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Legislature Passes Budget Plan

In the early morning of February 19, the Legislature passed a spending plan aimed at addressing the state's worsening budget crisis. This summary is based on legislation passed as part of the budget package, as well as media reports. The CBP will prepare a more detailed analysis of the budget agreement when the final spending plan is signed into law by the Governor.

The final agreement includes a total of \$40.8 billion in "solutions" – \$26.1 billion to balance the 2009-10 budget and \$14.8 billion to close the gap projected for the remainder of 2008-09. Specifically, the agreement includes \$14.1 billion in spending reductions, \$11.1 billion in new and increased taxes, and \$11.4 billion in new borrowing. The agreement assumes that the state will receive \$5.0 billion from the sale of bonds backed by lottery proceeds in 2009-10. The budget agreement assumes voters will approve changes in the allocation of lottery proceeds in a measure that would appear in a special election. The agreement also assumes that the state will raise \$5.9 billion from the sale of Revenue Anticipation Warrants (RAWs). Finally, the final agreement assumes \$432.6 million in internal borrowing from several special funds.

The agreement includes a trigger mechanism linked to California's receipt of federal funds from the federal economic recovery bill signed into law on February 17. If California does not receive at least \$10 billion in funds that can offset state General Fund expenditures, additional cuts totaling \$947.4 million and an additional tax increase of \$1.8 billion would be triggered. If California receives the targeted amounts, the cuts and tax increase would not take effect and \$5.9 billion of the federal funds would be substituted for the proposed RAWs. The Legislative Analyst and others have raised issues with the use of RAWs for budget-balancing purposes, rather than strictly for cash-flow management, as a result of language added to the state's Constitution in 2004 by Proposition 58, which authorized the issuance of deficit financing bonds on a one-time basis.

Final Budget Agreement Changes Election Laws, Increases Personal Income Tax Rates

The final budget agreement places two constitutional amendments before the voters. One would adopt an "open primary" system under which all candidates for a state or congressional office in a primary election would be listed on a single ballot, regardless of party affiliation; the two gaining the most votes, regardless of party, would appear on the general election ballot. This measure will be placed on the June 2010 ballot. The second proposed constitutional amendment would eliminate salary increases for state officers, including the governor and members of the Legislature, in years with a projected budget deficit. This measure will be placed on a May 19, 2009 special election ballot.

The final package temporarily increases personal income tax rates by 0.125 percentage points (0.25 percentage points if the state does not receive a specified amount of assistance from the recently signed federal economic recovery bill). For example, income currently taxed at the 4.0 percent rate would instead be taxed at a rate of 4.125 percent (4.25 percent if the state does not receive sufficient federal funds). The increase in rates would replace the previously proposed personal income tax surtax. However, the final budget agreement does not include the previously proposed 12-cent-per-gallon increase in gasoline and diesel fuel taxes. Finally, some press reports suggest that the Governor may use his line-item veto authority to cut spending by an additional \$600 million.

Spending Cap Could Severely Limit Future Spending

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

- Require the state to deposit an amount equal to 3 percent of annual General Fund revenues in the Budget Stabilization Fund (BSF) until the balance in the BSF equals 12.5 percent of General Fund revenues. This measure would limit the circumstances under which reserve contributions could be suspended or reduced.
- Shift half of the annual BSF contribution to one of two newly created accounts that would be dedicated to restoration of education funding levels and/or debt service and capital outlay, under specified circumstances. This provision would effectively double the contributions needed to reach the maximum balance in the BSF and would reduce the amount that is available to balance the budget in bad budget years.
- Limit the use of funds in the BSF in bad budget years to the difference between revenues and the prior year's spending level adjusted by the Consumer Price Index and population growth. This provision would have the effect of preventing the use of the reserve to bring spending up to "baseline" levels if the baseline is greater than the prior year's spending adjusted for inflation and population growth.
- Establish a complicated formula – using a statistical technique known as linear regression – to calculate a "revenue forecast amount" that would then be used to determine what, if any, portion of General Fund revenues should be considered "unanticipated revenues." Unanticipated revenues would be defined as the lesser of the difference between estimated revenue collections and the "revenue forecast amount" or the difference between estimated revenue collections and the prior year's spending adjusted by population growth and inflation. Unanticipated revenues either would be shifted to the BSF or, under certain circumstances, could be used to fulfill certain outstanding obligations.

Tax Cuts Will Worsen Future Budget Gaps

The final budget agreement includes four significant tax breaks that together will reduce revenues by more than \$2.5 billion over a five-year period from 2008-09 through 2012-13. Three of these provisions would be temporary; the fourth, which results in the largest revenue loss, would be permanent. Specifically, these provisions would:

- Create a tax credit of \$3,000 for each additional full-time equivalent increase in employment for businesses with 20 or fewer employees in the prior year. This provision would be in effect in tax years beginning on or after January 1, 2009 and would remain in effect until the total amount of credits claimed reaches \$400 million. Past experience suggests that such credits do not lead to new employment and that they are subject to considerable abuse. A similar proposal was dropped from the federal economic recovery plan in response to concerns over cost and lack of effectiveness.
- Provide \$100 million per year for five years – 2009-10 through 2013-14 – for a new tax credit for movie and television production activities.
- Provide a tax credit to individuals who purchase newly constructed homes. The credit would be equal to the lesser of \$10,000 or 5 percent of the purchase price. The credit could be used only for homes that have never

been occupied, that will serve as a buyer's principal residence for at least two years, and that are purchased between March 1, 2009 and February 28, 2010. This provision would cost up to \$100 million in lost revenues over a three-year period from 2009-10 to 2011-12.

- Give multi-state corporations the option to choose between two different formulas for determining how much of their income would be subject to tax in California. This provision would be in effect in tax years beginning on or after January 1, 2011 and would cost \$650 million in the first full year of implementation, eventually increasing to \$1.5 billion annually. This provision provides no benefit to small businesses that only operate in California.

Final Budget Agreement Includes \$11.1 Billion in New Tax Revenues

The final budget agreement would raise \$11.1 billion in new tax revenues. The new taxes would be in effect for three to four years if voters approve proposed changes to the state's budget reserve and limits on state spending, which the Legislature would put on the ballot as part of the budget package. If voters reject the spending cap, the new taxes would be in effect for two years. Specifically, the final agreement:

- Increases the state sales tax rate by 1 percentage point, raising an estimated \$1.203 billion in 2008-09 and \$4.553 billion in 2009-10. This provision would be in effect from April 1, 2009 through June 30, 2012 if voters approve the proposed spending cap; otherwise, this provision would expire on June 30, 2011.
- Increases the Vehicle License Fee (VLF) rate from 0.65 percent to 1.15 percent, except for large commercial vehicles, raising \$375 million in 2008-09 and \$1.722 billion in 2009-10. A portion of the increased revenues from this provision would be used to fund local law enforcement programs. This provision would be in effect from May 19, 2009 through June 30, 2013 if voters approve the proposed spending cap; otherwise, this provision would expire on June 30, 2011.
- Increase each of the state's personal income tax rates by an additional 0.125 percentage points, raising an estimated \$1.829 billion in 2009-10. The higher rates would apply in tax years 2009 through 2012 if voters approve the proposed spending limit, or for tax years 2009 through 2010 if voters reject the spending cap.
- Reduces the size of the dependent credit claimed by personal income taxpayers to the same level as the personal credit, raising an estimated \$1.440 billion in 2009-10. This provision would be in effect for tax years 2009 through 2012 if voters approve the proposed spending limit, or for tax years 2009 through 2010 if voters reject the spending cap.

Final Budget Agreement Includes \$14.1 Billion in Spending Cuts

The final budget agreement identifies the following major reductions:

- A total 2008-09 funding level of \$50.7 billion for K-14 programs covered by the Proposition 98 guarantee, \$7.4 billion (12.7 percent) lower than the level assumed by the 2008-09 Budget Act.
- Reduces 2009-10 funding by \$3.7 billion (6.3 percent) for K-14 programs covered by the Proposition 98 guarantee compared to the minimum funding level that the Governor assumed would be required with no reductions to 2008-09 spending.
- Reduces revenue limit payments and establishes a 7.8 percent deficit factor for both school district and county office of education revenue limit funding in 2008-09. The final budget agreement reduces revenue limit payments and establishes a 13.1 percent deficit factor for school districts and a 13.4 percent deficit factor for county offices of education in 2009-10. A deficit factor is the difference between revenue limit payments to school districts and county offices of education and the revenue limit funding level specified by state law.

- Uses \$618.7 million in Public Transportation Account and Mass Transportation Fund monies to pay for Home-to-School Transportation. In effect, this reduces the General Fund's obligation under the Proposition 98 guarantee by an identical amount.
- Eliminates \$100 million in funding for school facility emergency repairs in 2009-10. This amount is owed as a result of the settlement agreement in Williams v. California.
- Reduces funding for categorical programs by approximately 15 percent "across the board." The cuts would not apply to Special Education, Economic Impact Aid, K-3 Class Size Reduction, school lunch programs, the After School Education and Safety Program, the Quality Education Investment Act, Child Development Programs, and Home-to-School Transportation.
- Authorizes the transfer of funding among many categorical programs that are cut to a district's or county office of education's general fund through 2012-13. The transfer authorization does not apply to 11 categorical programs including instructional materials and the Targeted Instructional Improvement Grant.
- Diverts state and county First 5 funds to support state health and human services programs for children for state savings of \$608.0 million in 2009-10 and annual savings of \$268.0 million thereafter. This fund shift would require voter approval and would remain in effect through 2013-14.
- Diverts funds raised by Proposition 63 of 2004 to support the Early and Periodic Screening, Diagnosis and Treatment (EPSDT) Program for state savings of \$226.7 million in 2009-10 and up to \$234.0 million in 2010-11. This fund shift would require voter approval and remain in effect through 2010-11.
- Does not pass through – beginning May 1, 2009 – the 2009 federal SSI COLA in the SSI/SSP Program for state savings of \$79.8 million in 2008-09 and \$487.3 million in 2009-10. This change would reduce the maximum monthly grant for an individual recipient from the current \$907 to \$870. The final budget agreement also would suspend the June 2010 state COLA in the SSI/SSP Program for one-month savings of \$27.0 million in 2009-10 and annual savings of more than \$300 million beginning in 2010-11.
- Suspends the July 2009 COLA for CalWORKs grants for savings of \$79.1 million in 2009-10 and suspends funding for the Pay for Performance Program for additional savings of \$40.0 million in 2009-10. This program was intended to provide additional funding to counties that achieve certain CalWORKs outcomes; however, funds have not been provided since the program was created in 2005-06.
- Cuts Regional Center service provider payments by 3 percent, beginning on February 1, 2009, for savings of \$24.6 million in 2008-09 and \$60.2 million in 2009-10, and further reduces these payments by 7.1 percent, beginning on September 1, 2009, for additional savings of \$100.0 million in 2009-10. The latter cut would take effect only if the state does not enact – by September 1, 2009 – Regional Center cost-containment measures that achieve General Fund savings of \$100 million in 2009-10.
- Suspends the July 2009 COLA for county operation of the Medi-Cal Program for savings of \$24.7 million in 2009-10.
- Delays a child-support automation project for savings of \$36.1 million in 2009-10.
- Reduces support for the University of California (UC), California State University (CSU), and Hastings College of Law by a total of \$264.4 million – \$132.2 million in 2008-09 and \$132.2 million in 2009-10.
- Cuts \$427.6 million in 2009-10 relative to the level of support for the UC and CSU outlined in the Higher Education Compact.
- Does not provide the UC with \$20 million to reinstate employer contributions to staff retirement plans.
- Changes state employee compensation and overtime policies for savings of \$385.8 million in 2008-09 and \$1.0 billion in 2009-10.
- Reduces funding by \$6.5 million in 2008-09 and by \$32.0 million in 2009-10 for property tax assistance for seniors and blind or disabled Californians available through the Senior Citizens' Property Tax Deferral Program.
- Continues "one-time" reductions and fund shifts for the judicial branch for savings of \$109.3 million in 2009-10.
- Eliminates COLAs for trial courts and the state judiciary for savings of \$36.7 million in 2009-10.
- Eliminates the price increase for state agencies per the current projection of 0.4 percent inflation for savings of \$136.0 million in 2009-10.

- Reduces by 10 percent support for the federal-court-appointed receiver's inmate medical services budget for savings of \$181.2 million in 2009-10.
- Delays the implementation of the Guardianship and Conservatorship Reform Act of 2006 for savings of \$17.4 million.
- Diverts tribal gaming revenues from transportation to the General Fund for savings of \$100.8 million in each of 2008-09 and 2009-10.
- Reduces state funding for local transit agencies by \$153.2 million in 2008-09 and \$306.4 million in 2009-10.
- Authorizes the Director of Finance to redirect approximately \$250 million in 2008-09 and \$1.8 billion in 2009-10 from the Transportation Debt Service Fund to the General Fund for transportation-related general obligation debt.

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

Additional cuts totaling \$947.4 million and an additional tax increase of \$1.829 billion would be triggered if California does not receive at least \$10 billion in funds that can offset state General Fund expenditures from the federal economic recovery package. If federal funding does not meet the threshold, the budget agreement would require the state to:

- Increase each of the state's personal income tax rates by an additional 0.125 percentage points, raising an additional estimated \$1.829 billion in 2009-10. This would result in a total increase in personal income tax rates by 0.25 percentage points.
- Reduce SSI/SSP grants by 2.3 percent for a cut of \$268 million. Individual recipients would lose an additional \$20 per month and couples would lose an additional \$35 per month.
- Eliminate certain Medi-Cal optional benefits and reduce reimbursement rates for public hospitals by 10 percent for savings of \$183 million.
- Reduce CalWORKs grants by 4 percent for a cut of \$147 million.
- Cap the state's contribution toward the wages of In-Home Supportive Services (IHSS) workers at \$9.50 per hour plus \$0.60 for benefits and require some IHSS recipients to pay a larger share of the cost of the services they receive for combined savings of \$78 million.
- Reduce funding for the UC and CSU combined by an additional \$100 million.
- Impose an unallocated reduction of \$100 million on the trial courts.
- Reject a proposal to add 100 judges, for savings of \$71.4 million.

Controller Is Delaying State Payments to Counties — Final Budget Agreement Delays More

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

The Budget Bill and Accompanying Changes

- SBX3 1: 2009-10 Budget Bill
- SBX3 2: Changes to 2008-09 Budget Bill
- SBX2 3: Revisions to the Carl Moyer Memorial Air Quality Standards Attainment Program
- ABX3 3: Tax increases
- SBX2 4: Government Code revisions regarding design-build projects
- SBX3 4: Education
- ABX2 5: Limited flexible schedules
- ABX3 5: Health
- SB 6: Implementing language for a vote on an "open primary" constitutional amendment
- SBX3 6: Human services
- SBX2 7: Foreclosures
- SBX3 7: Transportation
- ABX2 8: California Environmental Quality Act: permitting, surplus property, engine retrofit
- SBX3 8: General Government, including changes to state employee compensation and establishment of a "trigger" regarding receipt of federal funds
- SBX2 9: Prevailing wage, labor compliance
- SBX2 10: Pass-through of increased vehicle license fees by car rental companies
- SBX3 10: Redirection of certain Proposition 63 funding to the Early and Periodic Screening, Diagnosis and Treatment Program
- SBX2 11: Judicial benefits status quo
- ABX3 11: Statewide special election on May 19, 2009 regarding a budget reserve and limits on state spending, education finance, the California State Lottery, redirection of Proposition 10 funds, and redirection of Proposition 63 funds
- SBX2 12: Courthouse construction continuing appropriation
- ABX3 12: Lottery modifications
- ABX3 13: Cash management
- SBX3 14: AB 900 regarding prison construction and financing
- SBX2 15: Homebuyer tax credit for new construction
- SBX3 15: Tax cuts, including a tax credit for motion picture production, single-sales-factor apportionment for corporate taxes, and a tax credit for new hires
- SBX2 16: Horse racing fairs and licensing fees
- ABX3 16: Budget adjustments to be "triggered" if California receives certain federal funds
- ABX3 17: Redirection of certain monies from Proposition 10's First 5 state and county funds to the General Fund
- SBX3 19: Addition of SCA 8 regarding state officer pay increases in deficit years to the May 19, 2009 special election
- SBX3 20: Deletion of \$1 million in funding for furniture for the State Controller
- ACAX3 1: Establishment of a state budget spending cap
- ACAX3 2: Supplementary Proposition 98 funding
- SCA 4: "Open primaries" for state and congressional elections
- SCA 8: No pay increase for governor, legislators, or other state officers in deficit years