

January 8, 2009

## 2009–10 Budget Analysis Series

# Overview of the Governor's Budget

## Summary

### Budget Gap Projected to Grow to \$40 Billion

In November, the administration projected a \$24 billion drop in revenues from the estimates in place a few months earlier when the *2008–09 Budget Act* was adopted. Now, due to the worsening economy, the administration projects an additional \$7 billion decline in revenues. Combined with the state's chronic operating shortfall and rising expenses, the administration projects that the state would end 2009–10 with a deficit of \$40 billion absent corrective action.

### Additional Solutions Proposed

In response to the budget shortfall, the administration in November proposed a package of budgetary solutions, including a large increase in the sales tax rate and deep reductions in education, health, and social services programs. The January budget proposes additional solutions, including:

- Lowering the value of the dependent credit for income tax returns (\$1.4 billion).
- Issuing revenue anticipation warrants to push part of the deficit to 2010–11 (\$4.7 billion).
- Capturing further savings in K–14 education—through spending reductions, accounting changes, and cost deferrals (\$4.5 billion).
- Seeking voter approval to redirect funds dedicated by prior initiatives (\$0.5 billion).

### LAO Comments

**Outlook Turns Darker.** Two additional months have passed since the administration's original special session proposals. The overall budget problem has grown by another \$12 billion. The state's cash situation is now even more dire. The Legislature and Governor must act *now* to put the state's finances back on track.

**Generally Realistic Numbers, But Downside Risk.** The administration's budget generally is built upon reasonable numbers. There are, however, downside risks from further deterioration of the economy and state revenues, and from costs that the state is likely to incur but are not included in the Governor's budget.

***Reliance on Borrowing Comes With Major Uncertainty.*** The Governor’s budget heavily relies on access to the credit markets in order for the state budget to balance. In order for the plan to work, the state would need to obtain voter approval for a lottery measure, overcome legal questions, and issue billions of dollars of debt in a credit market in turmoil. Investors would need to be assured of the budget plan’s viability in order for these borrowing plans to work.

***Opportunity to Use Early Ballot to Craft Budget Outline.*** The administration’s plan would seek voter approval for several measures at a June 2009 special election to achieve budget solutions. The Legislature should consider accelerating the election to earlier in the spring to provide more time to develop alternatives in case some measures are defeated. In addition, we recommend that the Legislature adopt even more ballot proposals to generate additional savings, provide greater budgetary flexibility, and reduce legal risks.

***Governor’s Proposition 98 Approach Is a Mixed Bag.*** The Legislature can improve on the Governor’s approach to building the Proposition 98 budget by implementing categorical program and mandate reforms—rather than adopting across-the-board reductions, disregarding existing state priorities, and eliminating state mandate requirements on a wholesale basis. In addition, deferring costs into future years should only be used as a last resort.

### **LAO Bottom Line**

The Governor’s budget framework makes a good faith effort to close a colossal budget gap. The Legislature, however, can improve the plan by making further use of the ballot, adopting more strategic programmatic reductions and revenue increases, and reducing the reliance on borrowing. There are no easy paths to solving the crisis. But it is urgent that the Legislature and Governor act immediately to address a budgetary and cash situation that has the state on the edge of fiscal disaster.

## **Budget Overview—Outlook Turns Darker**

The national recession continues to drag the state’s revenue projections downward. Without corrective action, the administration now projects that the state would face a deficit of \$39.6 billion at the end of 2009–10. Consequently, on December 31, 2008, the administration released the outline of its *2009–10 Governor’s Budget*, which proposes \$41.7 billion in budgetary solutions to close the gap and establish a \$2.2 billion reserve. More than half of these solutions were originally proposed by the Governor in November when he first called a special session of the Legislature to address the crumbling 2008–09 budget situation.

In November, we advised the Legislature that the state had to attack the budget problem quickly and aggressively, making permanent improvements through major programmatic reductions and revenue increases. Two more months have passed, and the budget outlook has turned even darker. The time available to achieve current-year savings has shrunk,

and cash problems have worsened to the point that the state may not be able to pay all its bills beginning next month. It is even more urgent that the Legislature and Governor begin acting now.

### **Shortfall Projected to Grow to \$40 Billion**

**Comparison to November Projections.** In November, the administration announced that it expected revenues through 2009–10 to fall \$24.2 billion short of the amounts assumed at the time of the passage of the 2008–09 budget in September. Later in November, our office projected that a similar revenue decline, combined with rising expenditures, would leave the state with a \$27.8 billion shortfall. The Governor’s budget projections now represent an even more serious decline in the state’s fiscal outlook. The major factors in this decline are:

- **Continued Deterioration of the State’s Economy and Revenue Outlook.** The administration’s new baseline revenue forecast expects \$7 billion less over 2008–09 and 2009–10 combined than its earlier November estimate.
- **Revenue Interaction with Proposition 98.** The magnitude of the revenue drop, as well as the year-to-year change in revenues, affect the calculation of the 2009–10 Proposition 98 minimum guarantee. The administration’s new revenue forecast has baseline revenues that are roughly equal in 2008–09 and 2009–10. In contrast, our November estimate showed a large drop in revenues from 2008–09 to 2009–10. The difference in these revenue estimates means that the administration’s new calculation of the state’s Proposition 98 General Fund obligation (assuming no corrective action) is about \$3.5 billion higher than our November estimate.

### **How the Budget Closes the Shortfall**

**November Solutions.** In November, the administration proposed a \$25 billion package of special session solutions which included several tax increases and broad-based spending reductions. The administration continues to propose these changes, but it has reduced the value of the solutions to reflect delayed enactment of several months. In addition, the proposal to furlough state employees has been expanded from one day to two days each month (increasing the savings by more than \$600 million over two years). Figure 1 summarizes the current value of these proposals as estimated by the administration.

Figure 1

## How the Governor Proposes to Close \$40 Billion Deficit

(In Millions)	2008-09	2009-10
<b>November Special Session Proposals</b>	<b>\$7,111</b>	<b>\$15,845</b>
<b>Revenue Increases <sup>a</sup></b>		
Increase sales tax by 1.5 cents for three years	\$2,350	\$6,758
Expand sales tax to some services	272	1,111
Impose oil severance tax	348	836
Raise alcohol tax by a nickel a drink	244	585
<b>Expenditure Savings</b>		
Reduce Proposition 98 spending	\$2,500	\$663
Reduce higher education spending (unallocated)	132	132
Implement various health and social services reductions	462	3,312
Implement various criminal justice savings	199	1,101
Furlough state workers and reduce other costs <sup>b</sup>	415	1,006
Eliminate state funding to transit agencies	153	306
Eliminate funding for Williamson Act	35	35
<b>January Proposals</b>	<b>\$7,487</b>	<b>\$11,230</b>
<b>Revenue Increases</b>		
Reduce dependent credit	—	\$1,440
Redirect tribal payments for transportation	\$101	101
Other	34	3
<b>Expenditure Savings</b>		
Further reduce Proposition 98 spending	\$2,378	\$2,171 <sup>c</sup>
Provide no growth in university funding	—	428
Limit Cal Grant program	—	88
Reduce regional center spending	—	334
Redirect Proposition 10 funds	—	275
Redirect Proposition 63 funds	—	227
Suspend 2009-10 health and social services COLAs	—	131
Reduce Receiver's budget by 10 percent	—	181
Reduce judiciary funding	—	163
Lay off state employees	—	150
Reduce costs for state employee and retiree health care	—	132
Defer mandate reimbursements	—	91
Other	37	220
<b>New Budgetary Borrowing</b>		
Issue lottery bonds	—	\$5,001
Issue revenue anticipation warrants	\$4,673	—
Loans from special funds	264	94
<b>Total Solutions</b>	<b>\$14,598</b>	<b>\$27,075</b>
Revenue Increases	\$3,349	\$10,834
Expenditure Savings	6,312	11,146
Borrowing	4,937	5,095

a Net benefit to the General Fund.

b Amount includes savings from new proposal to expand furlough from one day to two days each month.

c Includes \$150 million in settle-up savings that the administration reflects as a prior-year adjustment.

**January Solutions.** In addition, the January budget adds \$19 billion in solutions. These solutions include \$5 billion by accounting for proceeds associated with the securitization of lottery revenues, as envisioned by the *2008–09 Budget Act*. The administration proposes that the lottery measure, as well as several other measures, be put before the state’s voters at a June 2009 special election. Major new January proposals are:

- **Revenue Anticipation Warrants (RAWs).** The administration proposes to borrow \$4.7 billion in RAWs in July 2009 to be repaid in June 2011. The proceeds would be applied to the remaining 2008–09 deficit.
- **Dependent Credit.** The budget would reduce the value of the dependent credit for income tax purposes beginning with the 2009 tax year to increase tax receipts by \$1.4 billion annually. The credit would be tied to the personal exemption credit, reducing the value by about \$210.
- **Proposition 98.** In addition to its earlier special session proposals, the budget reduces K–14 education spending obligations by deferring \$2.8 billion in 2008–09 costs, enacting several accounting changes, and allowing districts to shorten the school year by up to five days in 2009–10.
- **Other Savings.** The January budget proposal makes additional spending reduction proposals in many other areas of the state budget, including two redirections of revenues from propositions (which would require voter approval).

### **Total Revenues and Spending**

The Governor’s budget proposes General Fund revenues of \$97.7 billion in 2009–10. This represents a 7.2 percent increase over the revised revenue proposal for 2008–09—reflecting the full-year implementation of the administration’s tax increase proposals. The Governor’s budget proposes General Fund state spending in 2009–10 of \$95.5 billion. This represents a 3.4 percent increase from the revised spending proposal for 2008–09. Spending in both years would actually be about \$5 billion higher under the administration’s proposal, but the manner in which the administration reflects its RAW and lottery proposals lowers the spending totals. In each case, the budgetary benefit of the proposal is reflected as a “negative expenditure”—reducing total state spending.

### **General Fund Condition**

Figure 2 shows the General Fund’s condition from 2007–08 through 2009–10 under the Governor’s budget assumptions and proposals. With the crediting of the RAW proceeds to 2008–09, the current fiscal year is assumed to end with no reserve but also no deficit. In the budget year, with proposed revenues exceeding spending, the state would end 2009–10 with a reserve of \$2.2 billion.

Figure 2

**Governor's Budget  
General Fund Condition**

(Dollars in Millions)

	Actual 2007-08	Proposed 2008-09	Proposed for 2009-10	
			Amount	Percent Change
Prior-year fund balance	\$3,259	\$2,375	\$1,079	
Revenues and transfers <sup>a</sup>	102,102	91,117	97,708	7.2%
Total resources available	\$105,361	\$93,492	\$98,787	
Expenditures	\$102,986	\$92,413	\$95,524	3.4%
Ending fund balance	\$2,375	\$1,079	\$3,263	
Encumbrances	\$1,079	\$1,079	\$1,079	
<b>Reserve</b>	<b>\$1,296</b>	<b>—</b>	<b>\$2,184</b>	
Budget Stabilization Account (BSA)	—	—	—	
Special Fund for Economic Uncertainties	1,296	—	2,184	

<sup>a</sup> Display of revenues related to the BSA is different than the administration's. The 2006-07 revenue amount (reflected in the prior-year fund balance) includes \$472 million and the 2007-08 revenue 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.

## Economic and Revenue Projections

### Economic Forecast

Compared to its earlier November forecast, the administration modestly lowered its outlook of the national and state economies. For instance, for 2009, assumed state personal income growth was lowered from 2.2 percent to 2.0 percent, and an expected decline in employment was increased from 1.2 percent to 1.6 percent. The administration's revised economic forecast continues to reflect the consensus view that both the nation and the state will be in recession during the first half of 2009—with some firming up during the second half of 2009 and a recovery gaining momentum in 2010.

### Revenue Forecast

Responding to the worsening economic picture, the administration has also revised downward its earlier November revenue outlook. In November, the administration projected that revenues through 2009–10 had nosedived \$24.2 billion from the estimates at the time of the adoption of the *2008–09 Budget Act*. Now, the administration has lowered its revenue projections by another \$7 billion. About \$4 billion of this additional

decline is projected to be in lower personal income tax receipts. Much of this personal income tax decline is attributable to the administration's further reduction in projections for capital gains. The administration now expects two years of capital gains declines—55 percent in 2008 and an additional 10 percent in 2009.

## Expenditure Savings

### Proposition 98 K–14 Education

The Governor's January proposal includes major changes in Proposition 98 funding for 2008–09 and 2009–10. Figure 3 summarizes aggregate changes for K–12 education, the California Community Colleges (CCC), and other Proposition 98–supported agencies (including state special schools and the Division of Juvenile Facilities).

Figure 3

#### Governor's Proposition 98 Budget Summary

(In Millions)

	2008-09			2009-10	
	Budget Act	Proposed	Change	Proposed <sup>a</sup>	Change From 2008-09 Proposed
K-12 education	\$51,620	\$45,294	\$6,327	\$48,279	\$2,985
California Community Colleges	6,359	6,085	-274	6,482	396
Other agencies	106	106	—	107	1
<b>Totals</b>	<b>\$58,086</b>	<b>\$51,485</b>	<b>\$6,600</b>	<b>\$54,868</b>	<b>\$3,382</b>
General Fund	\$41,943	\$35,783	\$6,160	\$39,425	\$3,643
Local property tax revenue	16,143	15,703	-440	\$15,442	-260

<sup>a</sup> Amounts reflected do not include Proposition 98 backfill of lottery funds.

**Governor Proposes Deeper Midyear Reduction.** The continued deterioration of the state's revenues has led to a further decline in the Proposition 98 minimum guarantee. The Governor's January proposal provides Proposition 98 funding equal to the administration's revised estimate of the 2008–09 minimum guarantee—\$51.5 billion. This is \$6.6 billion less than the *2008–09 Budget Act* level (and a \$4.1 billion greater reduction than the \$2.5 billion midyear reduction the administration proposed in

November). As shown in Figure 3, the bulk of the proposed midyear reduction would be borne by K–12 education (\$6.3 billion)—reflecting a 12 percent drop from its *2008–09 Budget Act* level. While the administration proposes a large base reduction to K–12 revenue limits (\$1.6 billion), it makes no comparable reduction to CCC apportionments.

***Governor’s January Plan Includes Major New Current–Year Components.*** As shown in Figure 4, the administration proposes several new approaches to achieve the 2008–09 reduction. Specifically, the administration now proposes to retire the state’s existing prior–year Proposition 98 settle–up obligations (\$1.1 billion) and use special funds to directly support the Home–to–School Transportation program (\$619 million). In both cases, K–12 schools would continue to receive program funding, but an accounting change would exclude the funds from the Proposition 98 calculations. In addition, the administration’s plan includes a large deferral component. The Governor proposes to defer \$2 billion in K–12 revenue limit payments and \$570 million in K–3 Class Size Reduction payments from February to July. The Governor’s plan also would defer \$230 million in CCC apportionment payments from January and February to July. (These proposals would amend earlier 2008–09 budget decisions that postponed related payments only to April.) As with previous K–14 deferrals, local costs still would be incurred by districts in the current fiscal year, but state payments would not be made until the next fiscal year.

Figure 4

**Governor's Major Proposition 98 Budget Proposals**

(In Millions)

2008-09	
<b>Programmatic Cuts</b>	
Reduce base K-12 revenue limits	-\$1,639
Rescind K-14 COLA	-287 <sup>a</sup>
Unappropriate current-year funds expected to go unused	-153 <sup>b</sup>
Subtotal	<u><u>(-\$2,078)</u></u>
<b>Other Adjustments in Proposition 98 Spending</b>	
Defer certain K-14 payments	-\$2,800
Retire settle-up obligation	-1,101
Use special funds for Home-to-School Transportation	-619 <sup>c</sup>
Other	-3
Subtotal	<u><u>(-\$4,522)</u></u>
Total	<b><u><u>-\$6,600</u></u></b>
2009-10	
<b>Backfill Prior-Year One-Time Solutions</b>	\$4,126
<b>Reductions</b>	
Shorten school year (5 days)	-\$1,092
Eliminate High Priority Schools Program	-114
Adjust for decline in K-12 average daily attendance	-111

(0.3 percent)	
Make various child care reductions	-53
Suspend all CCC and most K-12 mandates	-4
Subtotal	<u>(-\$1,373)</u>
<b>Augmentations</b>	
Partially restore revenue limit cut	\$188
Fund CCC enrollment growth (3 percent)	185
Make various baseline adjustments	159
Pay behavioral intervention plans settlement	65
Fund child care growth (1.2 percent)	19
Pay two K-12 mandates	13
Subtotal	<u>(\$630)</u>
Total	<u><b>\$3,382</b></u>

- a Rescinds 0.68 percent cost-of-living adjustment (COLA) for K-12 revenue limits and California Community Colleges (CCC) apportionments included in the *2008-09 Budget Act*.
- b Of this amount, \$56 million is due to savings in K-12 programs and \$97 million is due to savings in child care programs.
- c Of this amount, \$420.3 million is from the Mass Transit Fund and \$198.4 million is from the Public Transportation Account.

***Governor’s 2009–10 Plan Achieves Additional Savings From Shorter School Year and Suspending Education Mandates.*** As shown in the bottom part of Figure 4, the growth in Proposition 98 funds for 2009–10 would be dedicated to backfilling funding for the one-time 2008–09 solutions. The Governor’s budget-year proposal also contains a set of new reductions and augmentations—resulting in a modest net reduction in year-to-year programmatic spending. The largest new savings proposal is to allow districts to shorten the K–12 school year by up to five days. (To achieve savings, the administration assumes districts would renegotiate teacher contracts to reflect the reduced number of work days, thereby reducing revenue limit costs.) The largest proposed augmentations are to partially restore the current-year cut to revenue limits and to fund 3 percent enrollment growth at the community colleges. The Governor’s plan also includes a proposal to suspend every CCC mandate and all but two K–12 mandates (in contrast to the state’s existing practice of deferring mandate reimbursements while still requiring districts to undertake mandated activities).

### **Other Reductions**

The administration’s other major new spending reduction proposals are described below.

***Ask Voters to Change Initiatives.*** The administration seeks voter approval at a June 2009 special election to allow the state to redirect a combined \$500 million from Proposition 10’s cigarette tax and Proposition 63’s income tax surcharge to benefit the General Fund.

The Governor would eliminate the Proposition 10 state commission and redirect half of local commission funding to offset General Fund child welfare and foster care costs. The Governor would also seek voter approval to allow Proposition 63 funds to be used in lieu of General Fund dollars to cover mental health managed care costs rather than to expand services.

***Elimination of Cost-of-Living Adjustments (COLAs).*** The budget proposes to suspend several health and social service COLAs in 2009–10. Specifically, the July 2009 California Work Opportunity and Responsibility to Kids (\$79 million), June 2010 Supplemental Security Income/State Supplementary Program (\$27 million), and July 2009 Medi-Cal county administration (\$25 million) COLAs would be suspended.

***Regional Center Savings.*** The budget does not fund regional center costs for developmental services that are projected to increase \$334 million in 2009–10. The budget provides no specific proposal as to how these savings would be achieved.

***Employee Compensation Savings.*** In addition to its furlough proposal, the administration assumes reduced spending of \$150 million from the layoff of state workers and \$132 million from the shifting of health benefit negotiations away from the California Public Employees' Retirement System to within the administration.

***Higher Education Savings.*** The administration scores more than \$400 million in savings from holding General Fund spending for the University of California and California State University basically flat and not providing a COLA or enrollment growth funding for the universities. The administration would allow the universities to retain about \$300 million in increased funding from assumed fee increases. In addition, the administration would reduce Cal Grant financial aid spending by terminating new participation in the competitive programs, freezing income eligibility limits, and lowering award levels.

## **LAO's Initial Assessment of the Governor's Proposals**

### **Colossal Budget Problem Demands Action**

In November, we advised the Legislature that the state was facing a huge problem that would require a monumental effort to address. We recommended:

- ***Early Action.*** By taking actions early, solutions can “double up” and generate savings in both 2008–09 and 2009–10.
- ***Spending Reductions and Tax Increases.*** The magnitude of the budget shortfall is too great to close on only one side of the ledger—revenues must be increased and expenditures must be decreased.
- ***Better Approaches to Get Similar Savings.*** While we supported the administration's general framework for closing the budget gap, the specific proposals raise policy and fiscal issues. In many cases, the Legislature has better alternatives to achieve similar levels of savings. In the coming weeks, we will

present the Legislature with further recommendations for amendments to the Governor's budget.

Two additional months have now passed. The overall budget problem has grown by another \$12 billion. The state's cash situation is now even more dire. Despite that virtually all options remaining have negative consequences, the Legislature and Governor must act immediately to put the state's finances back on track.

### **Framework Retains Much of November Plan's Positive Aspects**

In November, our assessment of the Governor's initial special session proposals was that the framework had many positive aspects, including realistic numbers, no borrowing, long-lasting solutions, and a balanced approach. Below, we provide our view of the Governor's new plan relative to these four key areas. The Governor's budget has more weaknesses compared to the prior plan. Yet, the significantly worse budget problem makes it very difficult for any comprehensive plan to maintain these positive aspects in full.

***Generally Realistic Numbers, But Some Downside Risk.*** Given the information available to the administration at the time it prepared its new economic and revenue outlooks, its new forecast is reasonable. Yet, additional economic data in recent weeks point to further worsening of the national and state economies. Similarly, the administration's revenue forecast has downside risk. We will be updating our own economic and revenue forecasts in February with the benefit of additional data from December and January.

Regarding spending projections, several of the savings proposals fail to include a concrete plan identifying how savings would be achieved. For example, proposals to cut regional center spending, health care expenses for state employees and retirees, and the Receiver's budget for correctional health care do not present ways that costs would be reduced. In addition, the budget fails to include funding for costs that the state is very likely to incur. For instance, the budget does not account for any increased interest costs from the issuance of registered warrants or penalties incurred from late payments due to the state's deteriorating cash situation. Likewise, the administration has not budgeted any funding to pay for a 2009 special election. In total, these factors could push state spending higher than the Governor's estimates by hundreds of millions of dollars. On the potential upside, however, the budget does not assume any savings from increased federal funding which could easily exceed these negative factors. (The administration notes its intent to reduce its RAW borrowing by any amount received in federal relief.)

***Borrowing Would Add to the State's Debt.*** In contrast to its earlier proposal, the Governor's budget now includes new budgetary borrowing as a major component of its plan to close the shortfall. The Governor depends on nearly \$5 billion from the issuance of RAWs which would simply push that amount of the state's deficit into 2010–11. The administration would also borrow additional monies from state special funds. In total,

about one-quarter of the Governor's solutions are budgetary borrowing (including the lottery proposal approved as part of the 2008–09 budget package).

**Long-Lasting Solutions.** Many of the Governor's proposals continue to provide budgetary relief for at least three years. While the plan would leave multibillion dollar annual shortfalls in future years, it makes significant progress in closing the state's operating shortfall.

**Balanced Approach Remains.** In adding additional solutions, the Governor continued to put forward a mix of broad-based revenue increases and spending reductions. The box below compares the Governor's mix of revenue increases and spending reductions with that of the recently vetoed legislative plan.

### Governor's Budget Has a Few Key Differences From Legislative Plan

On December 18, 2008, the Legislature passed a budget package addressing a portion of the state's budget shortfall—similar in scope to the Governor's special session proposals. The Governor vetoed the package in early January. Since the Governor's budget now attempts to close a budget problem roughly twice as large, it includes many more solutions. The figure below compares the major components of the two plans. The two plans also differ somewhat in their approach to stimulating the economy through waivers of regulatory laws and authorization of public-private partnerships.

#### Comparison of Governor's Budget and December Legislative Package

(In Billions)

	Governor's Budget			December Legislative Package		
	2008-09	2009-10	2-Year Totals	2008-09	2009-10	2-Year Totals
Revenue increases <sup>a</sup>	\$3.3	\$10.8	\$14.2	\$2.2	\$8.3	\$10.5
Expenditure savings	6.3	11.1	17.5	3.5	3.9	7.4
New budgetary borrowing	4.9	5.1	10.0	—	—	—
<b>Totals</b>	<b>\$14.6</b>	<b>\$27.1</b>	<b>\$41.7</b>	<b>\$5.7</b>	<b>\$12.2</b>	<b>\$18.0</b>

<sup>a</sup> Net benefit to the General Fund.

**Spending Reduction Differences.** Many spending reductions in the legislative package were similar to proposals made by the Governor. However, in other cases—particularly in the health and social services areas—the administration's reductions would go even further in making service reductions. The plans also differ in their approach to generating Proposition 98 savings. While the Governor uses across-the-board reductions to revenue limits, the legislative plan sought to reduce specific categorical programs.

**Tax Package Differences.** The plans differ most in their package of tax increases. The

Governor's budget focuses on increases in the sales tax—1.5 cents in the rate and the addition of services to the tax base. While the legislative package would have increased the sales tax (by 0.75 cents due to a base rate increase of 0.5 cents and an additional 0.25 cent increase due to the “single flip”), it would also have relied on a personal income tax surcharge and a change in income tax withholding for contractors to generate additional revenues. In total, the Governor's plan would generate more than \$14 billion in new revenues over the current and budget years. The legislative package (passed on a majority vote) would have generated more than \$10 billion over the two years.

### **Reliance on Borrowing Comes With Major Uncertainty**

**Cash Crisis Looming.** The continuing decline of state revenues has created a dire situation for the state's ability to manage its cash on hand and pay its bills on time. In addition to increasing revenues and reducing spending, the Governor's budget contains a number of measures intended to improve the state's cash situation—such as issuing revenue anticipation notes (RANs) and RAWs, delaying payments, and allowing increased internal borrowing of state funds. In addition, the State Controller has already indicated he may need to delay payments or issue registered warrants as early as February 1.

**Heavy Reliance on Borrowing.** The Governor's budget solutions increasingly rely on access to the credit markets in order to balance the state budget. The budget effectively relies on issuance of the following debt during 2009–10:

- Lottery securitization bonds to generate \$5 billion in net proceeds.
- Approximately \$5 billion of RAWs.
- \$6.3 billion of RANs (or additional RAWs), to smooth out 2009–10 cash flows.
- Issuance of about \$7 billion in infrastructure bonds.

Yet, achieving these levels of debt issuance will require overcoming a number of risks. First, the voters must approve a ballot measure at the special election to authorize the lottery proposal. Second, there are legal questions regarding the ability of the state to issue RAWs to close a prior-year deficit in the manner proposed by the administration. While issuing RAWs strictly for cash purposes is constitutional, Proposition 58 passed by the voters in 2004 restricted the state's ability to borrow for budgetary purposes. Finally, the national credit market remains in turmoil, and investors' confidence in the state has weakened. There is *major uncertainty* about the state's ability to access the capital markets for anywhere close to this volume of financing over the next 18 months.

### **Opportunity to Use Early Ballot to Craft Budget**

With the passage of the 2008–09 budget, the Legislature and Governor planned to use a 2009 special election for two purposes: (1) to authorize the borrowing of lottery funds to help balance the 2009–10 and 2010–11 budgets and (2) to strengthen existing balanced budget and reserve requirements. As described above, the Governor proposes two additional ballot measures that would redirect a portion of Proposition 10 and Proposition

63 funds for the General Fund's benefit. The Governor seeks legislation to call the election on these measures for June 2009.

**Consider Earlier Election.** Given the magnitude of 2009–10 solutions which depend on voter approval (\$5.5 billion), we are concerned that a June 2009 election will put the Legislature in a very difficult position in enacting the 2009–10 budget if any of the proposals (especially the lottery) are defeated. At the time of a June election, budget deliberations would likely have reached the Conference Committee stage and finding new major solutions at this point would be extremely challenging. Instead, we suggest the Legislature consider accelerating the election to earlier in the spring. That would give the Legislature and the Governor several more months to develop additional solutions if necessary.

**Add More Measures for Savings and Flexibility.** In addition, we recommend that the Legislature adopt even more ballot proposals to generate additional savings, provide greater budgetary flexibility, and reduce legal risks. We would suggest:

- **Amend Additional Ballot Measures.** By amending Proposition 49's set aside for after-school programs, the Legislature could further reduce state education costs. In addition, similar to the Governor's Proposition 10 proposal, Proposition 99 could be amended to simplify its funding structure and redirect cigarette tax revenues to the General Fund to support health programs.
- **Gas Tax Revenue Bonds.** As we discussed in our December 10, 2008 report *Advancing Transportation Projects to Stimulate the Economy: An Alternative Approach*, we recommend that the Legislature seek voter approval for gas tax revenue bond authority in order to accelerate transportation projects and take advantage of current favorable conditions for construction bids.
- **Reduce Risk of Borrowing Proposal.** As noted above, there are legal concerns regarding the constitutionality of issuing RAWs as a budgetary solution. Consequently, if the Legislature is inclined to approve the administration's approach, obtaining explicit voter authorization would eliminate the possibility that the plan is held up in the courts. Alternatively, the Legislature could seek additional economic recovery bond (ERB) authority from the state's voters to replace RAW and/or lottery borrowing. Issuing ERBs over RAWs would have the advantages of (1) allowing for repayment over several years rather than all in 2010–11 and (2) dedicating an existing revenue source (the "triple flip" sales tax) for repayment that is already accepted by investors as a solid security.
- **Tax Package.** The December budget package approved by the Legislature was vetoed by the Governor. Even if he had signed the package, the tax increases would have been challenged in court due to their approval on a majority vote basis. As an alternative to this approach, the Legislature could agree to place a package of tax increases before the state's voters. As with the RAW proposal, this would eliminate legal risk and ensure that increased revenues become available immediately.
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## Governor's Proposition 98 Approach Is a Mixed Bag

Overall, we give the Governor's new Proposition 98 plan a mixed review. While it contains certain positive components, it also retains some ill-advised components. Figure 5 summarizes our alternative Proposition 98 approach, which we discuss in more detail below.

Figure 5

### LAO's Proposition 98 Approach

#### ✓ **Do Swaps (\$1.7 Billion Proposition 98 Savings)**

Retire Proposition 98 settle-up obligations.  
Use special funds to directly support Home-to-School Transportation.

#### ✓ **Make Midyear Program Reductions (Up to Roughly \$4 Billion Savings), Provide Flexibility**

Make targeted reductions to categorical programs based upon their merits.  
Protect revenue limits—districts' most flexible funding source.  
Use categorical reforms for further flexibility.

#### ✓ **Make Deferrals Last Resort**

#### ✓ **Undertake Education Mandate Reform**

***Proposed Swaps Make Sense.*** The Governor's midyear plan contains two components that we have previously recommended: (1) paying off prior-year Proposition 98 settle-up obligations and (2) designating special fund monies directly for Home-to-School Transportation. In both cases, schools experience no midyear programmatic reduction but the state gains future fiscal flexibility.

***Make Cuts From Categorical Programs, Not Revenue Limits.*** We continue to recommend preserving districts' revenue limit funding (which is their most flexible source of funding) and instead making categorical reductions. Given some categorical programs are ineffective, poorly structured, and duplicative—and virtually all of them come with relatively elaborate state program and reporting requirements—we think this is an opportune time to pare back the state's categorical labyrinth. After eliminating certain categorical programs, we recommend the state pursue broad categorical reform by strategically consolidating remaining programs. Such current-year actions would provide districts with more certainty in building their own 2009–10 budgets (a process now underway) and establish ongoing savings.

***Current-Year Cuts Will Tap Reserves.*** Whether a midyear cut is nominally attributed to revenue limits or categorical programs, much of the cut actually would come from districts' reserves. Given that districts are more than halfway through the fiscal year, we estimate only roughly \$1 billion in real savings could be achieved at the local level by stopping some current-year activities, such as professional development or maintenance projects. Beyond that, other types of reductions in state funding would cut into districts' reserves. We estimate that cuts of more than \$4 billion from a combination of real savings and reductions to reserves would likely leave many districts in financial hardship (although districts' fiscal conditions vary widely).

***Rely on Deferrals Only as Last Resort.*** Deferrals strain districts' finances by requiring them to pay for expenses upfront, with state funds arriving after costs have been incurred. The length of time of the proposed \$2.8 billion deferral is considerably longer than previous K-14 deferrals, with state payments delayed five or six months (rather than only a few days, as with the existing set of K-14 budgetary deferrals). Given the size and length of the proposed deferral, coupled with midyear reductions likely to cut deeply into districts' reserves and reduce their internal borrowing options, we strongly recommend such a deferral be employed only as a last resort. We recognize, however, a deferral may be the only remaining option to lower current-year funding down to the revised estimate of Proposition 98 minimum guarantee, thereby providing the state additional budget-year flexibility. (If a new deferral is instituted, we recommend the state allow districts to apply for an exemption if delayed state payments would make them fiscally insolvent.)

***For Budget Year, Undertake Education Mandate Reform.*** Although the Governor's plan to suspend every CCC mandate and all but two K-12 mandates tries to address longstanding problems with the state's mandate reimbursement process, we think the approach is too blunt. Instead, we recommend the state reexamine individual mandates and, on a case-by-case basis, consider whether (1) the mandate serves a compelling purpose or (2) a statutory modification could significantly reduce the cost or improve the incentives of the mandate. As a result of such an analysis, we think the Legislature likely would want to eliminate certain mandates, enact changes to reduce the cost of some mandates, and find more effective policy solutions for promoting other currently mandated, high priority activities.

## **Closing the Gap**

The administration has accurately projected that the state faces a colossal budget shortfall. With each passing month without action, the fiscal outlook becomes more dire. We have concerns with some specific components of the administration's solutions, such as its risky borrowing plan. In addition, the plan's approaches to achieving programmatic savings often can be improved. Yet, the Governor's budget makes a good faith effort to close the gap. There are no easy paths to solving the crisis, and virtually all choices will have some negative consequences. But the Legislature must act immediately to address a budgetary and cash situation that has the state on the edge of fiscal disaster.

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The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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