



2008-09:

Overview of the Governor's Budget

ELIZABETH G. HILL • LEGISLATIVE ANALYST

The Governor's budget proposes more than \$17 billion in budget solutions to bring the state's 2008-09 budget into balance. In this document, we provide our initial assessment of the administration's proposals and advise the Legislature on how to approach the special session to address the state's fiscal emergency. ■

Acknowledgments

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SUMMARY

Budget Gap Addressed Through Borrowing and Spending Reductions

To close an estimated \$14.5 billion budget shortfall, the administration proposes more than \$17 billion in corrective actions, including:

- Issuing more deficit-financing bonds (\$3.3 billion).
- Suspending a supplementary payment in 2008-09, which would have helped pay off outstanding deficit-financing bonds (\$1.5 billion).
- Accruing tax revenues received in 2009-10 to 2008-09 (\$2 billion).
- Reducing K-14 education spending in the current year (\$400 million) and suspending the Proposition 98 minimum guarantee in 2008-09 (\$4 billion).
- Reducing spending in most other state programs (\$4 billion).

LAO Comments

Generally Reasonable Numbers From the Governor. The administration's revenue forecast is generally reasonable, though it has some downside risk from recent cash trends and continued negative economic reports. The budget's spending proposals also generally are built upon solid assumptions about caseload and program requirements.

All State Programs Are Not Equally Important. While the administration's approach of across-the-board reductions has the appeal of fairness, it reflects little effort to prioritize and determine which state programs provide essential

services or are most critical for California's future. The risk with the administration's approach is that—by attempting to preserve most funding for most programs—many programs end up operating in a less than optimal manner and provide lower quality services to the public.

Revenue Solutions Should Be Expanded. In the context of the amount of corrective actions that are proposed, the administration's ongoing revenue-raising proposals are minimal. The Legislature should identify additional revenue solutions, including tax expenditures (such as tax credits or deductions) that can be modified or eliminated, and/or costs that can appropriately be supported by user and regulatory fees.

Balancing Cash Demands With Programmatic Impacts. The administration's efforts to improve the state's cash balance make sense in light of the state's sluggish economy and continued uncertainty about revenue receipts on a month-to-month basis. Yet, the Legislature will have to balance a number of the proposals against the programmatic impacts from delaying payments to school districts and local governments.

Budget Reform Proposals Are Flawed. The proposed budget reforms represent a serious diminution of the Legislature's appropriation authority. In addition, the proposals would limit future policy makers' options to craft budgets.

Missed Opportunity on Proposition 98. In the current year, the administration loses a critical opportunity to achieve additional budgetary flexibility by not reducing education spending to the Proposition 98 minimum guarantee. We identify a way to do this without affecting current school operations.

LAO Bottom Line

The Governor has put forward an aggressive agenda for the special session and the 2008-09 budget. The Legislature should focus first on those areas where time is of the essence—where early decisions will allow state programs to achieve desired savings in the current year. The special session should also be used to lay the groundwork for achieving budget-year savings—for instance, by developing any program restructurings and taking any necessary actions on the

current-year Proposition 98 minimum guarantee. In contrast to the Governor’s approach of across-the-board reductions, in our view the Legislature should (1) eliminate or further reduce low-priority programs in order to minimize the impact on higher priority programs and (2) examine additional revenue options as part of a more balanced approach. Making tough choices now will allow the state to move closer to bringing its long-term spending and revenues into alignment.

BUDGET OVERVIEW

A declining economic outlook, sagging revenues, and rising costs have created bleak prospects for the state’s current- and budget years. The Governor identified a gap of \$14.5 billion between revenues and expenditures and proposes more than \$17 billion in current and budget-year solutions to bring the state’s budget back into balance. These budget-balancing actions include the issuance of additional deficit-financing bonds, higher revenue accruals, and budget reductions across most state programs. A number of these proposals would require legislative action in the current fiscal year, which led the Governor to declare a fiscal emergency under the State Constitution and call the Legislature into special session. The Governor also has a number of proposals to improve the state’s cash position.

Total Revenues and Spending

The Governor’s budget proposes General Fund state spending in 2008-09 of \$101 billion. After accounting for the administration’s proposals to change the 2007-08 budget, General Fund expenditures are projected to decline from \$103.4 billion in 2007-08 (a drop of 2.3 percent).

On the other hand, General Fund revenues are projected to grow from \$100.8 billion to \$102.9 billion (an increase of 2.1 percent).

General Fund Condition

Figure 1 shows the General Fund’s condition from 2006-07 through 2008-09 under the Governor’s budget’s assumptions and proposals. The current fiscal year is estimated to have begun the year with a reserve of \$3.5 billion. With proposed expenditures of \$2.6 billion more than revenues, the Governor’s budget projects ending 2007-08 with a reserve of less than \$1 billion. For the budget year, various budget-balancing proposals would allow the state to grow the reserve to \$2.8 billion.

How the Budget Covers the Shortfall

Comparison of the Problem Definition to Our November Forecast. In November, we estimated that, under current-law revenues and expenditures, the state would need \$9.8 billion in solutions to bring the 2008-09 budget into balance. In contrast, the Governor’s budget has identified a problem of \$14.5 billion. On the rev-

venue side of the budget, the administration’s revenue forecast is significantly below our estimates from two months ago. This reflects the continuing deterioration of the state’s cash collections and economic outlook. Specifically, as shown in Figure 2 (see next page), the administration’s revenue forecast through the current year is more than \$1 billion below our November forecast, and the 2008-09 amount is \$2.8 billion below our forecast. (These numbers also reflect that the administration expects \$500 million from the sale of EdFund in 2007-08 while we expected the sale to occur in 2008-09.)

Regarding expenditures, the administration’s estimate of overall baseline spending is slightly higher—\$742 million combined over all years—than our forecast. Some of the key differences are the administration (1) showing lower property taxes over multiple years (driving higher General Fund Proposition 98 spending) and (2) including its higher education compacts as part of its base-

line costs. Both forecasts accounted for rising costs from a lost teachers’ retirement lawsuit, the Southern California wildfires, and the administration’s proposal to provide correctional officers with a 5 percent raise (as part of imposing its last contract offer on the union). We will be updating our revenue and expenditure forecasts in February as part of our *The 2008-09 Budget: Perspectives and Issues (P&I)* publication.

Budget Solutions. To address this \$14.5 billion problem, the Governor’s budget includes more than \$17 billion in solutions. Figure 2 summarizes the major components of the Governor’s solutions (using the administration’s estimates of the solutions). Described in more detail later in this report, the major components are:

- **More Deficit-Financing Bonds and Slower Repayment.** Using its existing authority, the administration plans to issue \$3.3 billion in additional deficit-financing bonds in the current year. The adminis-

Figure 1
Governor’s Budget General Fund Condition

(Dollars in Millions)

	Actual 2006-07	Proposed 2007-08	Proposed for 2008-09	
			Amount	Percent Change
Prior-year fund balance	\$9,898	\$4,372	\$1,757	
Revenues and transfers ^a	95,887	100,758	102,904	2.1%
Total resources available	\$105,785	\$105,130	\$104,661	
Expenditures	\$101,413	\$103,373	\$100,998	-2.3%
Ending fund balance	\$4,372	\$1,757	\$3,663	
Encumbrances	\$885	\$885	\$885	
Reserve	\$3,487	\$872	\$2,778	
Budget Stabilization Account (BSA)	472	—	—	
Reserve for Economic Uncertainties	3,015	872	2,778	

^a Display of revenues related to the BSA is different than the administration. The 2006-07 amount includes \$472 million and 2007-08 amount includes \$1.023 billion in General Fund revenues received in those years and transferred to the BSA. The administration instead shows the entire \$1.494 billion as 2007-08 revenues, when the funds were transferred back to the General Fund.

tration also plans to suspend the 2008-09 transfer to the Budget Stabilization Account (BSA), which suspends a \$1.5 billion supplemental debt-service payment on deficit-financing bonds.

- **Revenue Accrual.** The budget adds \$2 billion in 2008-09 personal income

and corporation tax revenues by accruing dollars that are currently reflected as 2009-10 revenues.

- **Spending Reductions.** The budget proposes spending reductions across most areas of state government, including a \$4 billion suspension of Proposition 98 in the budget year.

COMPONENTS OF THE GOVERNOR'S BUDGET PLAN

ECONOMIC AND REVENUE PROJECTIONS

expected to experience slower growth in 2008 than in 2007—especially in the earlier parts of

Economic Forecast—Sluggish Growth Through 2008

The economy throughout 2007 exhibited somewhat mixed performance, but appears to have ended the year on a very soft note. Recent job gains for both the nation and state, for example, appear to have been quite weak, while turmoil in housing markets and high energy prices continued to drag down overall growth. The budget's economic forecast for the remainder of 2007-08 and 2008-09 is for subdued economic performance. Both the national and California economies are

Figure 2

How the Governor's Budget Closes the 2008-09 Shortfall

(In Millions)

	Reserve as of June 30, 2008
LAO November Forecast	-\$9,790
Lower Administration Revenue Forecast	
2006-07 and 2007-08	-\$1,166
2008-09	-2,781
Higher Administration Spending Forecast	-\$742
Administration's Definition of Shortfall	-\$14,479
Budget Solutions	
Reduce Proposition 98 spending	
2007-08 reduction	\$400
Suspend 2008-09 minimum guarantee	4,825 ^a
Issue additional deficit-financing bonds	3,313
Accrue 2009-10 revenues to 2008-09	2,001
Suspend transfer to Budget Stabilization Account	1,509
Reduce Medi-Cal spending	1,126
UC/CSU reductions (unallocated)	569
CalWORKs reforms	463
Early release of prisoners and summary parole	372
Suspend SSI/SSP COLAs	323
Other solutions	2,356
Governor's Budget Estimate of 2008-09 Reserve	\$2,778

Note: Positive numbers help the reserve and negative numbers hurt the reserve.

^a The administration proposes a \$4 billion suspension. Due to the way it built its baseline budget, it shows savings of a somewhat higher amount.

2008—followed by somewhat better but still modest growth in 2009. Continuing problems in the housing sector and high energy prices will be the main forces holding down growth.

Key Forecast Data. The administration’s revised economic forecasts for both the nation and state are softer than the May Revision economic forecast upon which the *2007-08 Budget Act* relied.

- **For the nation**, the Governor’s budget forecasts that real gross domestic product growth will slow from 2.1 percent in 2007, to 1.9 percent in 2008, before strengthening to 2.9 percent in 2009. Regarding national employment, it predicts job growth will drop from a weak 1.3 percent in 2007, to only 0.8 percent in 2008, and then increase to 1.2 percent in 2009.

- **For California**, personal income growth—the broadest single measure available of the state’s overall economic activity—is predicted to slow from 5.6 percent in 2007, to 4.8 percent in 2008, and then firm up a bit to 5.2 percent in 2009. Job growth is expected to drop from only 0.8 percent for 2007, to 0.7 percent for 2008, and then drift up to 1 percent for 2009. New housing permits in the state are expected to be very soft—only 95,000 in 2008, compared to an average of more than 160,000 annually for the past ten years. Figure 3 shows the predicted quarterly pattern of California job growth.

**The Revenue Forecast—
Down Substantially**

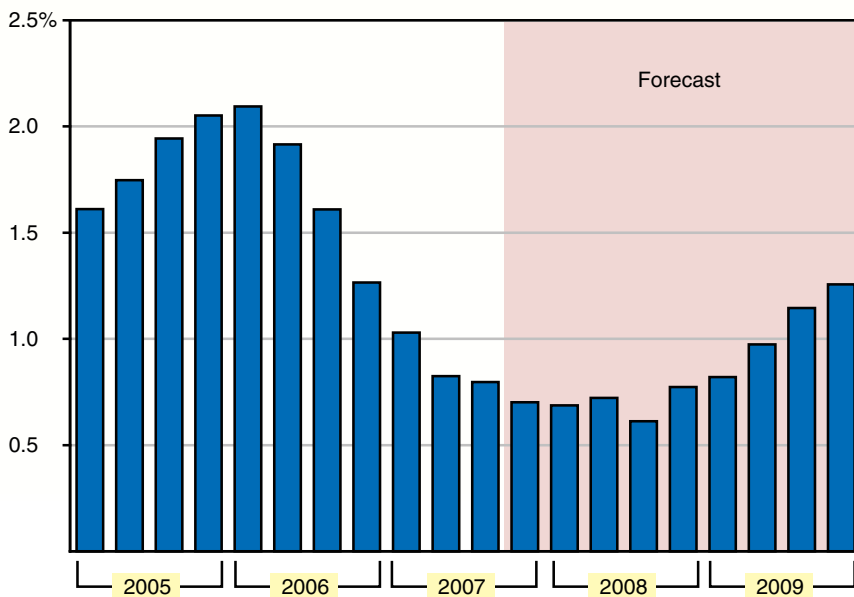
The budget estimates revenues of \$95.9 bil-

lion in 2006-07 (2.6 percent growth), \$100.8 billion in 2007-08 (5.1 percent growth), and \$102.9 billion in 2008-09 (2.1 percent growth). For the three years combined, these revenues are down by \$3.8 billion from the *2007-08 Budget Act* estimate. The current- and budget-year amounts reflect the combination of recent cash trends, the revised economic outlook, and \$5.5 billion in revenue-related proposals.

Figure 3

**Budget Predicts Sluggish
California Job Growth Through 2008**

Year-to-Year Change in Nonfarm Employment, by Quarter



Cash Has Been Weak. Reflecting weaker economic performance than was previously forecast, tax-related cash receipts during the first six months of 2007-08 fell far short of what was assumed in the *2007-08 Budget Act*. For example, through December, combined receipts from the largest three taxes were down \$1.7 billion from the budget act, which itself had assumed only modest growth. Although income tax withholding has been running somewhat ahead of expectations, other income tax payments, corporate tax payments, and sales and use tax revenues have all come up short.

Underlying Multiyear Revenues Down \$9.3 Billion. Incorporating this cash shortfall along with its revised, more subdued economic forecast, the administration's new revenue projections for the prior, current, and budget years combined are down—*absent policy changes*—by \$9.3 billion. This includes \$6.4 billion for personal income taxes, reflecting such factors as slower projected personal income growth and lower capital gains and stock-option income. It also includes \$2.9 billion for sales and use taxes, which in part reflects the depressed housing sector.

\$5.5 Billion in Revenue-Related Proposals. To partially make up for these economics-driven revenue declines, the administration is proposing \$5.5 billion in revenue-related proposals. These would leave its estimated revenues for the prior, current, and budget years combined down \$3.8 billion from the enacted budget. The administration's proposals include:

- Accruing \$2 billion in 2008-09 from the portion of personal income tax (\$1.2 billion) and corporation tax (\$0.8 billion) estimated payments associated with June activity and paid in September 2009.

These revenues currently are counted as 2009-10 revenues.

- Increased revenues of about \$150 million in 2008-09 and growing amounts thereafter from augmenting the Franchise Tax Board's (FTB's) and the Board of Equalization's (BOE's) tax enforcement and compliance activities.
- Reinstatement of the 12-month rule for applying the use tax to out-of-state purchases of vehicles, vessels, and aircraft, to generate \$5 million in 2007-08 and \$21 million in 2008-09.

The administration also proposes to issue \$3.3 billion in additional deficit-financing bonds, which is discussed below.

DEFICIT-FINANCING BONDS

The administration proposes two solutions regarding the state's deficit-financing bonds. Combined, these proposals would provide the state with \$4.8 billion in budgetary solutions on a one-time basis—with higher costs of a like amount (plus interest) in the future. Both of these actions are within the administration's control and would not require legislative action. The administration estimates that these two actions will delay paying off the bonds by more than two years, until the summer of 2012.

Issuing \$3.3 Billion. Propositions 57 and 58, passed by the voters in 2004, authorized the state to sell up to \$15 billion in deficit-financing bonds. In essence, the voters allowed the state to borrow money to pay off a portion of the state's budget debts (as of the end of 2003-04). After the passage of the measures, the state raised \$11.3 billion from these bonds. The administra-

tion now proposes to raise an additional \$3.3 billion in 2007-08 from issuing more bonds.

Suspending BSA Transfer. The basic mechanism for the repayment of the bonds is the “triple flip” which diverts one-quarter of a cent of local sales tax revenues to debt payments. (The local revenues are replaced on a dollar-for-dollar basis through the property tax, which in turn increases General Fund spending on education.) The triple flip is expected to make a \$1.5 billion payment towards bond debt in 2008-09. In addition, Proposition 58 provided that a supplementary payment for debt service would be made annually equal to one-half of the funds deposited into the BSA (the other half is used as a budget reserve). The BSA is scheduled to receive \$3 billion in 2008-09. Under the Constitution, however, the Governor is authorized to suspend the annual transfer. The administration plans to suspend the 2008-09 transfer—reducing 2008-09 expenditures by \$1.5 billion by not making the supplementary bond payment.

**SPECIAL SESSION—
CURRENT-YEAR SAVINGS**

Under Proposition 58, if the budget’s revenues and/or spending substantially change in a negative way, the Governor may declare a fiscal emergency and call the Legislature into special session to address the emergency. On January 10, the Governor called a special session for the current budget problem. Under Proposition 58, if the Legislature does not send the Governor at least one bill to address the fiscal emergency by the 45th day after the declaration, it cannot act on other legislation. The Governor has made a number of substantial proposals for the Legislature’s consideration. We describe the key proposals with current-year savings below and summarize them in Figure 4. The administration is also seeking early legislative action on a number of budget-year proposals which we describe later in this report.

Proposition 98

For the current year, the Governor proposes to reduce total Proposition 98 funding for K-12 schools and California Community Colleges (CCC) by roughly \$400 million. As shown in Figure 5 (see next page), Proposition 98 funding would decline from the 2007-08 Budget Act level of \$57.1 billion to \$56.7 billion.

Governor Proposes to Reduce Current-Year Proposition 98 Spend-

**Figure 4
Special Session Proposals With Current-Year Savings**

(In Millions)

	Amount of Savings	
	2007-08	2008-09
Proposition 98 spending reduction	\$400	—
Medi-Cal delayed provider payments	165	—
CalWORKs reforms	74	\$389
Medi-Cal provider rate reduction	33	602
SSI/SSP June 2008 COLA suspension	23	271
Early release of prisoners and summary parole	18	354
Various other proposals	104	800 ^a
Totals	\$817	\$2,416

^a LAO estimate.

ing, but Not Down to Minimum Guarantee. As described above, the administration’s estimate of state tax revenues in the current year is significantly lower than what was assumed when the budget was enacted. As a result, the administration’s estimate of the Proposition 98 minimum guarantee also has dropped. The estimated minimum guarantee is now almost \$1.5 billion lower than the Proposition 98 budget act funding level. The Governor’s budget proposes to reduce current-year Proposition 98 spending by \$400 million—leaving spending more than \$1 billion above the required funding level. The proposed reduction is made to K-12 and CCC apportionments (\$360 million and \$40 million, respectively). The administration, however, has stated that it hopes to identify one-time funds that could partly backfill those reductions, thereby lessening the impact on apportionments.

Decline in Local Property Tax Revenue Raises General Fund Obligation. Figure 5 also shows the proposed change in Proposition 98 funding by source. Even with the Governor’s proposal to reduce current-year spending by \$400 million, General Fund spending for Proposition 98 still increases by almost \$230 million. This is because of a reduction in local property tax revenue—a decline of \$645 million compared to what was assumed when the budget was enacted. The bulk of this decline is due to an

overestimate of property taxes in 2006-07, with the discrepancy carrying forward into the current year. Because school property taxes generally offset the General Fund share of Proposition 98 funding, the downward adjustment results in an automatic increase in General Fund spending.

Social Services

CalWORKs Reform Package. The Governor proposes California Work Opportunity and Responsibility to Kids (CalWORKs) changes which (1) result in net savings of \$74 million in 2007-08 and \$389 million in 2008-09, and (2) increase the state’s work participation rate. Key elements include:

- **Graduated Full-Family Sanction.** Currently, when an adult does not comply with program requirements, the family is sanctioned by eliminating the adult portion of the grant (about 19 percent). The Governor proposes to increase this sanction to 50 percent of the remaining child-only grant after six months in sanction status,

Figure 5
Governor Proposes Midyear Proposition 98 Reduction
(Dollars in Millions)

	2007-08		Change	
	Budget Act	Revised	Amount	Percent
K-12 education	\$50,797	\$50,423	-\$374	-0.7%
California Community Colleges	6,209	6,167	-41	-0.7
Other agencies	119	119	-1	-0.6
Totals	\$57,125	\$56,709	-\$416^a	-0.7%
General Fund	\$41,479	\$41,707	\$229	0.6%
Local property tax revenue	15,646	15,001	-645	-4.1

^a Of this amount, \$400 million reflects the Governor's proposed reduction to K-12 revenue limits (\$360 million) and California Community Colleges apportionments (\$40 million). The remaining \$16 million is due to technical adjustments that would have occurred automatically. Detail may not add due to rounding.

and completely eliminate the family's grant after another six months elapses, unless the adult comes into compliance.

- **Time Limits for Aided Children.** Currently, after five years of aid, a family's grant is reduced by the adult portion and the children receive a "child-only" grant in the safety net program. Effective June 1, 2008, the Governor proposes to eliminate the children's safety net grant unless their parent(s) meet federal work participation requirements. This five-year time limit also applies to most other child-only cases.
- **Work Incentive Nutritional Supplement.** Effective July 2009, the budget proposes to provide \$40 per month in additional food coupons to families who are receiving Food Stamps and meeting federal work participation requirements, but are not currently receiving CalWORKs.

Cost-Of-Living Adjustments (COLAs) for Cash Grants. The Governor proposes to delete the June 2008 state COLA for Supplemental Security Income/State Supplementary Program (SSI/SSP) recipients. This results in savings of \$23 million in 2007-08 and \$271 million in 2008-09. (The administration also proposes deleting the June 2009 SSI/SSP COLA, which would reduce 2008-09 costs by another \$29 million.) The budget reflects the pass-through of the federal COLAs in January 2008 and January 2009. The budget provides the July 2008 CalWORKs COLA (\$131 million).

Medi-Cal

Provider Payment Reductions. The budget proposes current-year General Fund savings of \$33 million, growing to \$602 million in the bud-

get year from reducing provider rates for Medi-Cal. The savings would be achieved through a 10 percent provider payment reduction to most fee-for-service providers (generally physicians). Medi-Cal managed care plans would also be reduced.

Delay Payments to Providers. The state generally makes weekly payments to Medi-Cal fee-for-service providers to reimburse them for the claims they have submitted. The budget plan proposes to permanently delay payments to Medi-Cal providers at the end of the year for a one-time General Fund savings of \$165 million. The providers would receive this payment instead in the budget year.

Corrections and Rehabilitation

Early Release of Prisoners and Summary Parole. The budget plan identifies initial savings of almost \$18 million in 2007-08 that would exceed \$758 million by 2009-10 from (1) the release up to 20 months early from prison of offenders who do not have violent or serious or certain sex crimes on their record and (2) no longer actively supervising such offenders on parole. The administration estimates that, at full implementation of these proposals, about 35,000 fewer prison beds would be needed and 28,000 fewer offenders would be under state parole supervision.

Other Reductions

The Governor's proposals also include a number of other smaller reductions to various programs which would reduce 2007-08 expenditures by more than \$100 million. These reductions would affect various programs primarily in the health and social services areas. Once these reductions are annualized for 2008-09, the reductions would generate an estimated \$800 million.

ADDITIONAL BUDGET-YEAR PROPOSALS

For 2008-09, the Governor's budget assumes full-year savings from the reductions proposed to be adopted in the special session. In addition, the budget proposes further reductions to most areas of the state budget.

Key programmatic features of the proposed 2008-09 budget—including program reductions, spending augmentations, and revenue changes—are summarized in Figure 6.

Budget Reductions

As described in more detail below, the administration's implementation of budget reductions can be categorized into four main types. The net result of the proposed \$9 billion in reductions is summarized by program area in Figure 7 (see page 14).

Exempt Programs. The administration chose to exempt a number of expenditure programs from its reductions. These programs include debt service, retiree health costs, the Proposition 42 transfer for transportation, most retirement contributions, tax collection agencies, state mental health hospitals, emergency fire suppression, and capital outlay spending. In total, these exemptions account for well over \$10 billion in annual state spending.

Specific Policy Proposals (About \$3 Billion). In order to generate savings in a number of areas, the administration proposes significant policy and/or funding changes to the way in which programs operate. These proposals have a policy rationale and specific mechanisms to achieve the savings. Some examples include the suspension of COLAs, the CalWORKs reform proposals, and the early release of prisoners.

Across-the-Board-Reductions (About \$5 Billion). In a number of other departments, the pro-

posed reductions tend to be evenly distributed across all of a department's programs. The largest example of this type of across-the-board reduction is Proposition 98, where revenue limits and categorical programs are generally cut by about 10 percent. In some cases, the administration identifies how these reductions will be achieved. In other cases, the approaches to generate the savings are less clear.

Unallocated Reductions (About \$1 Billion).

For constitutional officers (such as the Attorney General and State Controller), branches of government (the Legislature and the courts), and the university systems (University of California [UC] and California State University [CSU]), the administration chose not to allocate the reductions (typically 10 percent). Instead, these entities would be left to determine the nature of the reductions on their own. As such, the programmatic effect of the reductions is not estimated by the administration.

Proposition 98

Figure 8 (see page 15) displays the Governor's budget-year proposal for Proposition 98. For 2008-09, the Governor's budget provides \$55.6 billion in total K-14 Proposition 98 funding. This reflects a drop of almost \$1.1 billion compared to the Governor's revised current-year proposal. This equates to a reduction of roughly 2 percent. The entire year-to-year reduction is reflected by K-12 education. In contrast, community colleges would receive a slight increase (\$55 million, or 0.9 percent). The community college augmentation is due largely to higher apportionment funding relating to the Governor's proposals to restore the current-year apportionment cut and accommodate additional enrollment growth (which more than offset the proposed reductions to categorical programs).

