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Governor Signs 2008-09 Budget: Plan Includes Deep Spending Cuts, Massive Future Tax Breaks, Debt, and Budget Process Changes

On September 23, Governor Schwarzenegger signed the 2008-09 Budget, ending the longest budget stalemate in California's history. The Legislature initially passed the budget and a number of measures implementing the budget on September 15. Subsequently, the Governor threatened to veto the budget unless certain changes were made to an accompanying measure changing the state's budget process, and ultimately the Legislature agreed to the Governor's demands on Friday, September 19. The last minute changes to the agreement include adding tough restrictions on the use of funds from the Budget Stabilization Fund (BSF) and replacing a provision that would have increased amounts withheld from personal income taxpayers' paychecks with enhanced penalties for corporations that underpay their taxes. The penalties for withholding shift replaced one source of accelerated revenues with another, but would not increase the amount of taxes ultimately owed.

The final spending plan includes \$24.0 billion of "solutions," including \$10.3 billion in spending cuts, \$9.6 billion in revenue-related provisions, and \$4.0 billion in borrowing. Of this amount, \$7.1 billion was scored to 2007-08 or prior years and \$16.9 billion was scored to 2008-09. The new spending plan assumes that the state will seek voter approval to borrow an additional \$10 billion or more that would be repaid out of future lottery proceeds to address future years' budget shortfalls. The expenditure reductions include a \$510 million cut through the Governor's use of his line item veto authority. Health and human services programs and programs that help low-income seniors and people with disabilities pay their property taxes bore the brunt of the Governor's vetoes. The Governor's vetoes and summary description of the final budget are available on the web at: <http://www.ebudget.ca.gov/>. Future CBP analyses will examine the lottery proposal, changes to the budget process, and other policy issues raised by the new spending plan.

The final budget agreement includes:

- A total of \$10.3 billion in spending reductions, including \$3.3 billion in cuts to "base" K-14 education spending, deep cuts to the CalWORKs Program and other county-administered human services programs, and extension of the 10 percent Medi-Cal provider reimbursement rate cuts through February 2009.
- Only one modest permanent tax change – the so-called "yacht" tax – which requires boats, vehicles, and aircraft to be kept out of state for at least 12 months after purchase, rather than the 3 months required by prior law to avoid payment of the use tax. This provision is expected to raise \$16 million in 2008-09. The agreement includes a massive permanent tax cut that will cost the

state \$965 million in 2011-12 and similar amounts thereafter (see below) and a variety of measures aimed at accelerating the collection of revenues from future years into the budget year.

- Changes to the budget process that would substantially increase the size of the state's reserve and limit the use of future revenues that exceed anticipated levels. The agreement also would give governors vast new power to unilaterally reduce spending midway through the budget year.
- Assumes that the state will issue bonds backed by lottery proceeds in 2009-10. The budget agreement includes provisions aimed at doubling the amount Californians spend on lottery purchases and would replace schools' allocation from lottery proceeds with a General Fund appropriation equivalent to the amount allocated to education from the lottery in 2008-09. The General Fund allocation for education would increase over time based on enrollment and per capita personal income growth.

Revenue Package Includes Large Future Tax Cuts

The final budget agreement includes \$9.6 billion in "revenue solutions." The agreement:

- Suspends businesses' ability to claim net operating loss deductions in 2008 and 2009, increasing revenues by \$1.265 billion in 2008-09 and \$695 million in 2009-10, and then extends the carry forward period for loss deductions and allows businesses to "carry back" losses earned beginning in 2011. The expansion of net operating loss deductions would result in revenue losses of \$265 million in 2010-11, \$485 million in 2011-12, and similar amounts thereafter.
- Limits businesses' use of tax credits in 2008 and 2009 for a revenue increase of \$615 million in 2008-09 and \$260 million in 2009-10 and then allows corporations that are part of a "unitary group" for tax purposes to share tax credits thereafter. The sharing of tax credits marks a significant and costly change in tax policy that would result in substantial annual revenue losses. This change is anticipated to cost \$385 million in 2010-11 and \$480 million in 2011-12.
- Loans or transfers \$855 million from various state special funds to the General Fund.
- Accelerates \$6.0 billion into 2008-09 and prior years using a number of accounting changes, enhanced penalties for corporate taxpayers, changes to estimated income tax payment requirements, and other provisions. These provisions would not change the amount of revenues the state collects, but only the year in which revenues are scored for accounting purposes. As part of the final changes to the budget aimed at averting a gubernatorial veto, the Legislature dropped a proposal to increase the amount withheld from personal income taxpayers and a proposed tax amnesty. To offset the loss of revenues, the Legislature approved an increase in penalties for corporations that underpay their taxes and changes to the estimated payment requirements for very high-income personal taxpayers.
- Includes a one-time shift of \$350 million in property tax revenues from redevelopment agencies to schools and a commensurate reduction in state General Fund support for schools and community colleges.

Budget Process Changes Will Go to the Voters

The final budget agreement will send a constitutional amendment to the voters for approval at a special election that will occur sometime in early 2009. The proposed changes would increase the size of the state's budget reserve, limit the use of funds in the reserve, and limit the use of so-called "April surprise" revenues. The Legislature initially approved a measure, SCA 13, with more modest limits on the use of the reserve. The Governor then threatened to veto the budget unless the Legislature added additional restrictions, which were approved in SCA 30 on Friday, September 19. If approved by the voters, the proposed constitutional changes would:

- Require the state to contribute an amount equal to 3 percent of General Fund revenues to a Budget Stabilization Fund (BSF). Transfers would be required until the balance in the BSF reached 12.5 percent of estimated General

Fund revenues for the fiscal year. Transfers out of the BSF could only be made in a bill that contains no unrelated provisions.

- Limit the Governor's ability to suspend transfers into the BSF. In brief, transfers would be required annually unless, beginning in 2010-11, General Fund revenues are less than the prior year's General Fund expenditures, adjusted for population growth and inflation, as measured by the change in per capita personal income.
- Restrict the use of funds in the BSF. The changes to SCA 13 made in SCA 30 would limit the use of funds in the BSF to the difference between anticipated revenues and the prior year's expenditures, adjusted for population growth and per capita personal income growth. This limitation would prevent the use of funds in the BSF to fully support expenditures required by a workload budget, even if the balance in the BSF was sufficient to fully fund a workload budget. If this limitation had been in effect this year, this provision would have forced over \$2 billion in spending cuts even if the reserve contained sufficient funds to avert the need for these reductions.
- Limit the use of so-called "April Surprise" revenues. At the end of May of each year, the Director of Finance would be required to estimate revenues for the current fiscal year and compare this estimate to the estimate contained in the budget bill for the same fiscal year. The use of any amounts estimated in May to exceed 105 percent of the budget act estimate would be limited to payment of Proposition 98 obligations that exceed amounts previously appropriated for that fiscal year if the outstanding obligation exceeds 5 percent of General Fund revenues for the year. Any remaining amount would be transferred to the BSF. After the balance in the BSF reached 12.5 percent of General Fund revenues for the year, the excess could be used for specified one-time purposes, including payment of "settle up" or maintenance factor obligations pursuant to the Proposition 98 spending guarantee; repayment of loans from transportation funds authorized by Proposition 1A of 2006; repayment of amounts owed to local governments for property tax shifts pursuant to Proposition 1A of 2004; repayment of outstanding deficit financing bonds authorized by Proposition 57 of 2004; and unfunded retiree health benefit obligations. After fulfillment of these obligations, any balances in the BSF in excess of 12.5 percent of General Fund revenues could be used for one-time infrastructure expenditures, bond debt repayment, or a one-time tax cut.

Governor Gains Mid-Year Cut Authority

AB 1389 gives the Governor authority to make mid-year reductions to state spending in years when "the Director of Finance determines that General Fund total available resources for the fiscal year will decline substantially below the estimate of General Fund total resources available upon which the Budget Act was based or that General Fund expenditures will increase substantially above that estimate of General Fund total resources available." The Governor would be allowed to reduce state operations appropriations – moneys that support state government, including the California State University and University of California systems – by up to 7 percent. Certain appropriations, including those for debt service, the Legislature, and the Governor's office could not be reduced.

The Governor, acting through his or her Director of Finance, could also suspend cost-of-living adjustments (COLAs) and rate increases provided in the Budget Act if "the Director of Finance determines that suspension by up to 120 days of the effective date of a cost-of-living adjustment is necessary to mitigate conditions that would authorize the issuance of a proclamation declaring a fiscal emergency." During that period, the COLA or rate increase would not take effect. COLAs and rate increases also would be suspended if the governor issued a proclamation declaring a fiscal emergency until the Legislature passed a bill that addressed the fiscal emergency. COLAs for general purpose appropriations for public schools – revenue limits – could not be suspended. Beginning in 2009-10, the Budget Act would be required to include a list of COLAs and rate increases that could be suspended under the new provision.

The Governor's enhanced ability to make mid-year spending reductions would only take effect if the voters approve the constitutional changes to the budget process described above.

Lottery

The final budget agreement submits a ballot measure to the voters that would modify lottery operations and authorize the state to issue bonds that would be repaid out of future lottery proceeds. The Assembly Budget Committee estimates that bond sales would raise \$5 billion in 2009-10 and \$5 billion in 2010-11. Bond monies would be used to pay General Fund budgetary obligations. The ballot measure would make several changes to the lottery, including authorizing an increase in prizes as a share of lottery revenues. The budget agreement would also replace annual payments to K-12 and higher education from lottery proceeds with allocations from the General Fund beginning in 2009-10. Future General Fund allocations to K-12 and higher education would be based on the amount of lottery revenues received in 2008-09, adjusted for inflation and changes in attendance.

Health

The 2008-09 Budget and related legislation reject many of the Governor's proposed deep cuts to Medi-Cal and other health programs. However, the 2008-09 budget agreement:

- Extends the current 10 percent reduction to payments for Medi-Cal and other health care providers through February 28, 2009. Smaller cuts are scheduled to take effect starting on March 1, 2009, with payments reduced by 1 percent for some providers and by 5 percent for others, including pharmacies and adult day health care centers. A recent court ruling raises questions about whether these cuts can be sustained. A federal district court ordered the state to restore full payments to Medi-Cal providers starting August 18, a ruling that the state has appealed.
- Requires paperwork twice per year for children in the Medi-Cal Program. Currently, paperwork is required once per year for children.
- Increases Healthy Families Program premium contributions for families with incomes between 151 percent and 250 percent of the poverty line by \$2 to \$3 per child per month.
- Allows the Managed Risk Medical Insurance Board to cap – at a level as low as \$1,500 per child per year – the amount of dental coverage provided to children in the Healthy Families Program.
- Reduces rates to health, dental, and vision plans that provide coverage through the Healthy Families Program by 5 percent.
- Does not provide funding for counties' operating-cost increases in the Medi-Cal Program and cuts funding for county Medi-Cal administration by \$42.2 million (\$21.1 million General Fund).

The Governor's line item vetoes include:

- A \$13.0 million cut to funding for local public health activities, including a \$5.5 million cut to AIDS/HIV education and prevention and a \$2.3 million cut to the Domestic Violence Program.
- Elimination of \$11.7 million for the California Discount Prescription Drug Program, which the Legislature created in 2006 to provide drug discount cards to many Californians who lack prescription drug coverage. The program has not been implemented due to budget pressures, and the Governor's action delays the program for one more year.
- A \$3.3 million cut to the Department of Public Health, including funding for the Childhood Lead Poisoning Prevention Branch (\$1.0 million) and the Medical Device and Drug Safety Program (\$1.0 million).

California Work Opportunity and Responsibility to Kids (CalWORKs) Program

The 2008-09 Budget and related legislation suspend the October 2008 COLA for CalWORKs grants for low-income families with children – the fourth consecutive year that the COLA has been suspended. However, the budget agreement also rejects the Governor’s proposals to drop more than 225,000 children from the CalWORKs Program.

In addition, the Governor’s line item vetoes include:

- A \$70.0 million cut to funding that counties use to provide child care and help CalWORKs parents find and maintain employment.
- Deletion of \$2.0 million that would have gone to counties to begin implementing a new \$40-per-month supplemental food stamp benefit for low-income working families who do not receive CalWORKs cash assistance. Families would receive the benefit if they work sufficient hours to meet federal work participation requirements that apply to the CalWORKs Program, which could help the state increase its work participation rate and avoid federal penalties. The Governor’s action delays the program for at least one year.

Supplemental Security Income/State Supplementary Payment (SSI/SSP) Program

The 2008-09 Budget and related legislation suspend the October 2008 and June 2009 state COLAs for SSI/SSP grants, which help low-income seniors and people with disabilities meet basic needs. However, the 2008-09 budget agreement rejects the Governor’s proposal to divert the January 2009 federal COLA to the state’s General Fund, rather than passing it through to recipients.

Other Health and Human Services Programs

The 2008-09 Budget and related legislation reject the Governor’s proposed deep cuts to the Child Welfare Services, Foster Care, and In-Home Supportive Services (IHSS) programs. However, the 2008-09 budget agreement does not provide funding for operating-cost increases in county-run human services programs and reduces funding for county operation of the Food Stamp and IHSS programs by a total of \$35.9 million (\$13.9 million General Fund).

In addition, the Governor’s line item vetoes include:

- A \$13.2 million reduction to several Department of Aging programs, including Senior Community Employment (\$3.2 million), the Multipurpose Senior Services Program (\$2.5 million), Alzheimer’s Day Care Resource Centers (\$0.4 million), the Home Delivered Meals Program (\$0.3 million), and the Senior Legal Hotline (\$0.2 million).
- A cut of \$11.4 million (\$6.1 million General Fund) to the Adult Protective Services Program, which assists elderly and dependent adults who are victims of abuse, neglect, or exploitation.
- A \$10.0 million reduction to Proposition 36 (Substance Abuse and Crime Prevention Act), which funds substance abuse treatment for nonviolent offenders, along with a \$2.0 million cut to the Substance Abuse Offender Treatment Program, which provides treatment services for the population eligible for services under Proposition 36.
- An \$8.0 million cut to the California Methamphetamine Prevention Campaign.
- A \$7.7 million cut to the Mental Health Managed Care Program.
- Elimination of \$2.7 million for the Naturalization Services Program, which provides funding for community-based organizations that help legal permanent residents become US citizens.
- A \$2.3 million cut to Perinatal Substance Abuse Treatment Programs.

Child Care and Development

The 2008-09 budget and related legislation freeze the income eligibility limit for child care services at the 2007-08 level in 2008-09 and do not provide a COLA for child care and development programs in 2008-09.

The Governor's line item vetoes include:

- A \$16.4 million cut to CalWORKs Stage 2 child care funding, which the Legislature added to ensure that the state would be able to meet the child care needs of current and former CalWORKs families in 2008-09.
- Deletion of a budget bill provision that would have exempted families who receive child care services from paying fees if their incomes are less than 40 percent of the state's median income, adjusted for family size.

K-12 Education

As signed by the Governor, the 2008-09 Budget provides \$58.1 billion in funding for K-14 education programs under the Proposition 98 guarantee. The Budget reduces "base" K-14 education spending by \$3.3 billion.

The 2008-09 Budget and related legislation:

- Provide a 0.68 percent COLA to fund revenue limits for school districts and county offices of education, which is below the 5.66 percent statutory COLA and the 2.12 percent COLA proposed by the Conference Committee. The 2008-09 Budget does not provide a COLA for categorical programs, such as class size reduction and instructional materials.
- Do not provide \$150 million in 2008-09 Proposition 98 "settle-up" funds needed to meet prior-year Proposition 98 obligations.
- Proposed to modify Proposition 49, the After School Education and Safety Program (ASES) Act, by submitting a ballot measure to voters in November 2008. However, the Governor vetoed the bill that would have submitted the measure to voters. The measure would have removed Proposition 49's minimum funding level of \$550 million and would have allowed annual ASES budgeting decisions to be made by the Legislature.

The Governor's line item vetoes include:

- \$6.0 million for non-Title I schools subject to sanctions for failing to make progress under the No Child Left Behind Act (NCLB) or the state's accountability system.
- \$1.8 million in federal funds allocated to schools whose English learners are failing to make annual progress under NCLB.
- Reducing support for child nutrition programs that provide meals in schools and child care programs by \$862,000.
- \$253,000 for public libraries that provide literacy instruction to adults and children

Higher Education

- Include \$39.8 million to support a 0.68 percent COLA for California Community Colleges, which is below the 5.66 percent statutory COLA and the 2.43 percent COLA proposed by the Conference Committee. The 2008-09 Budget does not provide a COLA for California Community College categorical programs.

- Fund the California State University (CSU) and the University of California (UC) at the level proposed in the May Revision.
- Assume a 10 percent fee increase for CSU students and a 7.4 percent increase for UC students.

The Governor's line item vetoes include:

- \$5.4 million in funding for research on labor and employment and labor education throughout the UC system.
- Eliminating the requirement for the UC to shift \$15.0 million budgeted for administrator compensation to support salary increases for low-wage service employees.

Transportation

The 2008-09 budget agreement uses \$1.75 billion in transportation funds to offset costs traditionally paid out of the state's General Fund. A majority of the shift reflects a diversion of funds dedicated to public transit. The shifted amounts would be used to pay for home-to-school transportation (\$593 million), repayment of transportation-related bond debt and loans (\$1.022 billion), and transportation services provided by regional centers (\$138 million). The Governor line item vetoed \$100 million of support for State Transit Assistance (STA) program, which supports local transit operations and capital improvements, to ensure that sufficient funds would be available to offset General Fund obligations.

Other

The 2008-09 Budget and related legislation:

- Provide \$107 million each to the Citizens' Option for Public Safety (COPS) and Juvenile Justice Crime Prevention Act programs, which restores cuts that were included in the conference committee's proposed spending plan.
- Allocate \$31.5 million to reimburse local governments for booking fees. The conference committee initially proposed to eliminate this funding.
- Appropriate \$18.5 million to the Small/Rural Sheriffs Grant program. Funding for this program was slated for a 10 percent reduction; however, the bill containing the reduction, as well as other provisions, was not taken up as part of the budget agreement due to Republican opposition.
- Allocate \$25.8 million for the Senior Citizens' Property Tax Deferral Program.

In addition, AB 10 – included as part of the budget package – exempts certain high-wage computer professionals from overtime pay requirements.

The Governor's line item vetoes include the elimination of the entire \$190.9 million appropriation for the Senior Citizens' Property and Renters' Tax Assistance programs.

The Budget Bill and Accompanying Changes

The 2008-09 Budget and related legislation include:

- AB 1781: 2008-09 Budget Bill – signed by the Governor 9/23/08
- AB 10: Overtime compensation – signed by the Governor 9/30/08
- SBX1 28: Replaces amnesty and personal income tax withholding changes with enhanced corporate income tax penalties and estimated payment modifications – enrolled, no action as of 10/1/08
- ABX3 36: Tax withholding and estimated payment changes – vetoed by the Governor 9/30/08

AB 88: Changes to appropriations to reflect negotiations after the close of the budget conference committee – signed by the Governor 9/23/08

AB 158: Tribal gaming – signed by the Governor 9/30/08

AB 186: Rural crime prevention – signed by the Governor 9/30/08

AB 268: Transportation – signed by the Governor 9/30/08

AB 519: Education – signed by the Governor 9/30/08

AB 1183: Health – signed by the Governor 9/30/08

AB 1279: Human services – signed by the Governor 9/30/08

AB 1338: Resources – signed by the Governor 9/30/08

AB 1389: General government, including mid-year cut authority – signed by the Governor 9/30/08

AB 1452: Net operating loss, tax credit changes, and “yacht tax” – signed by the Governor 9/30/08

AB 1526: Proposition 49 after school programs – vetoed by the Governor 9/30/08

AB 1654: Lottery modifications – enrolled, no action as of 10/1/08

AB 1741: Lottery securitization authorization – enrolled, no action as of 10/1/08

AB 1805: Mental health services – vetoed by the Governor 9/30/08

AB 2026: State property – signed by the Governor 9/30/08

AB 2246: Charter schools – signed by the Governor 9/30/08

AB 2784: Medi-Cal hospital reimbursements – vetoed by the Governor 9/30/08

SCA 12: Constitutional changes related to Lottery securitization – chaptered by the Secretary of State

SCA 13: Budget Stabilization Fund and related provisions – chaptered by the Secretary of State

SCA 30: Modifies SCA 13’s changes to the Budget Stabilization Fund – chaptered by the Secretary of State