

January 12, 2009

The 2010-11 Budget: Overview of the Governor's Budget

Executive Summary

The Governor's Budget Proposal

\$19 Billion Budget Problem Identified. With billions of dollars of temporary budget solutions from last year set to expire and the economy recovering slowly, California once again faces a mammoth budget problem. In the *2010-11 Governor's Budget*, the administration puts the size of the problem to be addressed in the coming months at \$18.9 billion. This consists of a General Fund deficit of \$6.6 billion at the end of 2009-10—assuming no corrective budget actions by the Legislature and the Governor—and an additional \$12.3 billion operating deficit in 2010-11. The Governor declared a fiscal emergency on January 8, 2010, calling the Legislature into special session to begin taking action on the \$19.9 billion in solutions he proposes to address the budget problem and create a \$1 billion reserve. Around 40 percent of the Governor's budget solutions relies on funding or flexibility to be provided by actions of the federal government. Another 40 percent consists of reductions to state spending. The remainder of the Governor's proposals consist of various fund shifts. These include a transportation tax proposal and a proposal that the Legislature put measures before voters in June 2010 to allow use of a combined \$1 billion of Proposition 10 early childhood development funds and Proposition 63 mental health funds to help balance the budget. (Voters rejected similar measures in May 2009.)

Governor's Proposals Rely Heavily on Washington. Federal funds and federal approval of flexibility to make reductions in various programs are at the core of the Governor's budget proposals. In case the federal government fails to provide the relief requested in his base budget proposal, the Governor proposes that the Legislature approve the "triggering" of alternative program reductions and revenue increases, including elimination of significant health and social services programs.

LAO Comments

Reasonable Estimate of the Problem...but Some Downside Risk. In November 2009, our office put the size of the 2009-10 and 2010-11 budget problem at \$20.7 billion. The administration's \$18.9 billion estimate of the size of the problem is reasonable, but the Governor's baseline estimates of both revenues and expenditures are somewhat more optimistic than ours. A variety of lawsuits also threaten to expand the state's budget problems. Accordingly, to balance the 2010-11 budget, the Legislature and the Governor eventually may have to address a budget problem a few billion dollars larger than the administration identifies.

Governor Correct to Seek Additional Federal Relief... As we suggested in November, the Governor's plan aggressively seeks additional federal funding related to health, social services, education, and prison programs and flexibility to reduce spending in several areas, including the In-Home Supportive Services (IHSS) program and Proposition 98 school funding. Combined, these federal relief requests total about \$8 billion—around 40 percent of the Governor's proposed budget solutions.

... But Not Realistic to Expect All the Federal Relief Assumed. While the odds seem favorable for some federal relief sought by the administration, we believe that the likelihood of Washington agreeing to all of the Governor's requests is almost non-existent. In crafting the 2010-11 budget package over the next few months, the Legislature needs to operate on the assumption that federal government relief will total billions of dollars less than the Governor wants.

No Way to Avoid Reprioritizing State Finances. The Legislature must make very difficult choices affecting *both* state revenues and spending. The Governor's trigger cuts—to take effect if federal funding is less than the Governor hopes for—are painful and in some cases draconian. Nevertheless, there is no way that the Legislature can avoid making some similarly difficult decisions this year. At the same time, in determining its priorities, the Legislature need not be limited by the specific choices put forward by the Governor. For social services programs, for example, we advise the Legislature to consider more targeted changes so that benefits would be provided to only the most vulnerable recipients rather than completely eliminating the programs.

LAO Bottom Line

The Legislature faces incredibly daunting challenges in balancing this year's budget. Many of the major expenditure reductions in this budget will require significant lead-time for departments to implement. Accordingly, the Legislature and the Governor will need to agree to a framework to solve much of the budget problem by the end of March. While it is reasonable to assume the state will secure some additional federal funding and flexibility, securing all of the federal relief the Governor seeks is very unlikely. Therefore, in developing a plan to balance the 2010–11 budget and rebuild state finances for the long term, the Legislature must make the types of very difficult decisions suggested by the Governor's "trigger list" of cuts and revenue increases—even if the Legislature rejects some of the specifics of the Governor's list. Decisions like this will facilitate steady progress toward a new, sustainable budget framework. Such progress is imperative to restore the state's fiscal health and enhance public trust in state government.

Budget Overview

Administration Estimates an \$18.9 Billion Shortfall

Reasons for the Shortfall Similar to Those We Described in November. After a very difficult budget process in 2009, policymakers acknowledged that there would be more work to be done to balance the 2010–11 budget. Based on a review of current-law General Fund revenues and program spending, the *2010–11 Governor's Budget* estimates that, without corrective action by the Legislature and the Governor, the state would end 2010–11 with an \$18.9 billion deficit. In this estimate, the General Fund would end 2009–10 with a \$6.6 billion deficit (as opposed to the \$500 million reserve balance estimated by the administration when the Governor signed the July 2009 budget package). Moreover, the gap between revenues and expenditures would total an additional \$12.3 billion in 2010–11. The main reasons for the budget gap are similar to the ones we identified in our November 2009 report, *California's Fiscal Outlook*: the inability of the state to achieve previous budget solutions in several areas, the effects of several adverse court rulings, and, for 2010–11, the expiration of various one-time and temporary budget solutions approved in 2009.

How the Budget Addresses the Shortfall

Federal Relief Is a Large Component of the \$19.9 Billion of Proposed Solutions. Figure 1 shows the \$19.9 billion in budget solutions proposed by the Governor in his budget package (which includes a \$1 billion reserve). In 2009–10, the Governor proposes \$1.2 billion of General Fund solutions, including around \$893 million of savings related to various actions that would reduce Proposition 98 spending on K–14 education. For 2010–11, the Governor proposes \$18.7 billion of additional solutions, including about \$7.8 billion of solutions requiring either funding or the flexibility to change programs from the federal government and \$6.6 billion of expenditure-related solutions for which federal approval generally is not required. Another \$4.3 billion would come from other 2010–11 solutions—mainly shifts of various state funds to other purposes and the Governor's proposed funding shift related to transportation programs. In the event that federal funds do not materialize as the Governor hopes, the administration proposes additional spending reductions and revenue increases that would occur through an automatic trigger. (We describe these trigger budget solutions later in the report.)

Special Session Proposals. During the fiscal emergency special session, the Governor proposes that the Legislature adopt \$8.9 billion of his \$19.9 billion of budget solutions and put measures on the June 2010 ballot to facilitate General Fund budget relief of a combined \$1 billion from Proposition 10 and Proposition 63 funds. Including the ballot proposals, the special session requests encompass around three-fourths of the Governor's total expenditure reduction and funding shift proposals. In many cases, the administration believes that approval of solutions prior to March 1 is necessary to achieve the savings estimated in the Governor's budget.

Figure 1
Budget Solutions Proposed by the Governor
(General Fund, in Billions)

	2009-10	2010-11	Totals
Expenditure Solutions^a			
Reduce Proposition 98 spending	\$0.9	\$1.5	\$2.4
Reduce employee salaries, payroll, and state's retirement contributions	—	1.6	1.6
Implement various Medi-Cal changes	—	1.1	1.1
Reduce inmate medical care costs	—	0.8	0.8
Implement jail term instead of prison term for specified felonies	—	0.3	0.3
Defer or suspend mandate reimbursements	—	0.2	0.2
Implement various Developmental Services changes	—	0.2	0.2
Reduce SSI/SSP grants for individuals to the federal minimum	—	0.2	0.2
Eliminate Cash Assistance Program for Immigrants	—	0.1	0.1
Implement various changes in Healthy Families Program	—	0.1	0.1
Implement various changes in CalWORKs	—	0.1	0.1
Suspend new competitive CalGrant financial aid	—	0.1	0.1
Eliminate California Food Assistance Program	—	0.1	0.1
Reduce reimbursements to child care providers	—	0.1	0.1
Reduce other spending	—	0.1	0.1
Subtotals	(\$1.0)	(\$6.6)	(\$7.6)
Federal Funds and Flexibility Solutions			
Increase base FMAP rate in Medi-Cal to national average	—	\$1.8	\$1.8
Extend enhanced ARRA FMAP rate in Medi-Cal	—	1.2	1.2
Reduce IHSS substantially, which requires federal approval	\$0.1	0.9	1.0
Receive payments related to Medicare and prescription drug costs	—	1.0	1.0
Increase federal fund reimbursements for special education	—	1.0	1.0
Obtain full reimbursement for undocumented felon costs	—	0.9	0.9
Extend CalWORKs ARRA funding	—	0.5	0.5
Extend ARRA for various health programs	—	0.3	0.3
Extend ARRA funding and other relief in various social services programs	—	0.2	0.2
Subtotals	(\$0.1)	(\$7.8)	(\$7.9)
Other Solutions			
Swap Proposition 42 transfer for gas excise tax and related proposals ^b	\$0.1	\$0.9	\$1.0
Use Proposition 10 funding in various children's programs	—	0.6	0.6
Redirect county savings related to health and social services reductions	—	0.5	0.5

Use Proposition 63 funding for mental health services	—	0.5	0.5
Assume increase in miscellaneous revenues	—	0.5	0.5
Authorize automated speed enforcement to offset trial court costs	—	0.3	0.3
Use hospital fees to support children's health coverage in Medi-Cal	—	0.2	0.2
Implement insurance surcharge for emergency response	—	0.2	0.2
Approve Tranquillon Ridge oil lease	0.1	0.1	0.2
Other solutions	—	0.6	0.6
Subtotals	(\$0.2)	(\$4.3)	(\$4.5)

Totals, All Solutions	\$1.2	\$18.7	\$19.9
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^a Some solutions in this category may require federal approval, such as elements of the Medi-Cal and Proposition 98 proposals.

^b This transportation funding proposal also facilitates a portion of the Proposition 98 budget solutions, for a total savings of \$1.8 billion.

General Fund Condition

Solutions Estimated to Leave State With \$1 Billion Reserve at End of 2010–11. Figure 2 shows the administration's estimates of the condition of the General Fund under the Governor's proposals. The reserve deficit at the end of 2009–10 would be \$5.4 billion. In 2010–11, revenues would increase a modest 1.4 percent to \$89 billion, while expenditures would decline 3.7 percent to under \$83 billion. (This level of expenditures is roughly equivalent to the state's 1993–94 General Fund expenditures, adjusted for population and inflation.) The state would be left with a \$1 billion reserve at the end of 2010–11.

Figure 2

Governor's Budget General Fund Condition

(Dollars in Millions)

	Actual 2008–09	Proposed 2009–10	Proposed for 2010–11	
			Amount	Percent Change
Prior-year fund balance	\$2,314	–\$5,855	–\$3,863	
Revenues and transfers	82,772	88,084	89,322	1.4%
Total resources available	\$85,086	\$82,229	\$85,459	
Expenditures	\$90,940	\$86,092	\$82,901	–3.7%
Ending fund balance	–\$5,855	–\$3,863	\$2,558	
Encumbrances	\$1,537	\$1,537	\$1,537	
Reserve^a	–\$7,391	–\$5,400	\$1,021	

^a Special fund for economic uncertainties.

Economic and Revenue Projections

Sluggish Economic Recovery Still Expected for Nation and State

The Department of Finance's (DOF) national and California forecasts for 2010 and 2011 embedded in the Governor's budget project a slow recovery from the recession. Its outlook is slightly more upbeat than its May 2009 forecast and is consistent with the general consensus among forecasters. Projected real gross domestic product growth nationally is 2.2 percent for 2010 and 2.9 percent for 2011. These are typical growth rates for an economy in a mature expansion, but low for a recovery from a deep recession such as the nation endured in 2008 and 2009. California personal income is forecast to grow

2.4 percent in 2010 and 3.6 percent in 2011. These growth rates are well below the state's average rate of 5.5 percent between 1990 and 2007. State jobs are expected to shrink 0.7 percent in 2010 but grow 1.3 percent in 2011.

Revenues Would Grow Less Than 2 Percent Under Governor's Forecast

The administration's revenue forecast is consistent with its modest economic outlook. From an adjusted base of \$82.8 billion in 2008–09, the budget anticipates General Fund revenue growth of 6.4 percent in 2009–10, reaching \$88.1 billion. In 2010–11, however, revenues increase only 1.4 percent to \$89.3 billion. This modest gain reflects the reduction of \$1.6 billion in General Fund sales and use tax (SUT) revenues that are part of the administration's transportation tax proposal (described later in this report). If not for this policy proposal, the budget-year revenue total would increase 3.2 percent. This modest increase also reflects the sizable amount of one-time revenue accelerations adopted in this year's budget and included in the 2009–10 total.

Adjustments to Current- and Prior-Year Revenues. The budget significantly revises revenues for 2008–09 and 2009–10. In 2008–09, revenues decline by \$1.3 billion compared to the level assumed in the *2009–10 Budget Act*. The changes reflect that final receipts in the major tax programs fell significantly short of the amounts anticipated last summer. Similarly, total 2009–10 revenues have been revised down by \$1.5 billion—as tax collections in the first six months of the year have fallen short of expectations and the administration is no longer counting on \$1 billion in revenues from the sale of portions of the State Compensation Insurance Fund (SCIF).

Revenue Trend in 2010–11. The budget projects increases in most revenue sources in 2010–11. Corporate and SUT revenues are expected to grow at 5.3 percent and 6.9 percent, respectively. (The SUT rate reflects baseline growth in tax revenues absent the Governor's transportation tax proposal.) The budget, however, estimates that personal income tax (PIT) revenues will grow only 0.5 percent in the budget year, in part due to the expiration of a temporary 0.25 percent PIT rate increase at the end of 2010. The budget includes \$450 million in new 2010–11 General Fund revenues—but does not have any policy proposals attached to them.

LAO Assessment: Reasonable Forecast, but Some Risks

Overall Outlook Similar to November LAO Forecast. The DOF economic and revenue estimates are similar to the forecast published in our *California's Fiscal Outlook* report in November. Our forecast projects virtually the same growth in personal income in California over the next two years, although DOF's gains are slightly higher in 2010 and slightly lower in 2011. Our state job growth forecast is also quite similar to DOF's, with both our projected losses in 2010 and our expected gains in 2011 slightly larger. Both the Governor's budget (which reflects the revenue proposals described above) and LAO November estimates are significantly down from the budget act projection for all three fiscal years. For 2009–10, our November estimate is virtually identical to the revised estimate included in the Governor's budget (although the projections for the individual sources vary somewhat). Overall, DOF's forecast is consistent with our estimates, but we have some concern with the administration's 2010–11 forecast, as discussed below.

Risks in the 2010–11 Revenue Forecast. The administration's baseline estimate for 2010–11 is \$3.1 billion higher than our forecast. Our concern is based on three factors:

- **Corporate Liabilities.** First, the budget assumes that baseline corporate tax (CT) liabilities will grow 28 percent in the budget year, increasing revenues by more than \$2 billion from the current year. In contrast, our forecast assumes baseline growth of 12 percent in CT revenues. While CT revenues after past recessions have grown by more than 20 percent, the administration's economic forecast does not seem to justify such a rapid "bounce back" of revenues. Given the projected slow recovery of residential and commercial construction in California, we expect that profits in the financial sector (which had fueled CT revenue growth in

the mid-2000s) also will be slow to improve. For these reasons, we are concerned that the budget's projection of CT revenues may prove to be too aggressive.

- **Estate Tax.** Based on the provisions of current federal law, the budget assumes \$892 million in revenues from the estate tax in 2010-11, and our November estimate also included these revenues. It appears increasingly unlikely, however, that the federal government will allow the restoration of the state estate tax exemption in 2011 (known as the state "pickup" tax) as provided for under current law. In December, for instance, the U.S. House of Representatives passed legislation (which is pending action by the U.S. Senate) that would reauthorize the federal estate tax beginning in 2010 based on its current design. Since the pickup tax is not part of the current federal program, the state exemption would not be restored under the House bill.
- **Incomplete Forecast.** Finally, several revenue-related proposals that are part of the Governor's plan are incomplete. For instance, the budget includes \$450 million of new revenues for which there are no specific proposals. Similarly, revenue losses from the administration's proposed homebuyer tax credit and sales tax exemption for "green" technology are not reflected in its revenue estimates. Together, these oversights potentially could reduce revenues by more than \$650 million in the budget year.

Major Budget Proposals by the Governor

Below, we describe first the Governor's proposed non-federal budget solutions (generally, those not requiring federal approval), including expenditure solutions (such as reductions to state programs) and other solutions (such as fund shifts). Next, we describe the proposed federal budget solutions, including the alternative revenue solutions and additional expenditure solutions that would be triggered if federal funds are not received in the amount the Governor assumes. (Unless indicated, dollar figures relate to the General Fund.)

Proposed Expenditure Solutions

Proposition 98 Savings (\$2.4 Billion Over Two-Year Period). Proposition 98 spending on K-14 education would be reduced by \$2.4 billion as a result of various actions proposed by the Governor, which are described in more detail later in this report. The administration estimates that its various changes and the transportation funding shift would result in lower Proposition 98 funding requirements by \$893 million in 2009-10 and \$1.5 billion in 2010-11. Roughly \$600 million of these proposed reductions would require that the U.S. Secretary of Education provide a waiver from maintenance-of-effort (MOE) funding requirements included in the American Recovery and Reinvestment Act (ARRA).

Employee Compensation Savings (\$1.6 Billion). The Governor's budget assumes the end of the current three-day-per-month employee furlough program as scheduled on June 30, 2010. To continue generating significant state personnel savings in 2010-11, the Governor proposes what has been described as its "5/5/5 proposal," as follows:

- **5 Percent Salary Reduction.** State employee salaries would be reduced across the board by 5 percent.
- **5 Percent Increase in Employee Pension Contributions.** State employee pension contributions—now typically between 5 percent and 8 percent of employee salaries, depending on the bargaining unit—would be increased by an additional 5 percent of payroll. This would reduce the state's employer contributions to the California Public Employees' Retirement System (CalPERS) by a like amount.
- **5 Percent Unallocated Reduction to Departmental Personnel Costs.** The administration would direct departments to reduce salary costs by 5 percent. (Constitutional officers are exempt from this proposed cut because, according to the administration, their departments received permanent reductions in the 2009-10 budget package that equal or exceed this reduction.) Departments would have flexibility for how they would achieve these savings, but many likely would seek to meet their savings target through attrition and leaving positions vacant.

Reflecting the state's longstanding practices in making employee compensation adjustments, the 5/5/5 proposals would be applied to both General Fund and non-General Fund personnel costs in departments. In total, the administration estimates that its employee compensation proposals would produce \$2.9 billion of savings across all state funds, of which \$1.6 billion would be saved for the General Fund.

Various Medi-Cal Changes (\$1.1 Billion). The Governor proposes various measures to cut Medi-Cal costs through unspecified limits on services, utilization controls, and increased cost sharing with benefit recipients through co-payment requirements or premiums—which are scored collectively at \$750 million. (Some such changes may require federal approval.) The proposal also would save \$294 million in 2009–10 and 2010–11 combined by eliminating full-scope Medi-Cal services for certain immigrants, eliminating adult day health care benefits, delaying payments to institutional providers, and rescinding a family planning rate increase. Expanded antifraud efforts are proposed to reduce costs by \$26 million.

Inmate Medical Care Costs (\$811 Million). The Governor's budget assumes that per inmate medical costs can be reduced from \$11,627 per year to \$5,740 per year, producing \$811 million of savings in 2010–11. The administration indicates that such a reduction would bring the state's per inmate medical costs roughly to the amount that New York spends on such medical care. According to the administration, the reduction could be achieved by July 1, 2010 through unspecified measures, such as to reduce clinical salaries and unnecessary referrals to outside providers.

Other Non-Federal Savings Proposals (\$1.6 Billion). As indicated in Figure 1, a wide variety of other non-federal expenditure solutions in the Governor's proposal produce savings estimated at about \$1.6 billion. Such proposals include:

- **Jail Time—Not Prison—for Specified Felonies.** The budget assumes savings related to proposed statutory changes to require that offenders convicted of certain non-serious, non-violent, non-sex-offense felonies serve a maximum sentence of one year in county jail in lieu of a state prison sentence. The administration estimates this would reduce costs by \$25 million in 2009–10 and \$292 million in 2010–11.
- **Department of Developmental Services (DDS) Reductions.** The Governor proposes that the state achieve a total of about \$200 million in 2010–11 savings through four cost-control measures in DDS: (1) scoring full-year savings from cost-cutting measures that are already being implemented in the current year, (2) extending a 3 percent provider payment reduction into 2010–11, (3) assuming approval of a Medi-Cal state plan amendment that will allow the state to draw down additional federal funds, and (4) assuming \$25 million in savings to be developed through a workgroup process involving the department and stakeholders.
- **Suspension or Delay of Local Government Mandate Payments.** The Governor proposes savings of \$137 million by suspending mandates not related to elections, law enforcement, and property taxes, similar to recent legislative budget-balancing actions. In addition, \$95 million would be saved by deferring scheduled 2010–11 mandate payments for costs incurred prior to 2004–05, which are statutorily required to be repaid completely by 2020–21.
- **Reducing Social Services Cash Grants.** In the Supplemental Security Income/State Supplementary Program, the Governor proposes to reduce grants for individuals by \$15 per month (1.8 percent) to the federal minimum effective June 1, 2010. (Grants for couples already are at the minimum.) This would result in savings of \$178 million in 2010–11. The Governor also proposes a 15.7 percent reduction in CalWORKs grants for a state savings of \$117 million in 2010–11.
- **Other Reductions and Program Eliminations.** Among other non-federal actions that would produce less than \$200 million of 2010–11 savings each are gubernatorial proposals to eliminate the Cash Assistance Program for Immigrants and the California Food Assistance Program, both of which provide state-only benefits to legal immigrants not eligible for certain federal benefits. Several other proposals would affect other health and social services programs.

Other Non-Federal Solutions

Other non-federal budget solutions include the Governor's proposed transportation funding shift and a variety of shifts of other state funds to pay for General Fund expenses.

- **Transportation Funding Shift (\$1 Billion).** The transportation funding shift is a key element of the Governor's proposal and is summarized in more detail later in this report. The funding shift would benefit the General Fund directly to the tune of about \$1 billion in 2009-10 and 2010-11 as funds would be used to pay transportation debt-service costs. Including the effects on Proposition 98, the transportation funding shift results in a total of \$1.8 billion of General Fund savings in the Governor's proposal.
- **Proposition 10 Ballot Proposal (\$550 Million).** The Governor requests that the Legislature place before voters in the June 2010 election a measure to allow use of Proposition 10 early childhood development funds for General Fund-supported DDS and Department of Social Services programs that serve children. The proposal includes: (1) sweeping \$308 million on a one-time basis from the state commission's Proposition 10 reserves and (2) redirecting 50 percent of state and local commissions' revenues—amounting to an estimated \$242 million in 2010-11—for five years to fund state programs. The budget also assumes that Proposition 10 local commissions will voluntarily provide additional funds on a one-time basis to DDS and Managed Risk Medical Insurance Board programs in 2010-11. This proposal is similar to the failed Proposition 1D at the May 2009 special election.
- **Redirecting County Health and Social Services Savings (\$506 Million).** The budget proposes substantial reductions to IHSS and California Work Opportunity and Responsibility to Kids (CalWORKs), as described elsewhere in this report. The budget also assumes substantial savings due to additional federal funds for foster care and adoption assistance programs. Counties would share in these savings, and the Governor proposes to redirect about 75 percent of these freed-up county funds to offset other General Fund costs.
- **Proposition 63 Ballot Proposal (\$452 Million).** The administration's June 2010 ballot proposal, if approved by voters, would allow the shift of \$452 million of Proposition 63 mental health funds to pay General Fund costs for specified Department of Mental Health programs in each of the 2010-11 and 2011-12 fiscal years. This proposal is similar to the failed Proposition 1E at the May 2009 election.
- **Automated Speed Enforcement to Offset Trial Court Costs (\$297 Million).** The Governor proposes to use automated speed enforcement systems to identify and fine persons speeding through intersections. The administration estimates that this would produce \$338 million of revenues, of which \$297 million would be used to reduce state costs for trial courts.
- **Other Proposals (\$1.7 Billion).** As indicated in Figure 1, there are a number of other smaller solutions that fit into this category. Among these proposals is the Governor's Emergency Response Initiative, which would impose a 4.8 percent statewide surcharge on all residential and commercial property insurance—an estimated \$200 million in 2010-11—that would cover what would otherwise be General Fund fire protection costs of the Department of Forestry and Fire Protection. (Funds in future years also would be dedicated to emergency response program expansions.) In addition, the Governor's budget assumes either that the State Lands Commission or the Legislature approves a lease for the extraction of oil and gas from lands off the Santa Barbara coast known as Tranquillon Ridge. An estimated \$197 million would benefit the budget over the 2009-10 and 2010-11 fiscal years. The administration proposes that most of these lease revenues be dedicated to relieve General Fund costs for the state parks system.

Federal Funds and Flexibility

The Governor's proposal relies heavily on the federal government providing funding (\$6.9 billion) or, in other cases, operating flexibility (\$1 billion) for state-federal programs in order to allow the state to cut expenses and services. Figure 1 shows that federal funds and flexibility are necessary to implement \$7.9 billion of the Governor's proposed solutions. (It is sometimes difficult to categorize individual proposals as to whether federal approval is required, and therefore, this is a rough estimate. In addition, elements

of some of the administration's other budget solutions, such as its Proposition 98 and Medi-Cal reductions, may require federal approval.)

Governor Requests \$6.9 Billion of Federal Funds. The administration identifies \$6.9 billion of requested federal funds to relieve 2010–11 state costs, some of which—if received—would be one-time or temporary in nature. Requested federal funds include:

- **Increasing Federal Funding Ratio for Medi-Cal (\$1.8 Billion).** Long sought by California, this action by the federal government would save \$1.8 billion in state Medi-Cal costs in 2010–11 by having the federal government increase California's Federal Medical Assistance Percentage (FMAP) funding ratio to 57 percent, which the administration states is consistent with the FMAP provided to the ten most populous states, as well as the nationwide average.
- **Extend Federal Stimulus Provisions for Medi-Cal FMAP (\$1.2 Billion).** The ARRA of 2009 increased states' Medicaid FMAP, but this relief for state Medi-Cal funding will expire by the end of calendar year 2010. The Governor wants the federal government to extend California's ARRA-enhanced FMAP through June 30, 2011, for \$1.2 billion of savings.
- **Funding for Medicare Services and Prescription Drug Costs (\$1 Billion).** The budget assumes \$1 billion in Medi-Cal relief from various federal moneys the administration believes are owed to California. These funds include those relating to Medi-Cal's payment of health costs for disabled individuals who were actually eligible for Medicare and changes to the required level of state funding for prescription drug costs.
- **Increased Reimbursements Related to Special Education (\$1 Billion).** The budget assumes a \$1 billion federal reimbursement of General Fund costs related to mandated special education services. (It is assumed that this reimbursement could be spent by the state for any purpose.) Federal law references the federal government's commitment to provide 40 percent of the additional cost of meeting special education requirements. Despite this commitment, the federal government never has contributed the full amount, and in California, the federal share of cost is currently less than half of this target.
- **Increased Reimbursements for Undocumented Felons (\$880 Million).** The budget assumes that the federal government will provide the state with \$880 million of additional funds to fully offset the costs of incarcerating undocumented immigrants, which is estimated to be roughly \$1 billion. For the past several years, the state has received \$111 million annually to support such costs.
- **Other Federal Funding Requests (\$1 Billion).** Other federal funding requests include the extension of ARRA funding for CalWORKs (\$538 million) and other programs, as well as other federal funding, such as increased federal payments for foster care.

Federal Actions Necessary to Implement IHSS and Other Proposed Budget Solutions. In addition to the federal funding requests, the federal government likely would have to provide additional operating flexibility for California in order for other proposed cuts to be made. For example, the budget scores about \$1 billion of savings in 2009–10 and 2010–11 from various changes in IHSS, including a reduction in state participation in IHSS provider wages and benefits to a combined \$8.60 per hour and an elimination of IHSS services for recipients with functional index scores of less than 4. The administration states that these changes would require additional flexibility from the federal government as part of a new "federal–state relationship." In addition, as discussed earlier in this report, achieving the administration's \$892 million estate tax revenue projection for 2010–11 is dependent on the outcome of congressional deliberations.

More Cuts and Revenues Would Be Triggered if D.C. Does Not Deliver. If the \$6.9 billion of federal funds sought by the administration is not on the way by July 15, the Governor's proposal would cause other expenditure reductions and revenue increases to be triggered. (We await full details of the administration's proposed trigger mechanism.) Figure 3 shows the list of \$6.9 billion of additional expenditure reductions, revenue increases, and other actions that would be triggered in this circumstance under the Governor's plan. Included in the list are:

- **Triggered Expenditure Reductions (\$3.8 Billion).** In addition to other program reductions discussed above, triggered reductions (generally permanent) would include the elimination of CalWORKs, IHSS, and the Healthy Families Program, as well as an additional 5 percent state employee salary reduction and other program reductions.
- **Triggered Revenue Increases (\$2.3 Billion).** Triggered, one-time revenue increases would include an extension of recent business tax changes relating to net operating losses, an extension in the temporary reduction in the dependent PIT credit approved last year, delayed implementation of the ability of unitary groups of companies to use tax credits, delayed implementation of the change to a single sales factor allocation method for apportioning multistate corporate income, and a lowered first year phase-in of the ability of corporations to carry back losses to offset prior tax profits.
- **Other Solutions (\$847 Million).** In addition to the measures listed above, the trigger proposals include a further \$847 million funding of state mental health services with Proposition 63 funds. This would require voter approval at the June 2010 election along with the Proposition 63 fund shift described earlier.

Figure 3
Trigger Solutions in 2010–11 Governor’s Budget^a
(2010–11 General Fund Savings, in Millions)

Expenditure Solutions		(\$3,752)
Eliminate CalWORKs		\$1,044
Reduce Medi-Cal eligibility to federal minimum and eliminate some optional benefits		532
Reduce state employee salaries by an additional 5 percent		508
Eliminate IHSS program		495
Redirect additional county savings to benefit the General Fund		325
Eliminate most inmate rehabilitation programs and implement inmate population and other parole changes		280
Eliminate Healthy Families Program		126
Eliminate funding for UC/CSU enrollment growth		112
Eliminate various Proposition 99 programs		115
Reduce trial courts’ budget		100
Freeze eligibility and level of awards for CalGrant financial aid		79
Eliminate funding for housing programs for foster youth		36
Revenue Solutions		(\$2,339)
Extend suspension of net operating loss changes		\$1,200
Extend reduction in dependent tax credit		504
Delay implementation of sharing of tax credits		315
Delay single sales factor for corporate taxes		300
Delay changes in carry-back losses for corporations		20
Other Solutions		(\$847)
Fund existing mental health services with Proposition 63 funds		\$847
Total Trigger Solutions		\$6,938

^a Proposals would go into effect if \$6.9 billion in federal funds was not received.
IHSS = In-Home Supportive Services.

Other Proposals

In addition to his budget proposals, the Governor made other proposals in his final State of the State Address to the Legislature on January 6, 2010.

Governor's Jobs Package. In his speech, the Governor proposed a jobs package, which he described as including \$500 million to "train up to 140,000 workers and help create 100,000 jobs." Some elements of the package are incorporated in the budget proposal, such as borrowing from the Disability Insurance fund to support training grants to employers and a \$3,000 per job tax credit payable to employers for new employees retained for at least nine months. In addition, the Governor proposed homebuyer tax credits of up to \$10,000 for the purchase of new or existing homes and an exemption from the sales tax for "green-tech" manufacturing equipment. As discussed earlier, this tax credit and sales tax exemption were not reflected in the budget package's revenue estimates.

Constitutional Amendment Related to Prison and University Funding. The Governor also proposed in his speech a constitutional amendment that would in future years set a minimum funding guarantee well above current funding levels for the University of California and California State University systems and a maximum funding level well below current spending for state prisons. The measure would provide California Department of Corrections and Rehabilitation (CDCR) with certain new authority intended to allow it to reduce costs, including increased abilities to contract with private prisons and private prison staff.

Constitutional Amendment Related to the Budget Process. The Governor also asked the Legislature to put before voters an initiative that has been proposed by California Forward. This proposal would make significant changes to the state's budget process, including:

- Allowing appropriations made in the budget bill, amendments to the budget bill, and budget trailer bills to be passed by a majority vote in each house of the Legislature.
- Making fee increases subject to a two-thirds vote of the Legislature in certain limited circumstances.
- Giving the Governor new midyear expenditure reduction authority.
- Limiting the use of specified nonrecurring state revenue for one-time expenditures.
- Requiring the identification of funds to pay for certain state program expansions.
- Requiring the Legislature to review the performance of state programs at least once every ten years.
- Extending the Legislature's deadline for passing the annual budget by ten days—from June 15 to June 25—and prohibiting the Legislature from ever being paid for the days during a late-budget impasse.

Analysis of Transportation and K-14 Education Proposals

Two of the most important—and more complicated—programmatic proposals in the Governor's package are those related to the proposed transportation funding shift and Proposition 98, which provides funding to K-14 education. These two programs are discussed below.

Transportation Funding

Governor's Proposal

The Governor's budget proposes to significantly change (1) how the state generates revenues to fund transportation programs and (2) what programs would be funded with these revenues. Currently, the state imposes an 18 cents per gallon tax on gasoline and diesel fuel (known as the gas tax). These monies are used for state highways and local streets and roads. The state also charges a sales tax on

these fuels, and the revenues are used for public transit and rail, as well as state highway expansion and local street and road improvements. The Governor proposes to:

- Eliminate the state sales tax on fuel and make up most of the lost revenues with an increase in the per gallon gas tax. The gas tax increase would be capped so that in total motorists would not pay more than they do now in gas and sales tax combined.
- Use the revenues from the gas tax increase to (1) pay debt service on transportation bonds and (2) fund state highways and local streets and roads at amounts equivalent to what each would get under current law. The funding for state highways would be available for maintenance and rehabilitation (major repairs), in addition to expansion purposes.

No Funding for Transit and Rail, but Debt–Service Expenditures and a Tax Cut. For 2010–11, the proposal would reduce fuel sales tax revenues by \$2.8 billion. The budget proposes to partially offset the revenue loss with a 10.8 cents per gallon gas tax increase, which would generate about \$1.9 billion for the following:

- \$629 million for state highways.
- \$629 million for local roads.
- \$603 million for debt service on transportation bonds. (The Governor would use an additional \$400 million in transportation funds to pay other General Fund debt–service costs.)

As a result, there would be a net reduction in transportation revenues of about \$1 billion in 2010–11. This would effectively provide California motorists a tax cut equivalent to about 5 cents per gallon at the pump. No new state funding would be provided for public transit and rail in the budget year. Under current law, about \$1.6 billion would have been provided for these purposes.

Beyond the budget year, the Governor’s proposal would provide an ongoing dedicated source of funding, in addition to the General Fund, to pay transportation debt service. Depending on how the level of transportation debt–service costs changes from year to year, the gas tax rate would be adjusted, up to the proposed cap. As a result, it is uncertain whether motorists would continue to receive a tax cut at the pump in future years. Additionally, there would be no future state funds for transit and rail. Also, as described below in the “Proposition 98” section, the repeal of a General Fund revenue source (the sales tax on fuel) and its replacement with a non–General Fund excise tax would reduce the school funding guarantee.

Issues for Legislative Consideration

While the Governor’s proposal includes some features that have merit, it also raises a number of policy and potential legal issues. We discuss these below.

Funding State Transportation Based on Road Use Has Benefits. Under the proposal, the state would rely on the gas tax as the primary funding source for state transportation programs. This is consistent with past recommendations we have made to the Legislature. Because the gas tax is collected based on the amount (gallons) of fuel consumed, the charge is linked to the provision of a service—that is, the use of the roads by a driver. This would also be a more stable source of funding for transportation purposes. In contrast, fuel sales tax receipts fluctuate not only with the amount of fuel consumed, but also with changes in the price of fuel. Moreover, the amount of sales tax paid by a motorist may not closely reflect their use of the highway and road system.

Proposal Provides Ongoing General Fund Relief. The Governor’s proposal would provide a substantial and ongoing source of funding—hundreds of millions of dollars a year—to pay transportation debt service. This would significantly lessen the burden on the General Fund. The state has authorized about \$30 billion in transportation bonds in recent years. Annual debt service costs on these bonds are projected to exceed \$1 billion by 2011–12. A large portion of these costs could be paid for from the new gas tax.

Constitutional and Statutory Requirements May Pose Legal Problems. The use of state sales tax on fuel is restricted under provisions of the State Constitution and statute passed by the voters. The Governor’s proposal would not amend or eliminate any of the restrictions. Rather, the proposal would eliminate the source of revenues that are subject to the restrictions. The Legislature should carefully review whether all aspects of the proposal can be implemented in keeping with these legal restrictions.

What Should Be the State’s Role in Funding Transit? In recent years, due to increasing fuel prices, the amount of fuel sale tax revenues available to public transportation programs has ballooned to extraordinary sums—hundreds of millions of dollars a year—compared to the amounts historically provided by the state for these purposes. Under current law (and recent court rulings) these revenues cannot be redirected to other purposes. In weighing the Governor’s proposal to eliminate state funding for public transportation, the Legislature should consider whether providing funding assistance to regional and local transit and rail is a policy priority, and the type (capital versus operating) and level of any assistance it chooses to provide. Because the Constitution prohibits using the gas tax to support transit operations, the Legislature would have to identify a different source of funding if the Governor’s package were adopted.

Proposal Provides No Additional Highways Funding. As we have noted in past reports, funding for highway maintenance and rehabilitation has not kept pace with cost increases due to an aging system and inflation, and the state faces billions of dollars in highway repair and reconstruction needs. The Governor’s proposal would not provide any additional funding specifically for these activities. Instead, it would allow funding currently available for highway expansion to be used for rehabilitation instead. The Legislature should consider whether the gas tax should be increased beyond the proposed level in order to provide funding for highway rehabilitation.

Proposition 98

Governor’s Proposal for Proposition 98 K–14 Education

Figure 4 shows Proposition 98 spending from 2007–08 (actual) to 2010–11 (proposed) for K–12 education, the California Community Colleges, and other Proposition 98–supported agencies (including the state special schools and juvenile justice). As shown in the figure, the Governor’s January proposal has total Proposition 98 spending virtually flat across 2009–10 and 2010–11. Despite total spending remaining flat year over year, the state’s General fund share would increase (4.1 percent) whereas the share covered by local property tax revenues would decrease (8.7 percent). While the slumping housing market contributes to the drop in local property tax revenues, the bulk of the decline is attributable to the one-time \$850 million contribution from redevelopment agencies in 2009–10 (required as part of the 2009–10 budget package).

Figure 4

Proposition 98 Spending Stays Virtually Flat Under Governor’s Plan

(Dollars in Millions)

	2007–08 Final	2008–09 Final	2009–10 Revised	2010–11 Proposed	Change From 2009–10	
					Amount	Percent
K–12 Education						
General Fund	\$37,752	\$30,260	\$30,844	\$32,023	\$1,179	3.8%
Local property tax revenue	12,592	12,726	13,237 ^a	11,950	–1,287	–9.7
Subtotals	(\$50,344)	(\$42,986)	(\$44,082)	(\$43,974)	(\$108)	(–0.2%)
California Community Colleges						
General Fund	\$4,142	\$3,918	\$3,722	\$3,981	\$259	7.0%

Local property tax revenue	1,971	2,011	1,953	1,913	-40	-2.0
Subtotals	(\$6,112)	(\$5,929)	(\$5,675)	(\$5,895)	(\$219)	(3.9%)
Other Agencies	\$121	\$105	\$94	\$85	-\$9	-9.1%
Totals, Proposition 98	\$56,577	\$49,019	\$49,851	\$49,954	\$103	0.2%
General Fund	\$42,015	\$34,282	\$34,660	\$36,090	\$1,430	4.1%
Local property tax revenue	14,563	14,737	15,191 ^a	13,864	-1,327	-8.7

^a Includes \$850 million in one-time shift of local government revenues.

Governor Claims Proposition 98 Proposal Meets Constitution Obligations. For both 2009–10 and 2010–11, the Governor states he is funding at the constitutionally required minimum level (commonly called the “minimum guarantee”). Nonetheless, the administration acknowledges that it is veering away from the July 2009 budget agreement. Last year, disagreement emerged over the state’s long-term Proposition 98 funding obligations. The July budget deal addressed the issue by (1) statutorily setting the 2008–09 Proposition 98 minimum guarantee at \$49.1 billion, (2) establishing a certain long-term obligation (commonly called a “maintenance factor”) of \$11.2 billion, and (3) designating that associated maintenance factor payments be made as otherwise specified in the Constitution. The Governor’s January proposal: (1) recognizes a notably lower 2008–09 minimum guarantee (\$46.8 billion), (2) assumes the payment of \$1.3 billion in maintenance factor in 2008–09, and (3) delays the start of the remaining maintenance factor payments until 2012–13. In addition, the elimination of the sales tax on fuels described earlier reduces General Fund revenues and, therefore, also the minimum guarantee in 2010–11. Through these actions, the administration is able to achieve related savings in 2009–10 and 2010–11.

Governor Proposes Relatively Small Midyear Adjustment. Figure 5 highlights the Governor’s specific Proposition 98 proposals. As shown in the figure, the Governor proposes a \$568 million reduction in Proposition 98 spending for 2009–10. The only major midyear proposal is to recognize \$340 million in savings from the K–3 Class Size Reduction program. Beginning in 2008–09, the state allowed school districts to increase class size above the previous 20–student cap but applied funding penalties to those who chose to do so. As some districts increased K–3 class sizes for the 2009–10 school year, these funding reductions are leading to sizeable statewide savings. The remainder of the reduction is due to various technical changes, which are due primarily to student attendance being slightly lower than projected.

Figure 5
Proposition 98: Governor’s Major Spending Proposals
(In Millions)

Midyear 2009–10 Proposals	
Recognize K–3 Class Size Reduction (CSR) savings	-\$340
Make various other baseline adjustments	-228
Total Changes	-\$568
2010–11 Proposals	
Backfill prior-year one-time solutions	\$1,908
Make various other adjustments	238 ^a
Reduce K–12 revenue limits:	
Spend less on school district administration	-1,184
Remove restrictions on contracting out	-300

Consolidate County Office of Education functions	-45
Make K-14 cost-of-living adjustments (-0.38 percent)	-230
Recognize additional K-3 CSR savings	-210
Reduce CalWORKs Stage 3 child care funding	-123
Reduce child care reimbursement rates	-77
Fund CCC apportionment growth (2.21 percent)	126
Total Changes	\$103

^a Includes growth for revenue limits, special education, and child nutrition. Also includes funding for three K-12 mandates.

Heavy Reliance on One-Time Solutions in Current Year Leads to More Than \$2 Billion in Budget-Year Reductions. Although the Governor proposes to keep overall Proposition 98 spending virtually flat across the two years, his plan contains \$2.2 billion in budget-year programmatic reductions (detailed in Figure 5). These reductions are necessitated by the heavy reliance on one-time solutions in 2009-10. The largest of the proposed reductions for 2010-11 is a \$1.5 billion cut to K-12 general purpose funding (commonly known as revenue limits). Specifically, the Governor proposes to achieve this savings by: (1) requiring school districts to spend less on central administration, (2) consolidating certain county office of education functions, and (3) removing restrictions on the contracting out of non-instructional services. For most K-14 programs, the Governor also proposes to recognize an anticipated 0.38 percent decline in the cost of living (for savings of \$230 million). In addition, the Governor proposes to tighten eligibility for CalWORKs Stage 3 child care and reduce reimbursement rates for child care vouchers (for combined savings of \$200 million). The Governor's plan also includes an increase of (1) \$126 million to fund 2.2 percent growth in community college enrollment and (2) \$77 million to fund three K-12 mandates (including a newly recognized mandate relating to behavior intervention plans for special education students). All other mandates would be suspended under the plan.

New Flexibility Options Proposed for 2010-11. To provide some help to districts as they respond to another tight budget, the administration proposes several new flexibility options. Most notably, the Governor proposes three new flexibility options relating to teacher policies: (1) eliminating seniority rules that apply to layoffs, assignments/reassignments, transfers, and hires; (2) eliminating rules regarding priority for receiving substitute teaching assignments; and (3) extending the layoff notification window to 60 days after the state budget has been enacted.

LAO Assessment of Governor's Proposition 98 Plan

Overall, we give the Governor's January Proposition 98 plan a mixed review. On the one hand, the plan contains several major risks discussed below. (In addition, risk is associated with the Governor's assumption that California will obtain \$1 billion in one-time federal funding related to special education. This risk is assessed alongside the other federal funding proposals later in this report.) On the other hand, the plan has some merit—maintaining flat year-to-year funding within a difficult budget context while providing local education agencies with new forms of flexibility.

Unclear if Constitutional Obligations Would Be Met; Obligations Could Increase Significantly. The administration's claim that it is meeting the constitutionally required Proposition 98 minimum guarantee in 2009-10 and 2010-11 is based on its interpretation of the State Constitution. Based upon other interpretations of the Constitution, however, the state's Proposition 98 obligations could be significantly higher than asserted under the Governor's January plan. If this were the case, the Legislature could be required to suspend Proposition 98 if it wanted to fund K-14 education at the Governor's proposed levels. (In addition to these interpretation issues, the minimum guarantee in both years could increase due to changes in final 2008-09 revenues.)

Minimum Guarantee for 2010-11 Could Increase Even Further Due to Interaction With Revenue Proposals. As is the case almost every year, the Proposition 98 minimum guarantee in 2010-11 is sensitive to changes in the state's General Fund condition. The uncertainty is heightened in 2010-

11, however, due to the administration's major new revenue proposals. Most notably, the Governor's proposal to eliminate Proposition 42 monies would lower the Proposition 98 minimum guarantee for 2010–11 by roughly \$800 million. Were the Legislature to reject this proposal, the minimum guarantee would rise accordingly. Moreover, if the Legislature were to adopt other major proposals that increased/decreased General Fund revenues (or revenue increases were triggered), the minimum guarantee also would end up being significantly higher/lower than under the Governor's plan.

Uncertain if Federal Government Will Approve Waiver Request. The Governor's January plan assumes the United States Department of Education will approve its request to be exempted from an MOE requirement included in ARRA. Under the Governor's January plan, K–12 funding is roughly \$600 million below the required MOE level in 2010–11. Under ARRA provisions, states are allowed to apply for a waiver from the MOE requirement if they can show that education is receiving the same or greater share of the state budget as in the prior year. Under the Governor's January plan, the state appears to meet this waiver requirement. Ultimately, whether the waiver requirement will be met for 2010–11 will depend on many factors that will remain in flux until a new budget package is adopted. Moreover, ARRA gives the federal Secretary of Education discretion in deciding whether to approve states' waiver requests.

Governor's Proposition 98 Plan Might Be All State Can Afford. Despite all the risks highlighted above, the Governor's Proposition 98 plan has some merit. Given the state's large budget shortfall and the proposed reductions for other sectors of the budget, education is treated relatively favorably under the Governor's January plan. Within this overall budget context, holding total Proposition 98 spending flat from 2009–10 to 2010–11 might be the most that the state can afford. (Due to various one-time issues discussed earlier—combined with the one-time nature of billions of dollars of ARRA funds provided in 2009—flat Proposition 98 funding would leave school districts facing a reduction in programmatic resources in 2010–11.)

Flexibility Proposals Have Potential. We also think the Governor's flexibility proposals have merit. For example, we recommend the Legislature pursue the administration's proposals to remove restrictions on contracting out as well as modify various teacher policies though in some cases with significant refinements. Furthermore, we recommend the Legislature consider various other flexibility options, such as consolidating additional categorical programs and sponsoring a ballot measure to repeal the autopilot funding formula of Proposition 49. Finally, we recommend against taking major actions that would restrict local discretion and thereby work at cross-purposes with new flexibility options. For example, we recommend the Legislature reject the Governor's district administration proposal which provides no new flexibility but instead restricts how school districts can use existing general purpose funding.

LAO Comments on the Governor's Budget Package

Estimate of the Budget Problem Reasonable, but Some Downside Risk

A major cause of the newly-identified 2010–11 budget shortfall is the failure of several major budget solutions enacted in 2009 to produce expected savings. The administration, for example, has adjusted its budget to reflect the state's inability to achieve certain 2009 budget solutions related to the sale of SCIF and solutions related to CDCR and Medi-Cal, among others. There is still a possibility for further erosion in such budgeted savings or increases in other baseline costs for various departments assumed in the budget package. In addition, several major court cases related to past budget solutions could expand the budget problem if those cases conclude adversely for the state. Finally, as discussed in the "Economic and Revenue Projections" section of this report, the administration's 2010–11 revenue forecast is subject to several notable risks. These risks could add a few billion dollars to the budget problem that the Legislature and the Governor have to solve.

Risks in Implementing Numerous Proposed Budget Solutions

Significant Legal Risks for Some Proposals. Just as the Legislature should be aware of several risks that could increase the size of the budget problem, it should be cautious about enacting budget solutions that are subject to significant legal risk. For example, it is quite unclear if the state can unilaterally—without agreements with its employee unions—increase required employee contributions for CalPERS pensions. While the state’s collective bargaining law explicitly gives the Legislature the authority to not fund some costs—such as salaries—included in state employee collective bargaining agreements, retirement funding decisions are subject to much more stringent legal restrictions. In addition, numerous lawsuits challenging recent budget solutions concerning health, social services, transportation, and other areas suggest that many of the Governor’s proposed solutions could face court challenges. The Legislature should be careful to draft budget-balancing measures (both budget and trailer bills) that anticipate such lawsuits and attempt to put the state in the strongest possible legal position to win them.

Many Proposals Would Require Implementation Time. Another issue will be the timing of budget actions, relative to the July 1 start of the fiscal year. Often, as noted by the administration in calling a special session, several months of lead time are required to implement major program reductions, particularly in health, social services, and criminal justice programs. The earlier that such program changes can be adopted, the more likely that estimated savings can be achieved. The administration’s proposed measure to dramatically cut prison medical care costs of the Receiver—difficult to achieve in any event—would at the very least require months of lead time in order to be implemented. Also very difficult to achieve would be the unallocated personnel cost reductions that are part of the administration’s employee compensation proposal. Most of the General Fund savings would have to be identified by CDCR (which comprises the majority of General Fund personnel costs), and it is very unlikely the department could do so unless those changes are accompanied by specific sentencing, policy, or operating changes, many of which would require legislative approval and significant lead time. Finally, if voters again reject the Proposition 10 and Proposition 63 proposals, the Legislature would need to identify alternatives quickly after the June election.

Adverse Fiscal Consequences for Some Proposals. In some cases, the Governor’s proposals may not generate the level of savings he assumes in his budget package. For example, the Governor proposes to limit IHSS services to individuals with the most severe impairments, resulting in General Fund savings of about \$650 million. This eligibility restriction would make about 87 percent of the existing caseload ineligible for services. Although the Governor’s budget includes about \$50 million to cover increased developmental services costs for some of these individuals, the budget does not appear to include additional funding for long-term care costs which are also likely to increase when former IHSS recipients seek out-of-home care. We believe a cut of this magnitude could result in increased long-term care costs which could exceed the estimated savings in IHSS.

Much of the Federal Funds and Flexibility Sought by Governor Not Likely

Legislature Needs to Be Realistic. In our view, the federal government can and should provide some relief to the state on an ongoing basis, especially in cases, such as special education, where it mandates certain services and does not pay its designated share. Also, a series of federal mandates and court rulings restrict the state’s ability to reduce health and social services costs.

We believe there is a good prospect for the state receiving some significant new federal relief—perhaps several billion dollars worth—that will help balance the 2010–11 budget. (A federal jobs package—effectively a further round of economic stimulus—could be a vehicle that would deliver additional federal funds to California and other states.) Nevertheless, the chance that anywhere near all of the federal funds and flexibility sought by the Governor in his budget package is almost nonexistent. The state is very likely to fall several billion dollars short of the Governor’s goals. Moreover, there is a huge tension between—on the one hand—some of the administration’s proposals to cut health and social services programs and—on the other hand—the administration’s requests for extensions of ARRA and other

federal relief. Such federal relief actions typically come with "strings attached" in the way of limitations on the state's ability to cut services in these programs, as was the case in 2009 with ARRA.

The Legislature needs to approach the 2010–11 budget realistically with all of these issues in mind. The inability to secure the federal funds and flexibility sought by the Governor will mean the state must make even more difficult spending and revenue decisions than it would otherwise, such as those included in the Governor's trigger proposal or alternatives. We, therefore, recommend that the Legislature adopt a more modest assumption of new federal funds in its budget package. (For a discussion of the difficulty in structuring a federal funds trigger, see the nearby box.)

Considerations in Constructing a Federal Funds Trigger

The concept of a federal funds trigger proposed by the Governor—having a back-up plan in case the assumed influx of additional federal funds does not materialize—makes sense. Solely relying on an assumption of billions of dollars in federal funds could easily leave California with another multibillion dollar budget shortfall early in 2010–11. Moreover, it would threaten the state’s ability to secure enough cash-flow borrowing from investors during the summer to allow the continued timely payment of state expenses. One year ago, the Legislature took a similar approach in crafting its February 2009 budget package, which was enacted within days of the passage of the federal stimulus package. Yet, at that time, what the Legislature approved was a trigger to determine *how much* the stimulus package would benefit the budget—not *if* funds would be forthcoming. At the time this report was prepared, we had not received the administration’s initial trigger language. We understand, however, that it will be a simple “all-or-nothing” determination on July 15—if increased federal funds totaling at least \$6.9 billion is not expected, then all of the alternative spending and revenue proposals would go into effect. For a number of reasons discussed below, we believe crafting a trigger for the 2010–11 budget will require a more sophisticated approach.

Timing Considerations. Unlike 2009, it is not clear now if the federal government will be providing the state with significant fiscal relief in 2010. Consequently, it is also not clear when the right time would be for a trigger determination. The later that the state waits, the more information it will have regarding the federal government’s intentions. Yet, waiting until the start of the state’s fiscal year or later would make it impossible to achieve full-year savings for many alternatives. (For instance, most health and social services reductions would require at least three months to get up and running.) As a result, a late trigger decision would necessitate even deeper reductions for the remaining months of the year under alternative proposals to maintain a dollar-for-dollar equivalent to the federal funds assumption. The chances are nearly nonexistent that the federal government will provide anywhere near \$7 billion in new fiscal relief for 2010–11. We, therefore, advise using a more modest federal funds assumption and adopt other solutions to help: (1) ensure that adopted solutions have enough time to generate expected savings and (2) the public and program beneficiaries have an accurate understanding of the impacts of the budget as early as possible.

Budget Reductions Interact With Federal Assumptions. The magnitude and type of the additional federal funding the state may receive affects the types of solutions that the Legislature may want to or could implement. For example, if the American Recovery and Reinvestment Act (ARRA) funding for the California Work Opportunity and Responsibility to Kids (CalWORKs) program is extended as the Governor assumes, the proposed 15.7 percent grant cut results in state savings of \$117 million and a loss of \$468 million in federal funds. Conversely, if ARRA is not extended, state savings from this grant reduction would be about \$470 million. To help maximize the receipt of federal funds, some social services proposals, such as this CalWORKs grant reduction, could be adopted on a contingent basis, whereby the cut is made only if specified federal funding streams are not available. On the other hand, some reductions otherwise contained in the budget may be prohibited if federal relief comes with new strings attached.

Setting Legislative Priorities. Under the administration’s approach, the receipt of \$2 billion in federal relief would still cause all \$6.9 billion in alternative solutions to be implemented. A tiered trigger, rather than an all-or-nothing approach, would allow the Legislature to better delineate its priorities. For instance, if only \$2 billion in general-purpose relief is provided, what cuts or revenue increases would the Legislature want to avoid? Another way to reflect legislative priorities in a trigger is to make any determination by the Director of Finance and/or other officials as ministerial as possible. By precisely crafting the trigger language to anticipate as many contingencies as possible, the Legislature can help ensure that the executive branch is not forced to make judgments about the language’s intent. Such judgments, on the natural, would reflect the administration’s priorities—rather than the Legislature’s.

LAO Recommendations to the Legislature

Time Is of the Essence for Many Proposals

Action No Later Than March Needed for Many Proposals. In our opinion, many key decisions necessary to balance this year's budget problem probably need to be made by the end of March. First, action by March is necessary to put measures on the June 2010 ballot. A straightforward package of proposals seeking fiscal flexibility from the state's voters could yield substantial benefits. Second, as noted above, the magnitude of expenditure reductions necessary to balance the budget often will require months of lead time. Not all budget solutions, however, need to be enacted on such an accelerated timeline. For example, major uncertainties with various Proposition 98 factors suggest the Legislature might want to wait to make significant K-14 education decisions until it has better information. (At the same time, it may be difficult to put other major pieces of the budget solution in place early without knowing the overall approach to Proposition 98.) In any event, the longer that lawmakers wait to develop their budget framework, the less likely that a balanced budget in 2010-11 actually can be achieved and the more likely that the choices facing the Legislature over the next year or two will be even more dire.

No Way to Avoid Reprioritizing State Finances

Very Difficult Cuts Required. By relying on billions of dollars of federal funds, the Governor's base budget proposal (not including the trigger cuts) is able to escape directly putting forward some of the most dramatic programmatic changes discussed in recent budget deliberations. The Governor's list of trigger cuts, however, includes reductions that sometimes are draconian. Unfortunately, based upon a more realistic view of likely federal assistance, we see no way that the Legislature can produce a credible balanced budget that avoids the types of choices posed by the Governor's trigger list. The Legislature will have to make very painful cuts to programs in order to balance this year's budget. Those choices about priorities likely will shape state government for years to come.

Legislature Not Limited by the Choices Put Forward by the Governor. While balancing the budget will require very difficult decisions, the Legislature need not be limited by the specific choices put forward by the Governor. For many of the proposed reductions in social services programs, for example, the Legislature has the option of making more targeted changes so that benefits would be provided to only the most vulnerable recipients rather than completely eliminating the programs. This is particularly true in the state-only programs for noncitizens where there are no federal constraints. In addition, even with the trigger cuts, the Governor's plan would leave universities at roughly their current level—far above the relative fate of other program areas. The Legislature will need to determine if it shares this priority with the Governor. (Regardless of the budget approach adopted for higher education this year, based on our experience in dealing with the state's many budget restrictions, we cannot advise the Legislature strongly enough to reject the Governor's proposed constitutional amendment on prison and university funding. It is a "feel good," but ultimately ill-conceived, autopilot budgeting measure that would unwisely tie the budgetary fates of two very different state programs.)

Revenue Actions Should Be a Part of the Budget Solution

Governor's Trigger Proposals on Revenues Are Worth Considering. The Legislature also needs to consider increased revenues as part of its budget solutions. We do not recommend further stressing the economy with additional broad-based tax rate increases above their current levels. Nevertheless, several revenue options on the Governor's trigger list do not violate this criterion and merit legislative consideration for this year's budget. For example, we urge consideration for extending the dependent personal income tax credit reduction, a proposal on the Governor's trigger list—perhaps even on a permanent basis. In addition, modification or elimination of tax expenditure programs—special credits, deductions, and exemptions—that are not cost-effective can raise revenues without resulting in marginal tax rate increases. The Legislature—like the Governor in some cases—also should look to

increasing fees in cases where the costs of state programs currently supported by the General Fund can appropriately be shifted to specific beneficiaries.

Multiyear Approach Is Needed

Majority of Solutions Need to Be Ongoing or Multiyear in Nature. With a slow economic recovery expected and many federal relief funds likely to be one-time in nature, the majority of the Legislature's budget-balancing decisions in 2010 need to be ongoing or multiyear in nature in order to begin restoring state finances to a sound footing. Even the administration's proposal—with ongoing new federal assistance and sometimes painful cuts—shows a multibillion-dollar deficit problem (under its own estimates) that would linger for the state in 2011–12, 2012–13, and 2013–14. The state's budget problem is so severe that the Legislature will not be able to close the entire budget shortfall with ongoing solutions this year. Nevertheless, this year, lawmakers should aim for a mix of one-time and ongoing solutions that results in a much smaller structural deficit—preferably well under \$10 billion per year in future years.

Conclusion

The Legislature faces incredibly daunting challenges in balancing the budget during the fiscal emergency special session, as well as its regular session, this year. In order to make the major expenditure reductions that will be required in this budget, the Legislature and the Governor will need to agree to a framework to solve much of the budget problem by the end of March. While it is reasonable to assume the state will secure some additional federal funding and flexibility, securing all of the federal relief the Governor seeks is very unlikely. Therefore, in developing a plan to balance the 2010–11 budget and begin the multiyear approach of rebuilding state finances, the Legislature will need to make the types of very difficult decisions suggested by the Governor's trigger list of cuts and revenue increases—even if the Legislature rejects some of the specifics of the Governor's list. Decisions like this will facilitate steady progress toward a new, sustainable budget framework. Such progress is imperative to restore the state's fiscal health and enhance public trust in state government.

Acknowledgments

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