



## WHERE ARE WE AND WHERE ARE WE GOING: SLOUCHING TOWARD THE MAY REVISION TO THE 2007-08 BUDGET

As April comes to a close, the Franchise Tax Board is tallying personal and corporate income tax payments and the Budget Subcommittees of each house of the Legislature are completing their initial hearings on the 2007-08 budget. The Governor will release updated revenue and expenditure estimates, along with revised policy proposals, on Monday, May 14. The following examines major developments since January in preparation for the next stage of the budget debate.

**Revenue collections were down at the end of March.** Department of Finance reported revenue collections as of the end of March were \$1.3 billion (2.0 percent) below the Governor's January budget forecast. The lower than anticipated collections reflect lagging personal income tax collections, which were down by \$1.7 billion (4.9 percent), combined with higher than anticipated corporate tax collections, which were up by \$396 million (6.0 percent). Sales tax revenues were almost on target, falling \$24 million (0.1 percent) below forecast levels.

**The Legislative Analyst's forecast assumes that revenue will lag the Governor's forecast.** In February, the Legislative Analyst's Office (LAO) forecast that combined 2006-07 and 2007-08 revenues would be \$2 billion below the Governor's budget estimates. The LAO projected that 2006-07 revenues would be \$939 million below the Governor's forecast and 2007-08 revenues would be approximately \$1 billion lower than the Governor assumes. Thus, as of the end of March, 2006-07 revenues were below even the LAO's modestly weaker estimates. The LAO's forecast estimated that 2006-07 personal income tax collections would be \$1.3 billion less than the Governor's estimate and that corporate income tax collections would be \$429 million above the Governor's forecast. The LAO projects that 2007-08 personal income tax collections will be \$788 million below the Governor's estimate and that corporate income taxes will be \$584 million above the Governor's forecast.

**April is a critical month.** Approximately one out of every six dollars that flow into the state's General Fund are collected during the month of April, primarily due to the April 15<sup>th</sup> personal income tax filing deadline, which was extended to April 17<sup>th</sup> this year. In 2006, for example, the state received \$11.7 billion in personal income tax collections during the month of April. Press reports suggest that April income tax collections are on track with forecast levels and may, in fact, make up for a portion of the shortfall in revenue collections during the first quarter of 2007.

**Several major items will push costs above budgeted levels.** Recent developments suggest that current year spending will be significantly higher than prior estimates. Major issues include an arbitrator's award that will boost costs for correctional officer salaries and benefits (\$153.5 million in 2006-07 and 2005-06 and an additional \$46.3 million in 2007-08).

**Prison package will significantly increase the state's costs.** Recently passed legislation aimed at addressing overcrowding in the state's prison system will have both immediate and long-term costs. The measure, AB 900 (Solorio and Aghazarian), appropriates \$350 million for infrastructure improvements at existing prisons and improved rehabilitation services. The measure also authorizes \$7.4 billion in lease-revenue bond financing for construction of

53,000 additional state prison and local jail beds. The Assembly Floor Analysis of AB 900 states that the bonds will cost the state approximately \$600 million per year in principal and interest. The Governor's January budget outlined a prison reform plan, but did not allocate funds to implement the plan. Thus, these costs will add to proposed state spending.

**Governor revises proposal for shifting Public Transportation Account funds.** In January, the Governor proposed to shift \$627 million in home-to-school transportation costs from the General Fund to the Public Transportation Account and adjust the Proposition 98 guarantee downward by an equal amount. In a March 29 letter to the Legislature, the Governor's Department of Finance revised this proposal. The new proposal would use Public Transportation Account dollars to reimburse the General Fund for \$627 million in home-to-school transportation costs. The significance of this proposal is that it would not affect Proposition 98's school funding guarantee. It would still result in a loss of transit operating dollars.

**The state wins its appeal of the Guillen case.** The Governor's January budget assumed \$553 million in savings from withholding the October 2003 cost of living adjustment (COLA) for CalWORKs grants. The savings assumed the state would prevail in its appeal of a lawsuit arguing that grants should have been increased when the Governor lowered Vehicle License Fees when he assumed office in 2003. In February, the appellate court ruled in the state's favor, thereby enabling the state to continue to withhold the COLA. In March, the Western Center on Law and Poverty – the attorneys for the plaintiffs – appealed the case to the State Supreme Court.

**Tribal gaming revenues are unlikely to reach the Governor's targets.** The Governor's January budget assumed that the state would receive \$506 million in revenues from yet-to-be-ratified tribal gaming compacts in 2007-08. The State Senate approved the compacts in question in mid-April; however, the Assembly has yet to act. In February the LAO estimated that, if ratified, the compacts would be unlikely to result in more than \$200 million in revenues in 2007-08 due to the time necessary to install the new gaming machines and lower "per machine" estimates of the revenues that might be generated. According to press reports, the Department of Finance has lowered its estimates of revenues from the new compacts from \$506 million to \$382 million. However, the new lower estimate remains above the level forecast by the LAO.

**The bottom line.** Year-to-date developments suggest that the state will continue to face a budget gap when the Governor releases updated estimates as part of his May Revision. Current year revenues are not likely to exceed, and may lag behind, the Governor's forecast and several large expenditure items are likely to push spending higher. Economists point to continued weakness in the housing sector and modest increases in inflation as signs that economic growth may be lower in 2007 than in the prior year. This could, in turn, result in slower revenue growth in 2007-08 than was previously expected.