CALIFORNIA BUDGET PROJECT

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Legislature Continues To Debate Budget Plan

The Legislature continues to debate a spending plan aimed at addressing the state's worsening budget crisis. As of mid-day Wednesday, February 18, the State Senate lacked the required two-thirds support for the tax increases included as part of the budget agreement. The agreement under consideration includes a total of $40.8 billion in "solutions" – $26.1 billion to balance the 2009-10 budget and $14.8 billion to close the gap projected for the remainder of 2008-09. The proposed agreement includes $14.1 billion in spending reductions, $12.8 billion in new and increased taxes, and $11.5 billion in new borrowing and various accounting gimmicks.

The agreement assumes that the state will receive $5.0 billion from the sale of bonds backed by lottery proceeds in 2009-10. The proposed budget agreement assumes voters will approve changes in the allocation of lottery proceeds in a measure that would appear in a special election. The proposed agreement also assumes that the state will raise $5.9 billion from the sale of Revenue Anticipation Warrants (RAWs). Finally, the proposed agreement assumes $432.6 million in internal borrowing from several special funds.

The agreement includes a trigger mechanism linked to California's receipt of federal funds from the federal economic recovery bill signed into law on February 17. If California does not receive at least $9.1 billion in funds that can offset state General Fund expenditures, additional cuts totaling $947.7 million and an additional tax increase of $1.6 billion would be triggered. If California receives the targeted amounts, the cuts and tax increase would not take effect and $5.9 billion of the federal funds would be used to eliminate the proposed issuance of RAWs. The Legislative Analyst and others have raised issues with the use of RAWs for budget-balancing purposes, rather than strictly for cash-flow management, as a result of language added to the state's Constitution in 2004 by Proposition 58, which authorized the issuance of deficit financing bonds on a one-time basis.

Proposed Cap Could Severely Limit Future Spending

The proposed budget agreement includes a constitutional amendment, ACAX3 1 (Niello and Adams), that would withdraw a measure placed on the ballot in September as part of the 2008-09 budget package. The new measure would:

- Require the state to deposit an amount equal to 3 percent of annual General Fund revenues in the Budget Stabilization Fund (BSF) until the balance in the BSF equals 12.5 percent of General Fund revenues. The proposed measure would limit the circumstances under which reserve contributions could be suspended or reduced.

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- Shift half of the annual BSF contribution to one of two newly created accounts that would be dedicated to restoration of education funding levels and/or debt service and capital outlay, under specified circumstances. This provision would effectively double the contributions needed to reach the maximum balance in the BSF and would reduce the amount that is available to balance the budget in bad budget years.
- Limit the use of funds in the BSF in bad budget years to the difference between revenues and the prior year's spending level adjusted by the Consumer Price Index and population growth. This provision would have the effect of preventing the use of the reserve to bring spending up to "baseline" levels if the baseline is greater than prior year's spending adjusted for inflation and population growth.
- Establish a complicated formula – using a statistical technique known as linear regression – to calculate a "revenue forecast amount" that would then be used to determine what, if any, portion of General Fund revenues should be considered "unanticipated revenues." Unanticipated revenues would be defined as the lesser of the difference between estimated revenue collections and the "revenue forecast amount" or the difference between estimated revenue collections and the prior year's spending adjusted by population growth and inflation. Any unanticipated revenues either would be shifted to the BSF or, under certain circumstances, could be used to fulfill certain outstanding obligations.

Tax Cuts Will Worsen Future Budget Gaps

The proposed budget agreement includes four significant tax breaks that together will reduce revenues by more than $2.5 billion over a five-year period from 2008-09 through 2012-13. Three of these provisions would be temporary. The fourth, which results in the largest revenue loss, would be permanent. The first of the proposed changes would create a tax credit of $3,000 for each additional full-time equivalent increase in employment for businesses with 20 or fewer employees in the prior year. This provision would be in effect in tax years beginning on or after January 1, 2009 and would remain in effect until the total amount of credits claimed reaches $400 million. Past experience suggests that such credits do not lead to new employment and that they are subject to considerable abuse. A similar proposal was dropped from the federal economic recovery plan in response to concerns over cost and lack of effectiveness. The second proposal would provide $100 million per year for five years – 2009-10 through 2013-14 – for a new tax credit for movie and television production activities. The third proposal would provide a tax credit to individuals who purchase homes. The credit would be equal to the lesser of $10,000 or 5 percent of the purchase price. The credit could be used only for homes that have never been occupied, that will serve as a buyer's principal residence for at least two years, and that are purchased between March 1, 2009 and February 28, 2010. This provision would cost up to $100 million in lost revenues over a three-year period from 2009-10 to 2011-12. The fourth proposal would give corporations the option to choose between two different formulas for determining how much of their income would be subject to tax in California. This provision would be in effect in tax years beginning on or after January 1, 2011 and would cost $650 million in the first full year of implementation, eventually increasing to $1.5 billion annually.

Proposed Budget Agreement Includes Up to $14.4 Billion in New Tax Revenues

The proposed budget agreement would raise up to $14.4 billion in new tax revenues. The new taxes would be in effect for three to four years if voters approve proposed changes to the state's budget reserve and limits on state spending, which the Legislature would put on the ballot as part of the budget package. If voters reject the spending cap, the new taxes would be in effect for two years. Specifically, the proposed agreement:

- Increases the state sales tax rate by 1 percentage point, raising an estimated $1.203 billion in 2008-09 and $4.553 billion in 2009-10. This provision would be in effect from April 1, 2009 through June 30, 2012 if voters approve the proposed spending cap; otherwise, this provision would expire on June 30, 2011.

- Increases the Vehicle License Fee (VLF) rate from 0.65 percent to 1.15 percent, except for large commercial vehicles, raising $375 million in 2008-09 and $1.722 billion in 2009-10. A portion of the increased revenues from this provision would be used to fund local law enforcement programs. This provision would be in effect from May 19, 2009 through June 30, 2013 if voters approve the proposed spending cap; otherwise, this provision would expire on June 30, 2011.
- Imposes a surtax equal to 2.5 percent of personal income tax liability, raising an estimated $1.627 billion in 2009-10. This provision would be in effect for tax years 2009 through 2012 if voters approve the proposed spending limit, or for tax years 2009 through 2010 if voters reject the spending cap.
- Reduces the size of the dependent credit claimed by personal income taxpayers to the same level as the personal credit, raising an estimated $1.440 billion in 2009-10. This provision would be in effect for tax years 2009 through 2012 if voters approve the proposed spending limit, or for tax years 2009 through 2010 if voters reject the spending cap.
- Increases the gasoline and diesel fuel taxes by 12 cents per gallon, raising $250 million in 2008-09 and $1.812 billion in 2009-10. This provision would be in effect from April 1, 2009 through June 30, 2013 if voters approve the proposed spending limit; otherwise, this provision would expire on June 30, 2011.

Proposed Budget Agreement Includes Up to $15.1 Billion in Spending Cuts

The proposed budget agreement identifies the following major reductions:

- $8.6 billion in cuts to programs covered by the Proposition 98 guarantee – $5.6 billion in 2008-09 and $3.0 billion in 2009-10.
- $710.8 million in additional savings attributable to funding the Proposition 98 guarantee at the minimum level required in 2008-09 and 2009-10.
- Reduces revenue limit payments and establishes a 7.8 percent deficit factor for both school district and county office of education revenue limit funding in 2008-09. The proposed budget agreement reduces revenue limit payments and establishes a 13.1 percent deficit factor for school districts and a 13.4 percent deficit factor for county offices of education in 2009-10. A deficit factor is the difference between revenue limit payments to school districts and county offices of education and the revenue limit funding level specified by state law.
- Uses $618.7 million in Public Transportation Account and Mass Transportation Fund monies to pay for Home-to-School Transportation. In effect, this reduces the General Fund's obligation under the Proposition 98 guarantee by an identical amount.
- Eliminates $100 million in funding for school facility emergency repairs in 2009-10. This amount is owed as a result of the settlement agreement in Williams v. California.
- Reduces funding for categorical programs by approximately 15 percent "across the board." However, no reductions are slated for Special Education, Economic Impact Aid, K-3 Class Size Reduction, school lunch programs, and nine relatively small categorical programs.
- Authorizes the transfer of funding among the categorical programs that are cut to a district's or county office of education's general fund through 2012-13.
- Diverts state and county First 5 funds to support state health and human services programs for children for state savings of $608.0 million in 2009-10 and annual savings of $268.0 million thereafter. This fund shift would require voter approval and would remain in effect through 2013-14.
- Diverts funds raised by Proposition 63 of 2004 to support the Early and Periodic Screening, Diagnosis and Treatment (EPSDT) Program for state savings of $226.7 million in 2009-10 and up to $234.0 million in 2010-11. This fund shift would require voter approval and remain in effect through 2010-11.
- Does not pass through – beginning May 1, 2009 – the 2009 federal SSI COLA in the SSI/SSP Program for state savings of $79.8 million in 2008-09 and $487.3 million in 2009-10. This change would reduce the maximum

monthly grant for an individual recipient from the current $907 to $870. The proposed budget agreement also would suspend the June 2010 state COLA in the SSI/SSP Program for one-month savings of $27.0 million in 2009-10 and annual savings of more than $300 million beginning in 2010-11.

- Suspends the July 2009 COLA for CalWORKs grants for savings of $79.1 million in 2009-10 and suspends funding for the Pay for Performance Program for additional savings of $40.0 million in 2009-10. This program was intended to provide additional funding to counties that achieve certain CalWORKs outcomes; however, funds have not been provided since the program was created in 2005-06.
- Cuts Regional Center service provider payments by 3 percent, beginning on February 1, 2009, for savings of $24.6 million in 2008-09 and $60.2 million in 2009-10, and further reduces these payments by 7.1 percent, beginning on September 1, 2009, for additional savings of $100.0 million in 2009-10. The latter cut would take effect only if the state does not enact – by September 1, 2009 – Regional Center cost-containment measures that achieve General Fund savings of $100 million in 2009-10.
- Suspends the July 2009 COLA for county operation of the Medi-Cal Program for savings of $24.7 million in 2009-10.
- Delays a child-support automation project for savings of $36.1 million in 2009-10.
- Reduces support for the University of California (UC), California State University (CSU), and Hastings College of Law by a total of $264.4 million – $132.2 million in 2008-09 and $132.2 million in 2009-10.
- Cuts $427.6 million in 2009-10 relative to the level of support for the UC and CSU outlined in the Higher Education Compact.
- Cuts funding for higher education retirement contributions in 2009-10 by $95.7 million.
- Changes state employee compensation and overtime policies for savings of $385.8 million in 2008-09 and $1.0 billion in 2009-10.
- Reduces funding by $6.5 million in 2008-09 and by $32.0 million in 2009-10 for property tax assistance for seniors and blind or disabled Californians available through the Senior Citizens' Property Tax Deferral Program.
- Continues "one-time" reductions and fund shifts for the judicial branch for savings of $109.3 million in 2009-10.
- Eliminates COLAs for trial courts and the state judiciary for savings of $36.7 million in 2009-10.
- Eliminates the price increase for state agencies per the current projection of 0.4 percent inflation for savings of $136.0 million in 2009-10.
- Reduces by 10 percent support for the federal-court-appointed receiver's inmate medical services budget for savings of $181.2 million in 2009-10.
- Delay the implementation of the Guardianship and Conservatorship Reform Act of 2006 for savings of $17.4 million.
- Diverts tribal gaming revenues from transportation to the General Fund for savings of $100.8 million in each of 2008-09 and 2009-10.
- Reduces state funding for local transit agencies by $153.2 million in 2008-09 and $306.4 million in 2009-10.
- Authorizes the Director of Finance to redirect approximately $250 million in 2008-09 and $1.8 billion in 2009-10 from the Transportation Debt Service Fund to the General Fund for transportation-related general obligation debt.

Additional Cuts and an Additional Tax Increase Would Be Triggered if California's Share of Federal Economic Recovery Funding Does Not Meet a Certain Threshold

Additional cuts totaling $947.7 million and an additional tax increase of $1.6 billion would be triggered if California does not receive at least $9.1 billion in funds from the federal economic recovery package that can offset state General Fund expenditures. If federal funding does not meet the threshold, the proposed budget agreement would require the state to:

- Impose an additional 2.5 percent personal income tax surtax. This surtax would be in addition to the one included in the proposed package. The additional tax would raise $1.6 billion in 2009-10.
- Reduce SSI/SSP grants by 2.3 percent for a cut of $267.8 million. Individual recipients would lose an additional $20 per month and couples would lose an additional $35 per month.
- Eliminate certain Medi-Cal optional benefits and reduce reimbursement rates for public hospitals by 10 percent for savings of $183.6 million.
- Reduce CalWORKs grants by 4 percent for a cut of $146.9 million.
- Cap the state's contribution toward the wages of In-Home Supportive Services (IHSS) workers at $9.50 per hour plus $0.60 for benefits and require some IHSS recipients to pay a larger share of the cost of the services they receive for combined savings of $78.0 million.
- Reduce funding for the UC and CSU by an additional $100 million.
- Impose an unallocated reduction of $100 million on the courts.
- Reject a proposal to add 100 judges, for savings of $71.4 million.

Controller Is Delaying State Payments to Counties – Proposed Budget Agreement Would Delay More

Due to the state's cash-flow crisis, the State Controller's Office (SCO) has begun to delay payments to counties for the operation of health and human services programs. The SCO is delaying a number of state payments due in February, including $114 million for CalWORKs grants and services, $144 million for county administrative funding for Medi-Cal and various human services programs, and $188 million for the state portion of SSI/SSP grants. State officials believe the US Social Security Administration will pay full SSI/SSP grants in March and, if necessary, in April, according to the County Welfare Directors Association of California. In addition to these current-year delays, the proposed budget agreement would defer the state's 2009-10 payments that are due in July and August 2009 until September 2009. These payment delays would affect county-operated mental health and human services programs, with the exception of the SSI/SSP and IHSS programs.