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Budget Gap Widens Significantly, Governor Proposes Deep Cuts, New Taxes

With the ink barely dry on the 2008-09 spending plan, both the Governor and the Legislative Analyst's Office (LAO) identify substantial erosion in projected revenues leading to large projected gaps in the current and upcoming budget years' spending plans. While a portion of the widening gap was anticipated at the time the budget was enacted, largely due to outdated revenue forecasts and overly optimistic projections, most of the widening gap is attributable to the rapid decline in the California and, indeed, national and world economies. In a report released November 11 (available at: http://www.lao.ca.gov/2008/bud/nov_revise/nov_revise_overview_111108.pdf), the LAO projects a combined shortfall of \$27.8 billion in the remainder of the 2008-09 and 2009-10 fiscal years. This is larger than the \$22.5 billion gap over the same period identified by the Governor in a document (available at: http://www.dof.ca.gov/documents/special_session_08-09_web.pdf) released as part of his calling the Legislature into a special session to consider action on a range of budget "solutions." The difference between the two forecasts largely stems from the fact that the LAO takes into account higher-than-anticipated spending for some programs. To bridge the gap, the Governor has proposed a substantial tax increase coupled with large reductions in state spending, primarily affecting education, health, human services, and higher education programs.

How Did Things Get So Bad, So Fast?

Most of the state's widening budget gap is attributable to the impact of the economic downturn on current and projected revenue collections. The Governor's special session call estimates that 2008-09 revenues will be \$10.7 billion below the projections used for the Budget Act and that 2009-10 revenues will be \$13.0 billion below prior forecasts. The LAO estimates that 2008-09 revenues will be \$1.9 billion above the Governor's estimate, but that 2009-10 revenues will be \$2.8 billion below the Governor's forecast.

State, national, and global economic conditions have eroded rapidly and more severely than forecasters anticipated as recently as the spring and summer, spurred by the "credit crunch" and a contraction in consumer spending. In California:

- The seasonally adjusted unemployment rate reached 7.7 percent in September 2008 – its highest level in 12 years – up from 5.6 percent in September 2007 and 4.9 percent in September 2006. The steady rise in the state's unemployment rate between 2006 and 2008 contrasts with trends during the previous two years, when California's seasonally adjusted unemployment rate declined from 6.1 percent in September 2004 to 4.9 percent in September 2006.

- The number of jobs declined by 78,700 (0.5 percent) between September 2007 and September 2008. Since April 2008, the state has lost an average of 11,000 jobs each month. In contrast, California added 72,400 jobs between September 2006 and September 2007 – a modest 0.5 percent increase – and added 236,500 jobs between September 2005 and September 2006, a 1.6 percent increase
- Year-to-date collections for the three major taxes are \$1.2 billion (4.6 percent) below where they were one year ago. The State Controller notes that “Retail sales are \$367 million below (-4.9 percent) last year at this date. Corporate taxes are \$612 million below (-19.5 percent) last year and income taxes are \$190 million lower (-1.3 percent) than last year at this date.”

Governor Proposes Tax Hike

In recognition of the state’s widening budget gap, the Governor proposes to increase state sales and alcoholic beverage taxes, expand the state’s sales tax to selected services, raise vehicle registration fees, and impose a severance tax on oil produced within the state. His proposals would increase state revenues by \$4.868 billion in the remainder of 2008-09 and by \$10.614 billion in 2009-10. Specifically, the Governor proposes to:

- Increase the state’s sales and use tax rate by 1.5 percentage points for three years effective January 1, 2009. His proposal would raise an estimated \$3.540 billion in 2008-09 and \$7.319 billion in 2009-10.
- Extend the state’s sales tax to appliance and furniture repair, vehicle repair, golf, veterinarian services, amusement parks, and sporting events. This proposal would raise an estimated \$357 million in 2008-09 and \$1.156 billion in 2009-10. Counties and cities also would receive increased revenues from the expanded tax base.
- Impose a 9.9 percent tax on the gross value of each barrel of oil produced in California. This proposal is expected to raise \$528 million in 2008-09 and \$1.195 billion in 2009-10.
- Increase alcoholic beverage taxes by the equivalent of a nickel a drink.
- Raise vehicle registration fees by \$12 per vehicle effective February 1, 2009 to offset a shift in Vehicle License Fee (VLF) revenues from the Department of Motor Vehicles (DMV) to local governments. The shifted VLF would replace state funds that the Governor would cut from state programs that support local criminal justice activities.

The LAO suggests that the Legislature could consider an increase in the VLF tax rate, a surcharge on the personal income tax, or elimination of tax expenditure programs in place of some or all of the Governor’s proposed sales tax increase.

The Bottom Line

The LAO projects that California will face substantial gaps – close to \$20 billion in 2009-10 and in excess of \$20 billion thereafter – between revenues and expenditures required by current law (“operating deficits”) for the foreseeable future. Taken together, the Governor’s tax and spending proposals would bring the 2009-10 budget approximately into balance. However, deep deficits would return in 2010-11 and thereafter. The re-emergence of sizeable shortfalls assumes an economic downturn that is deeper and longer than previously expected coupled with:

- The reliance of the current year’s budget on one-time solutions;
- The expiration of the Governor’s proposed temporary 1.5 percentage point increase in the sales tax rate described above;
- The fact that current forecasts assume that the state will receive \$5 billion in each of the next two fiscal years (2009-10 and 2010-11) from the sale of bonds backed by future years’ lottery proceeds. After 2010-11, the lottery proposal would have a negative impact on the General Fund, which would assume responsibility for a greater share of school spending; and

- The permanent tax cut included in the 2008-09 budget agreement, which will cost the state an estimated \$650 million in 2010-11 and increasing amounts annually thereafter.

Medi-Cal Program

The Governor's special session budget proposal includes a number of cuts to the Medi-Cal Program that would take effect on December 1, 2008. These are mainly proposals previously made by the Governor that the Legislature rejected earlier this year. Specifically, the Governor proposes to:

- Eliminate dental and other benefits for Medi-Cal recipients, for savings of \$41 million in 2008-09 and \$129.9 million in 2009-10. The elimination of dental benefits would affect only adult beneficiaries. Other benefits that would be eliminated include vision services, podiatry, and incontinence creams and washes.
- Require more low-income seniors and people with disabilities to pay a share of cost for Medi-Cal services, for savings of \$43.8 million in 2008-09 and \$203.7 million in 2009-10. This proposal would affect people with incomes that exceed the limit for the Supplemental Security Income/State Supplementary Payment (SSI/SSP) Program.
- Substantially restrict eligibility for low-income parents with children. The Governor would reduce the maximum income level for parents applying for Medi-Cal to the limit in effect prior to March 2000. In addition, the Governor proposes to make it more difficult for two-parent families to enroll in and retain Medi-Cal coverage by reinstating a rule requiring the family's principal wage earner to work less than 100 hours per month. The Administration estimates that these changes – when fully implemented in 2011-12 – would prevent 429,000 low-income parents from obtaining Medi-Cal coverage. Savings are estimated to rise from \$8.6 million in 2008-09 to \$342.5 million in 2011-12.
- Reduce the services provided to certain legal immigrants – such as those who have been in the US for five years or less – for savings of \$29.7 million in 2008-09 and \$144.4 million in 2009-10.
- Restrict access to health care services for unauthorized immigrants by requiring them to reapply for Medi-Cal monthly in order to receive emergency services. The proposal assumes savings of \$15.1 million in 2008-09 and \$73.5 million in 2009-10 by reducing the number of immigrants covered by Medi-Cal.
- Use federal Safety Net Care Pool funds that support public hospitals to support several state programs, including the California Children's Services and Genetically Handicapped Persons programs. This funding shift would result in state savings of \$3.7 million in 2008-09 and \$54.2 million in 2009-10.

California Work Opportunity and Responsibility to Kids (CalWORKs) Program

The Governor's special session budget proposal includes a number of CalWORKs policy changes that would take effect on March 1, 2009. The Legislature rejected these or similar proposals earlier this year. Specifically, the Governor proposes to:

- Reduce CalWORKs grants by 10 percent, for savings of \$93.2 million in 2008-09 and \$279.6 million in 2009-10. This proposal would reduce the maximum monthly grant for a family of three in high-cost counties from \$723 to \$651.
- Eliminate cash assistance:
 - For children in the CalWORKs "safety net" program if their parents do not work sufficient hours to meet federal work participation requirements, for savings of \$80.7 million in 2008-09 and \$242 million in 2009-10. The CalWORKs safety net program provides aid to children whose parents have reached the CalWORKs 60-month time limit and therefore are no longer eligible for cash assistance.

- After 60 months for some children whose parents or caretakers are ineligible for CalWORKs, including US citizen children of undocumented immigrants, for savings of \$76.8 million in 2008-09 and \$230.3 million in 2009-10.
- For certain CalWORKs families in which an adult fails to attend a meeting with a county worker, for savings of \$23.3 million in 2008-09 and \$94.8 million in 2009-10.

SSI/SSP Program

The Governor's special session budget proposal would:

- Reduce SSI/SSP grants to the minimum level required by federal law beginning on March 1, 2009, for savings of \$348.9 million in 2008-09 and \$1.1 billion in 2009-10. This change would reduce the monthly SSI/SSP grant for an individual from \$907 in January 2009 to \$830 in March 2009.
- Eliminate the Cash Assistance Program for Immigrants (CAPI) beginning on March 1, 2009, for savings of \$37.8 million in 2008-09 and \$114.1 million in 2009-10. CAPI provides state-funded cash assistance to approximately 10,000 elderly and/or disabled legal immigrants who are not eligible for SSI/SSP payments due to their immigration status.

In-Home Supportive Services (IHSS) Program

The Governor's special session budget proposal includes three changes to the IHSS Program that would take effect on March 1, 2009. The Legislature rejected these proposals earlier this year. Specifically, the Governor proposes to:

- Cap the state's contribution toward the wages of IHSS workers at the state's minimum wage – currently \$8.00 per hour – plus \$0.60 per hour for benefits, for savings of \$82.9 million in 2008-09 and \$248.8 million in 2009-10.
- Eliminate domestic and related services for IHSS recipients with less severe impairments, for savings of \$23.1 million in 2008-09 and \$71.4 million in 2009-10.
- Require IHSS recipients with less severe impairments to begin paying their own Medi-Cal "share of cost," for savings of \$12.3 million in 2008-09 and \$37 million in 2009-10.

Other Health and Human Services Programs

The Governor's special session budget proposal would:

- Eliminate the California Food Assistance Program (CFAP) beginning on July 1, 2009, for savings of \$30.3 million in 2009-10. CFAP provides food assistance to certain legal noncitizens who are ineligible for the federal Supplemental Nutrition Assistance Program – formerly the Food Stamp Program – solely due to their immigration status.
- Reduce payments for Regional Center operations and certain services provided to people with developmental disabilities by 3 percent and make additional changes beginning on December 1, 2008, for savings of \$34.2 million in 2008-09 and \$59.8 million in 2009-10.

Child Care and Development Programs

The Governor's special session budget proposal would:

- Reduce funding for non-CalWORKs child care and development programs by \$55 million in 2008-09. The Administration states that this cut would not reduce services to families because "this amount has not been allocated for contracts" with child care providers.
- Cut funding for CalWORKs Stage 2 and 3 child care by \$42 million in 2008-09, citing lower-than-projected caseload growth.

K-12 Education

The Governor's special session budget proposal reflects a 2008-09 funding level of \$55.6 billion for K-14 education programs covered by the Proposition 98 school funding guarantee, \$2.5 billion below the funding level of \$58.1 billion assumed in the 2008-09 budget agreement. The Governor's proposed spending reductions are in addition to a \$3.3 billion reduction to "base" K-14 education spending included in the 2008-09 Budget. To achieve 2008-09 General Fund reductions, the Governor proposes to:

- Reduce revenue limit funding by \$2.0 billion for school districts and county offices of education (COE) which includes eliminating the 0.68 percent cost-of-living adjustment (COLA) provided in the 2008-09 budget agreement and making further reductions of \$1.8 billion. The 2008-09 Budget did not provide a COLA for categorical programs, such as class size reduction and instructional materials.
- Reduce funding for several K-12 education programs by \$71.2 million, including reductions to K-3 class size reduction (\$28.6 million), alternative credentialing (\$3.3 million), principal training (\$2.6 million), and the Pupil Retention Block Grant (\$1.0 million).

The Governor also proposes to:

- Authorize the transfer of funding for categorical programs, such as class size reduction and instructional materials, to a district's or COE's general fund. The Governor's proposal would limit the amount of these transfers to the reduction in funding made to the district or COE. The Governor's proposal states that districts or COEs that choose to make these transfers must report the amount transferred, the programs from which transfers were made, and the purposes for which those funds were used.
- Allow districts to cut reserves for economic uncertainties in half and reduce routine maintenance reserves from 3 percent to 2 percent.
- Suspend requirements for districts to match state deferred maintenance funding.

Higher Education

The Governor's special session budget proposal would:

- Reduce general apportionment funding by \$332.2 million for California Community Colleges, which includes eliminating the 0.68 percent COLA provided in the 2008-09 budget agreement and making further reductions of \$292.4 million.
- Reduce funding for the University of California by \$65.5 million.
- Reduce funding for the California State University by \$66.3 million.
- Reduce funding for the Hastings School of Law by \$402,000.

Transportation

The Governor's special session budget proposal would eliminate funding for the portion of State Transit Assistance grants that comes from the Public Transportation Account. This proposal would result in savings of \$222.9 million in 2008-09 and \$306 million in 2009-10.

State Employees

The Governor's special session budget proposal includes several changes in state employees' compensation and benefits. Specifically, the Governor proposes to:

- Require most state employees to take a one-day furlough each month between December 1, 2008 and June 30, 2010, for savings of approximately \$263 million in 2008-09 and \$451 million in 2009-10.
- Eliminate two state holidays – Lincoln's Birthday and Columbus Day – and eliminate "premium pay" for hours worked on the remaining state holidays, resulting in savings of approximately \$39.4 million in 2008-09 and \$74.5 million in 2009-10.
- Change the method for calculating overtime pay for state employees, resulting in savings of approximately \$17.5 million in 2008-09 and \$30 million in 2009-10.

Local Government

The Governor's special session budget proposal includes a number of cuts to programs that provide funds to local governments. Specifically, the Governor proposes to:

- Reduce state payments to local governments by \$34.7 million for revenues lost because of Williamson Act contracts. The Williamson Act lowers property taxes paid by agricultural landowners that agree not to develop their land. The 2008-09 Budget reduced these payments by \$3.9 million.
- Eliminate \$51.7 million in 2008-09 and \$103.5 million in 2009-10 for local public safety programs, including juvenile camps and ranches, the Small/Rural Sheriffs Grant program, and several local assistance programs administered by the Office of Emergency Services.

In addition, the Governor proposes to shift VLF proceeds that currently support the DMV to fund certain law enforcement grant programs traditionally paid out of the General Fund, for savings of \$198.8 million in 2008-09 and \$397.5 million in 2009-10. Programs that would receive VLF funds include local juvenile probation activities, the Citizens' Option for Public Safety (COPS) and Juvenile Justice Crime Prevention Act programs, and booking fee payments. The Governor proposes to increase the annual vehicle registration fee by \$12 to replace VLF funds shifted from the DMV.

Corrections

The Governor's special session budget proposal would reduce funding for the Department of Corrections and Rehabilitation by \$78.1 million in 2008-09 and \$677.6 million in 2009-10. To achieve these reductions, the Governor proposes to:

- Eliminate parole supervision for inmates without current or previous convictions for serious, violent, or sexual crimes, for savings of \$78.7 million in 2008-09 and \$535.9 million in 2009-10. The Legislature rejected the Governor's prior proposed changes to parole policies.
- Expand the credits that inmates can earn to reduce their time in prison, which would cost \$3.4 million in 2008-09, followed by ongoing savings of \$90.5 million beginning in 2009-10. Although the Legislature approved the savings that would have resulted from a proposal to modify inmate credits in the 2008-09 Budget, it did not approve the accompanying legislation that was necessary for implementing the proposal.
- Reduce the number of property crimes that could be prosecuted as felonies, for savings of \$2.9 million in 2008-09 and \$51.3 million in 2009-10.