non-Proposition 98 Expenditures	$61,798	$61,618	$60,776
Proposition 98 Expenditures	$41,552	$41,807	$45,337
Total Expenditures	**$103,350**	**$103,425**	**$106,113**
Fund Balance	**$3,893**	**$1,943**	**$2,331**
Reserve for Liquidation of Encumbrances	$885	$885	$885
Special Fund for Economic Uncertainties	$3,008	$1,058	$1,446
Budget Stabilization Account[1/]	**$0**	**$0**	**$0**
Total Available Reserve	**$3,008**	**$1,058**	**$1,446**

1/ In 2007-08, includes the transfer of $1,494 million from Budget Stabilization Account back to the General Fund under Control Section 35.60. Reflects suspension of transfers in 2008-09 and 2009-10.

The May Revision identified $24.3 billion in solutions needed to address the projected shortfall at the end of 2008-09 and leave a reserve of $2 billion. The Compromise proposes a reserve of $1.1 billion and therefore proposes solutions totaling $23.3 billion. Figure INT-02 displays how the proposed solutions in the Compromise are divided among various categories, with cuts accounting for the largest contribution to solving the budget problem.

Figure INT-02
Solutions By Category
(Dollars in Millions)

Cuts	$11,343	49%
Temporary Sales Tax Increase	4,029	17%
Borrowing	4,027	17%
Revenue Acceleration	3,306	14%
Revenues (non-tax increase)	622	3%
Total Solutions	**$23,327**	**100%**

Note that of the $23.3 billion in solutions proposed in the Compromise, $7 billion have already been achieved by the actions of the Legislature and the Governor as a result of the Emergency Session called by the Governor pursuant to Proposition 58 on January 10, including the sale of the Economic Recovery Bonds.

Figure INT-03 displays the various revenue solutions in more detail. A description of the major revenue solutions appears in the next chapter.

Figure INT-03
Revenue Solutions
(Dollars in Millions)

	2007-08	2008-09	Total
Taxes			
1-cent Sales Tax		$4,029	$4,029
Borrowing			
Economic Recovery Bonds	$3,313		3,313
Loans from Special Funds		714	714
Revenue Acceleration			
Tax Accrual	1,321	535	1,856
NOL (2-year and federal conformity)		1,090	1,090
Tax Amnesty	470	-110	360
Revenues (non-tax increase)			
FTB/BOE revenue options		226	226
Additional Tideland Revenues	24	166	190
Transfers from Special Funds		141	141
Additional Revenues from Tribal Compacts		38	38
Justice Settlement (transfer to GF)		11	11
Miscellaneous		16	16
Total Revenue Solutions	**$5,128**	**$6,856**	**$11,984**

Figure INT-04 displays the program cuts by agency. A description of the major cuts appears in the following chapter.

Figure INT-04
Expenditure Reductions By Agency
(Dollars in Millions)

	2007-08 and Prior	2008-09	Total
Legislative, Judicial, Executive	$29	$386	$415
State and Consumer Services	1	7	8
Business, Transportation & Housing	0	27	27
Resources	33	0	33
Environmental Protection	2	8	10
Health and Human Services	252	1,481	1,733
Corrections and Rehabilitation	0	231	231
K-12 Education	821	2,907 [1/]	3,728
Higher Education	0	752	752
Labor and Workforce Development	0	2	2
Suspend Prop 58 Transfer	0	1,509	1,509
Use of PTA for Home-to-School Transportation	0	589	589
Use of PTA for Debt Service	0	485	485
General Government	287	1,534	1,821
Total	**$1,425**	**$9,918**	**$11,343**

Note: Numbers may not add due to rounding.

[1/] While the Compromise fully funds the Proposition 98 Guarantee, and provides a $1.2 billion year over year increase, it does not fund the cost-of-living adjustments required under current law.

Proposed Compromise Compared to the Conference Committee Report

The proposed Compromise includes $2 billion in additional spending reductions beyond the $9.3 billion in reductions adopted by the Conference Committee. Specifically, the Compromise maintains funding for public transit at the 2007-08 level for savings of $317 million, suspends the federal cost of living adjustment for SSI for savings of $109 million in 2008-09 and $218 million in 2009-10, achieves $210 million in savings from temporary Medi-Cal provider rate reductions, temporarily shifts $228 million in funding from local redevelopment agencies to schools, suspends homeowner assistance programs and reduces senior's property tax relief for savings of $56 million, saves $150 million by deferring "settle up" payments and makes reductions of $50 million to various health and human services programs. The Compromise provides $57.8 billion to

fund the Proposition 98 guarantee, $1.1 billion less in funding than what was proposed by the Conference Committee and $1.2 billion above the 2007-08 level. Lastly, the Compromise proposal restores $145 million in funding for local public safety programs, including the Mentally Ill Offender Crime Reduction program and the COPS and Juvenile Justice Programs.

The Conference Committee Report included $9.7 billion in revenue increases and accelerations, including $6.6 billion in ongoing tax increases. These ongoing tax increases included higher personal income taxes and higher corporate taxes. If enacted, these tax increases would increase the volatility of California's revenue structure and target specific sectors of the state's economy. Recognizing a temporary decline in revenues and the need for a balanced approach to address the budget shortfall, the Compromise includes a three year, one-cent increase in the state sales tax that will be repaid by a permanent 1/4 cent decline in the sales tax. Given higher gas prices, the increase exempts gasoline, diesel and jet fuel from the proposed increase. In addition, the Compromise modifies the tax amnesty proposal included in the conference report to target the proposal to truly non-compliant taxpayers, it suspends the Net Operating Loss deduction for 2 years instead of three years, and it does not require Limited Liability Corporations (LLCs) to pre-pay their fee.

Budget Reform

California's fiscal strength and security hinges on fixing our broken budget system.

In his State of the State speech, Governor Schwarzenegger proposed a constitutional amendment to address two shortcomings in the state budget process: volatile revenues and over-spending. This Compromise would achieve both of these goals, by building on a proposal made by the Legislative Analyst and negotiated with the Legislature.

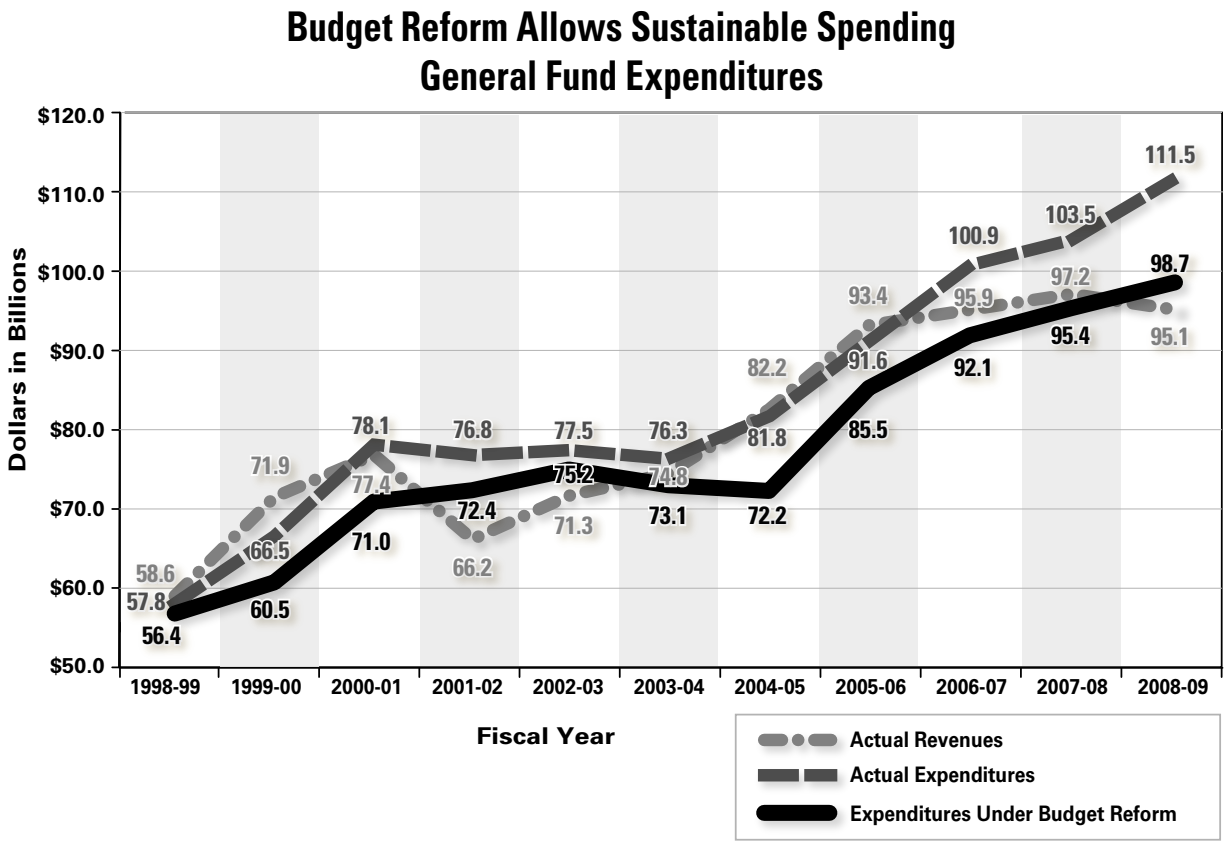
The Compromise strengthens Proposition 58 by increasing the size of the Rainy Day Fund from 5 percent to 12.5 percent, capturing unexpected increases in revenues following passage of the budget, and ensuring annual transfers to the reserve occur. Specifically, it ensures annual 3-percent of General Fund revenue transfers into the Budget Stabilization Account (BSA), except in years when the reserve exceeds 12.5 percent of General Fund revenue or in years in which revenues are low enough to allow for transfers from the BSA. Transfers from the BSA back into the General Fund would only be allowed when revenues are insufficient to cover baseline spending increases (i.e., the current level of spending as reflected in the annual Budget Act adjusted by the Gann Limit adjustment factors). Lastly, it ensures that one-time revenues available when the reserve has reached the

cap are only available for one-time purposes, including paying off state bonds, making pre-payments for the health benefits of retirees, or granting tax rebates. The Compromise proposal would not impact Proposition 98. These Constitutional amendments would take effect in 2010-11 in order to give the state time to recover from the current cyclical downturn in the economy.

This Compromise also proposes a statutory change that would grant the Governor the power to reduce spending on state operations by 7 percent and to suspend implementation of cost of living adjustments or rate increases whenever a budget deficit developed after the enactment of the annual budget.

As (Figure INT-05) shows, had this budget reform proposal been in effect since 1998-99, spending would have grown at a more sustainable rate, $23 billion in one-time dollars would have been spent on one-time purposes, and state spending today would be within $3.6 billion of baseline revenues. At the same time, there would only have been two years in the last ten in which significant budget reductions would have been needed, a major improvement compared to what actually happened in the absence of budget reform. As importantly, but not shown on the figure, the state would have a "rainy day" fund of $9.2 billion at the end of 2008-09.

Figure INT-05



Lottery Securitization

The Lottery remains a greatly underutilized state asset. Because of constraints that prevent California's lottery from performing like those in other states, it produces revenues that are only about half of the national average. This compromise proposes to place a ballot measure before the people to modernize the Lottery and authorize a securitization of the resulting increased revenues. The modernization would allow an increase in game payouts and provide more administrative flexibility. These modest changes are expected to improve the Lottery's performance significantly.

The compromise further proposes to use Lottery revenues to the benefit of the General Fund and to compensate education for the loss of these revenues by an equal increase in the Proposition 98 minimum guarantee and the base budgets of higher education.

Revenues from the modernized lottery would be available to pay down General Fund debts or to augment the state's "rainy day fund" (BSA). It is further proposed that a portion of the revenue stream from the lottery be securitized to provide $5 billion in 2009-10 to be used for these purposes.

Revenue Solutions

A total of $12.0 billion or 51 percent of all solutions are revenue solutions. Figure INT-03 provides a recap of all revenue solutions. They are also summarized in the following categories:

Temporary Sales Tax Increase

Temporarily increase for three years the General Fund sales and use tax rate from 5 percent to 6 percent, but the incremental one-percent increase would not apply to the sales of motor vehicle fuel and diesel fuel. At the end of three years, the sales and use tax rate would be decreased to 4.75 percent.

- Operative date would be September 1, 2008.
- On September 1, 2011, the rate would be decreased to 4.75 percent, including the sales and use tax on fuels.
- This proposal is expected to generate additional sales tax revenue of $4.029 billion in 2008-09, $4.813 billion in 2009-10, and $5.091 billion in 2010-11.
- By 2012-13, taxpayers would be paying $1.595 billion a year less than under current law.

Borrowing

Economic Recovery Bonds

- As part of the Governor's Budget in January, the Governor proposed and the Legislature agreed that the remaining authorization of $3.3 billion of Economic Recovery Bonds would be sold to provide much needed resources for the 2007-08 fiscal year.

Loans from Special Funds

- A total of $714 million from over forty different special funds will be loaned to the General Fund. There will not be any adverse impact on the operations of these programs supported by these funds. Loan repayments are anticipated to be made in 2010-11 or after.

Revenue Acceleration

Suspend Net Operating Losses (NOL) for Two Years and Partially Conform to Federal Carry Back and Carry Forward Provisions:

Suspension of NOL usage for taxable years 2008 and 2009, with the following changes to the carry back and carry forward provisions:

- Extend the carry forward periods for NOLs incurred in taxable years beginning before January 1, 2008, by two years.
- Conform to federal law by extending the carry forward period from 10 years to 20 years for losses attributable to taxable years beginning on or after January 1, 2008.
- Conform to federal law by allowing two-year carry back for losses incurred in taxable years beginning on or after January 1, 2011, with the following phase in
    - The amount of the NOL carry back attributable to the 2011 tax year would be limited to 50 percent, and 75 percent in 2012.
    - The entire NOL attributable to tax years 2013 and beyond would be eligible for carry back treatment.
    - The special NOL federal provisions for real estate investment trusts and corporate equity reduction transactions would apply.
    - NOL carry backs could not be taken in any taxable years before January 1, 2009.

- This proposal is expected to result in revenue increases of $1.090 billion in 2008-09 and $600 million in 2009-10, followed by revenue losses of $320 million in 2010-11, $600 million in 2011-12, and $485 million in 2012-13.

Amnesty: Personal Income Tax and Corporate Income

Enact a 2009 amnesty program for Personal Income Tax (PIT) and Corporate Income Tax (CIT) taxpayers similar to the program implemented in 2005. In general, the amnesty proposal would do the following:

- Require the Franchise Tax Board (FTB) to administer the amnesty program from February 1, 2009, to March 27, 2009.
- Be applicable to taxable years beginning on and after January 1, 2003, and before January 1, 2007 (the 2003 through 2006 tax years).
- Installment payments would be due in full by June 30, 2010.
- The amnesty penalty would not apply to tax years undergoing FTB audit or litigation during the amnesty period.
- This proposal is expected to accelerate revenue of $470 million in 2007-08, which reduces revenue by $110 million in 2008-09, $95 million in 2009-10, and similar amounts in following years.

Accrual of Personal Income Tax and Corporate Income Tax Estimated Payments

Conform tax revenue recognition accounting rules to Generally Accepted Accounting Principles (GAAP) by improving the measurement of tax receipts from income earned in a prior year. This proposal will result in the accrual of one-third of the September estimated payments made for the personal income tax and corporate income tax.

- This will be a one-time acceleration in the recognition of revenues. It will not change taxpayer liability or payment due dates.
- This will better align state accrued revenues with accrued expenditures.
- The Corporation Tax accrual will be phased in over two years to help level out revenues over the 2007-08 and 2008-09 fiscal years.
- This proposal is expected to result in accelerated revenues of $1.321 billion in 2007-08, $535 million, in 2008-09, $133 million in 2009-10, and similar amounts in following years.

Revenue (Non-Tax Increase)

FTB/BOE Collection Efforts

- Included in the Budget Act are $226 million in additional revenues associated with both new and continuing efforts at the Board of Equalization (BOE) and the Franchise Tax Board (FTB) to close the state's tax gap. These efforts are designed to ensure persons and businesses that owe tax are paying the full amount required by law. The new initiatives at BOE include efforts to improve audit and collection activities. Existing BOE efforts include expansion of successful programs to register businesses that are operating without seller's permits, and to coordinate with Department of Food and Agriculture border inspection stations to identify goods brought into the state without the payment of applicable use taxes. The new initiatives at FTB include efforts to review tax returns to identify fraudulent deductions, the cross-checking of Department of Motor Vehicles registration records to identify non-filers of Personal Income Tax returns, and the provision of new resources to handle audit and collections workload.

Additional Tideland Revenues

- The Compromise includes an additional $190 million in tidelands oil revenue, including $166 million in 2008-09, above the May Revision estimate. This revised estimate assumes oil prices of approximately $110 per barrel, which more accurately reflects current market conditions.

Transfers from Special Funds

- A total of $141 million will be transferred from ten different special funds. These transfers will not result in an adverse impact on the operations of the programs supported by these funds.

Program Reductions

A total of $11.3 billion or 49 percent of all solutions represent reductions in program costs. For a complete summary of all expenditure solutions by agency, please see Figure INT-04.

Proposition 98

Proposition 98 Guarantee

- As a result of these actions in the special session, and the revised revenue estimate being proposed in the Compromise, the Proposition 98 General Fund appropriations for 2007-08 are now approximately $41.6 billion, which is $187.3 million lower than the minimum Proposition 98 Guarantee. Total Proposition 98 funding for 2007-08 is $56.6 billion.
- The Proposition 98 Guarantee for 2008-09 is projected to grow to $57.8 billion of which $41.8 billion would be from the General Fund. While the Compromise fully funds the Proposition 98 Guarantee, and provides a $1.2 billion year over year increase, it does not fund the cost-of-living adjustments required under current law. This level of funding is higher than the amount necessary to fund Proposition 98 programs, including Special Education, Class Size Reduction and Child Nutrition, at their 2007-08 base program levels.
- 2008-09 Proposition 98 Guarantee Program Savings:

- Cost-of-Living Adjustment: $2.9 billion savings: The Budget does not provide Proposition 98 programs with the statutory 5.66 percent cost-of-living adjustment resulting in a $2.9 billion savings, including $353.9 million from Community Colleges.
- Community College Growth: $58 million additional savings are realized by reducing new enrollment growth from 3 percent to about 2 percent resulting in a total Proposition 98 expenditure level of $4.46 billion for the community colleges.
- Redevelopment Agency: 5 percent or $225 million savings: The Budget also proposes a shift in the amount of funding provided by local redevelopment agencies (RDA's) to local schools and community colleges in each county. For 2008-09 through 2010-11, RDA's will be required to shift the greater of (a) five percent of their tax increment revenue, or (b) $225 million, to the Education Revenue Augmentation Funds (ERAF's) in their respective counties. For 2008-09, the Budget assumes that $228 million in additional local revenue will be passed on to schools and community colleges, which in turn reduces the state's Proposition 98 General Fund contribution by an identical amount.

- 2009-10 Proposition 98 Guarantee: Increase $1.1 billion: Under the Lottery proposal, commencing with the 2009-10 fiscal year, the Proposition 98 Guarantee would be increased to reflect a shift of $1.1 billion, which is the amount that was dedicated to K-14 education programs from the Lottery in 2008-09. The University of California, California State University and Hastings College of Law, will receive non-Proposition 98 General Fund in 2009-10, in place of the amount they would have otherwise received from Lottery proceeds.
- Proposition 98 Settle-Up Payment: $150 million deferral. The Budget proposes to defer the annual $150 million settle-up payment. Proposition 98 appropriations for fiscal years 1995-96, 1996-97, 2002-03, and 2003-04 are $1.4 billion below the amounts required for those years. Chapter 216 of the Statutes of 2004 annually appropriates $150 million beginning 2006-07 to repay prior-year Proposition 98 settle-up obligations.
- Home to School Transportation Reimbursement from Public Transportation Account: $1 billion savings over two years: The Special Session authorized up to $409 million in Proposition 98 General Fund expenditures for the Home-to-School Transportation Program for the 2007-08 fiscal year to be reimbursed from the Public Transportation Account (PTA). Similarly, the Budget Act includes $592.9 million from

the PTA to reimburse the General Fund for the 2008-09 cost of the Home to School Transportation Program, including Special Education transportation (reflected in the totals for General Government).

Higher Education (Non-Proposition 98)

- Savings of $486 million are realized for higher education segments (excluding community colleges) resulting in a $7.1 billion General Fund expenditure level. Major reductions include $233.4 million for UC and $215.3 million for CSU from the workload budget level. The savings include unallocated reductions of $201.1 million and $172.1 million for UC and CSU, respectively, and 10 percent reductions to Institutional Support of $32.3 million for UC and $43.2 million for CSU. One-time savings of $24 million were realized in the Student Aid Commission budget due to a one-time fund shift to the Student Loan Operating Fund for a portion of CalGrant payments.

Health and Human Services

Department of Health Care Services

- As part of the 2008 Third Extraordinary Legislative Special Session, legislation was enacted to reduce expenditures by authorizing a ten percent reduction in payments to Medi-Cal fee-for-service and managed care Medi-Cal providers/programs, inpatient care payments to hospitals that do not contract with Medi-Cal, as well as provider payments for the California Children's Services (CCS) program, the Child Health and Disability Prevention (CHDP) program and Genetically Handicapped Persons Program (GHPP). This Compromise retains these reductions until March 1, 2009, which will save $505.4 million General Fund in 2008-09.

Department of Social Services

- Withholding the pass-through of the January 2009 federal Supplemental Security Income COLA would result in General Fund savings of $108.8 million in 2008-09.
- Current law suspends provision of the June 2008 State Supplementary Payment (SSP) COLA until Oct 2008. Permanent suspension of the June 2008 SSP COLA would result in General Fund Savings of $198.3 million in 2008-09.
- Suspension of the June 2009 SSP COLA would result in General Fund Savings of $48.9 million in 2008-09.

- Current law suspends provision of the July 2008 CalWORKs COLA until Oct 2008. Permanent suspension of the July 2008 CalWORKs COLA would result in General Fund Savings of an additional $111 million in 2008-09.

Business, Transportation and Housing

Public Transportation Account, Mass Transportation Fund

- The proposal includes a total $1.671 billion in transportation uses of increased revenues that offset costs that the General Fund bore in past budgets. Of this amount, $1.098 billion represents solutions compared to existing law. This is an increase of $250 million over the May Revision proposal, reflecting the projected availability of increased sales taxes due to higher fuel prices than forecast.
    - A total of $593 million for Home to School transportation (reflected in the totals for General Government)
    - $138 million for transportation to Department of Developmental Services' regional center clients (reflected in the totals for Health and Human Services)
    - $461 million to offset current year transporation debt service through the Mass Transportation Fund (reflected in the totals for Business, Transportation and Housing)
    - $479 million to offset prior year payments on transit bonds (reflected in General Government totals)
- This proposal provides $306 million (the 2007-08 level) for ongoing state grants for transit operations and capital. Capital expenditures are projected to be $348 million from sales taxes on fuels and $350 million form Prop 1B bonds.
- State Intercity Rail and High Speed Rail are funded at $127 million from sales taxes on fuels and another $108.3 million from bond funds.

Employee Compensation

Health Benefits for Annuitants and Active Employees

- A savings of $91.7 million General Fund for 2008-09 resulting from CalPERS Board approved Health Benefit Rate increases being lower than originally projected and $17.5 million General Fund savings from shifting health premium payments to the Public Employees' Contingency Reserve Fund (Medicare Part D).

Miscellaneous Issues

Suspension of Transfer pursuant to Proposition 58

- The Governor issued an Executive Order that suspended the 2008-09 transfer of $1.509 billion from the General Fund to the Budget Stabilization Account, in light of the projected condition of the General Fund.

California Department of Corrections and Rehabilitation

- $174.6 million associated with structural changes to inmate credit earnings, implementing various parole reforms, and adjusting property crime thresholds for inflation.

Judicial Branch

- $256.6 million for the State Judiciary and the Trial Courts, primarily consisting of a $92.2 million reduction to be offset with the use of trial court fund reserves, a $70.9 million reduction reflecting a delay in adding judgeships, a $56.1 million reduction reflecting a change in the growth rate applied to the trial courts, and a $17.4 million reduction reflecting a delay in the implementation of the Guardianship and Conservatorship Reform Act.

Mandates

- One-time savings of $75 million General Fund by eliminating payments for estimated reimbursement claims.
- One-time savings of $75 million General Fund by deferring the annual payment for old mandate claims.

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