



California Spending Plan 2008-09

The Budget Act and Related Legislation

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Chapter 1

Key Features of the 2008-09 Budget

The state’s already difficult budget situation was made worse this year by a significant drop in revenues due to a sluggish economy. The enacted budget, combined with special session actions in February 2008, contains about \$24 billion in solutions and projects a General Fund reserve of \$1.7 billion. As described in more detail below, this large gap primarily was closed through numerous one-time revenue solutions and the lack of inflationary adjustments for many state spending programs. Unfortunately, the nation’s worsening economic troubles have already threatened the budget plan’s viability.

BUDGET OVERVIEW

Total State Spending

The state spending plan for 2008-09 includes total budget expenditures of \$131.6 billion. This includes \$103.4 billion from the General Fund and \$28.2 billion from special funds. As Figure 1 shows, total state spending declines slightly by \$511 million from 2007-08 (0.4 percent). Bond fund spending is expected to increase by 1.3 percent, as the state continues to allocate funds from the \$43 billion bond package approved at the November 2006 election.

Figure 1
2008-09 Budget Package
Total State Expenditures

(Dollars in Millions)

Fund Type	Actual 2006-07	Estimated 2007-08	Enacted 2008-09	Change From 2007-08	
				Amount	Percent
General Fund	\$101,413	\$103,333	\$103,401	\$68	0.1%
Special funds	22,554	28,767	28,188	-578	-2.0
Budget Totals	\$123,967	\$132,100	\$131,589	-\$511	-0.4%
Selected bond funds	6,001	12,736	12,900	164	1.3
Totals	\$129,968	\$144,836	\$144,489	-\$347	-0.2%

The General Fund Condition

Figure 2 summarizes the estimated General Fund condition for 2007-08 and 2008-09 under the budget plan.

2007-08. The figure shows that 2007-08 began the year with a fund balance of \$4.8 billion. Three major budgetary solutions adopted this year push 2007-08 revenues \$5 billion higher than they otherwise would be:

- The issuance of an additional \$3.3 billion in deficit-financing bonds (also known as economy recovery bonds, or ERBs). These bonds are paid back from the “triple flip” financing mechanism and transfers from the Budget Stabilization Account (BSA).
- The adoption of new penalties on corporations for underpayment of taxes. Most of the new penalties (\$1.4 billion) will be accrued to 2007-08.
- As a result of a change in state accounting practices, the accrual of \$0.4 billion in revenues to 2007-08.

Figure 2
2008-09 Budget
General Fund Condition

(Dollars in Millions)

	2007-08	2008-09	
		Amount	Percent Change
Prior-year fund balance	\$4,777	\$3,999	
Revenues and transfers ^a	102,555	101,991	-0.5%
Total resources available	\$107,332	\$105,990	
Expenditures	\$103,333	\$103,401	0.1%
Ending fund balance	\$3,999	\$2,589	
Encumbrances	885	885	
Reserve	\$3,113	\$1,703	
Budget Stabilization Account (BSA)	—	—	
Special Fund for Economic Uncertainties	\$3,113	\$1,703	

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

Despite these revenue changes, the state spent almost \$800 million more during 2007-08 than it received.

2008-09. The budget plan projects revenues of \$102 billion in 2008-09, a decrease of 0.5 percent from 2007-08. The plan authorizes expenditures of \$103.4 billion, an increase of 0.1 percent. Under the plan, the state has a projected reserve of \$1.7 billion and will spend \$1.4 billion more than it is projected to receive.

Programmatic Features of the 2008-09 Budget

Figure 3 (see next page) outlines the major pieces of the state's \$24 billion in solutions adopted in response to its major budget shortfall.

Revenue-Related Solutions. The key revenue solutions include:

- **Borrowing.** As noted above, the state sold an additional \$3.3 billion in ERBs during the spring of 2008. This sale exhausts the state's \$15 billion in authority provided by the voters through Proposition 57 in 2004. In addition, the budget plan borrows \$648 million from various state special funds. These funds are generally not expected to be paid back to special funds until 2010-11 or later. This special fund borrowing is in addition to the \$750 million in outstanding special fund loans from prior years. As shown in Figure 4 (see page 5), the state began the year with more than \$18 billion in outstanding budgetary borrowing—requiring more than \$2 billion in repayments during the budget year.
- **Timing Changes on Tax Payments.** The budget package accelerates the timing of two types of tax payments—estimated payments and limited liability company fee payments. Combined, these changes are expected to increase 2008-09 revenues by \$2.7 billion.
- **Revenue Accrual.** The budget package changes the state's accounting practices to accrue about \$1.9 billion earlier than otherwise would be the case. This is a "paper change" and does not alter the amounts or timing of any tax payments.
- **Corporation Penalties.** The budget anticipates \$1.5 billion in increased revenues resulting from new penalties on corporations for underpayment of taxes.
- **Net Operating Loss (NOL) Provisions.** The budget suspends the use of NOL deductions for two years for larger companies while providing more benefits to businesses in future years.

Figure 3

2008-09 Budget Plan Includes \$24 Billion in Solutions

Special Session and Budget Act (2007-08 and 2008-09, In Millions)

Revenue-Related

Sale of additional deficit-financing bonds	\$3,313
Accelerated estimated payments	2,305
Revenue accrual	1,856
Corporation penalties	1,510
Net operating loss suspension and carryback	1,190
Tax credit limitations	690
Special fund loans	648
Move limited liability companies payment forward	360
Tax gap enforcement enhancements	205
Special fund transfers	152
Red Hawk Casino compact revenues	38
Use tax on vehicles and vessels	16
Other	308
Subtotal, Revenue-Related	<u>(\$12,591)</u>

Spending-Related

Proposition 98	
Reduce 2007-08 spending	\$507
Provide only 0.68 percent COLA	2,845
Higher property tax estimate	600
Redevelopment funds shift offset	350
Defer settle-up payment	150
Capture redevelopment pass-throughs	98
Suspend Budget Stabilization Account transfer	1,509
Redirect transportation funds to the General Fund ^a	819
Provide no funding for pay raise for correctional officers	521
Reduce UC/CSU (unallocated)	373
Assume savings from July executive order on personnel	340
Reduction of Medi-Cal provider rates	291
Suspend SSI/SSP COLAs	288
Adopt regional center cost containment measures	241
Veto of senior tax relief funding	191
Delay of Medi-Cal checkwrite	165
Suspend CalWORKs COLA	162
Delay of new judges	93
Use of court reserve funds	92
Defer mandates repayment	75
Shift payment schedule for mandate claims	75
CalSTRS supplemental benefit account package	66
Cash management package	60
Reduce county funding for Medi-Cal administration	53
Unallocated reductions	50
All others	1,366
Subtotal, Spending-Related	<u>(\$11,380)</u>

Total Solutions

\$23,971

^a Amount above current law.

- **Tax Credit Limitations.** The budget plan restricts for larger companies the use of specified business-related tax credits in 2008 and 2009, resulting in an estimated increase of \$690 million in 2008-09.

Spending-Related Solutions. The key spending-related solutions include:

- **Proposition 98.** The budget provides a 0.68 percent cost-of-living adjustment (COLA) to K-14 programs—substantially below the 5.66 percent level that otherwise would be required under state law.
- **BSA Transfer.** The Governor issued an executive order to suspend the annual transfer to the BSA. Consequently, a \$1.5 billion supplemental debt-service payment for outstanding ERBs will not be made this year.

Figure 4
Budgetary Borrowing and the 2008-09 Budget

(In Millions)

	Estimated Outstanding Borrowing ^a	2008-09 Budgeted Payment
Resources		
<i>Paterno</i> lawsuit financing	\$278	\$62
Transportation		
Proposition 42 loan	\$662	\$83
Tribal gambling bond-related loan	871	100
Education		
Settle-up	\$1,101 ^b	—
Quality Education Investment Act	2,514	\$450
Mandates		
Noneducation	\$970	—
Special Funds		
Various loans	\$1,397	\$32
Economic Recovery Bonds		
Triple Flip	\$10,465	\$1,440
Budget Stabilization Account		—
Surplus property sales		30
Totals	\$18,258	\$2,197

^a At time of budget enactment.

^b Reflects settle-up obligation for 2002-03 and 2003-04.

- **Transportation.** The budget uses \$1.7 billion in transportation funds to reduce General Fund expenditures. This is about \$800 million more than would have been used to benefit the General Fund under the 2007-08 budget agreement.
- **State Employee Pay.** Most state employees (other than highway patrol officers and engineers) are not budgeted for COLAs this year. The Legislature rejected funding (over a two-year period) for a correctional officer pay increase proposed as part of the administration's compensation offer.
- **Social Services COLAs.** The budget plan suspends scheduled state-supported COLAs for both Supplemental Security Income/State Supplementary Payment (SSI/SSP) and California Work Opportunity and Responsibility to Kids (CalWORKs) recipients.
- **Other Reductions.** In other areas, the budget includes many of the budget-balancing reductions (BBRs)—generally 10 percent of program funding—originally proposed as part of the Governor's January budget.

Ballot-Related Measures. The Legislature passed a series of measures to be placed before the state's voters pertaining to the state lottery and budget practices. It is expected that a special election will be called for the first part of 2009 to vote on these propositions. The lottery proposition would provide the Lottery Commission with increased flexibility to set prize payouts. In addition, the state would be authorized to borrow billions of dollars in future lottery profits to benefit the General Fund in the near term. The budget reform package would increase payments to the BSA, further restrict when funds can be taken out of the BSA, and provide the Governor with enhanced authority to make spending reductions during the fiscal year.

General Fund Spending by Program Area. Figure 5 shows General Fund spending by major program for 2006-07 through 2008-09. These amounts do not include other sources of funding, such as state special, local, or federal funds. For instance, K-12 education excludes funding provided by local property taxes. In addition, year-to-year changes in spending are significantly affected by a variety of one-time factors. For example, resources spending as budgeted is expected to drop in the budget year, due to extraordinary firefighting costs in 2007-08. (However, the actual firefighting costs in 2008-09 are uncertain and could be considerably higher than budgeted.) Spending in the "other" category will drop by more than \$2 billion. About one-half of this drop is due to the state not making a supplemental debt-service payment on outstanding ERBs through the BSA in 2008-09. Much of the redirection

of transportation dollars to benefit the General Fund is also reflected in this category as a negative expenditure. Finally, General Fund spending on social services is growing at 8.1 percent, due primarily to funding shifts and federal requirements in the CalWORKs program.

General Fund Spending Over Time

Figure 6 (see next page) shows General Fund expenditures from 1998-99 through 2008-09 both in current dollars and as adjusted for population and inflation (that is, in real per capita terms). The figure illustrates that after growing rapidly in the late 1990s, real per capita spending fell significantly throughout the first part of the 2000s before rebounding through 2006-07. For 2008-09, real per capita spending is projected to be at the same level as it was in 1998-99.

Out-Year Impacts of the 2008-09 Budget

As described above, many of the budget solutions are of a one-time nature. Based on the 2008-09 budget plan's policies, therefore, the state would once again face multibillion dollar operating shortfalls in the coming years. A key piece of the budget plan is the lottery proposal to ask voters to authorize the borrowing of billions of dollars in future lottery profits. Currently, the plan envisions borrowing \$5 billion in each of the next two fiscal years to help balance the budget. The magnitude of additional solutions that will be necessary to balance upcoming budgets will largely depend on the health of the state's economy and tax revenues. We will be updating our fiscal projec-

Figure 5
2008-09 Budget Package
General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 2006-07	Estimated 2007-08	Enacted 2008-09	Change From 2007-08	
				Amount	Percent
K-12 Education	\$39,255	\$39,485	\$40,018	\$534	1.4%
Higher Education	11,190	11,780	12,070	290	2.5
Health	19,235	20,095	20,705	610	3.0
Social Services	9,777	9,631	10,415	784	8.1
Criminal Justice	11,856	13,186	13,221	34	0.3
Transportation	2,980	1,416	1,432	16	1.1
Resources and Environmental Protection	2,054	2,060	1,912	-148	-7.2
All other	5,066	5,679	3,627	-2,053	-36.1
Totals	\$101,413	\$103,333	\$103,401	\$68	0.1%

tions for 2008-09 and future years in November 2008, when we release our annual *California's Fiscal Outlook*.

EVOLUTION OF THE BUDGET

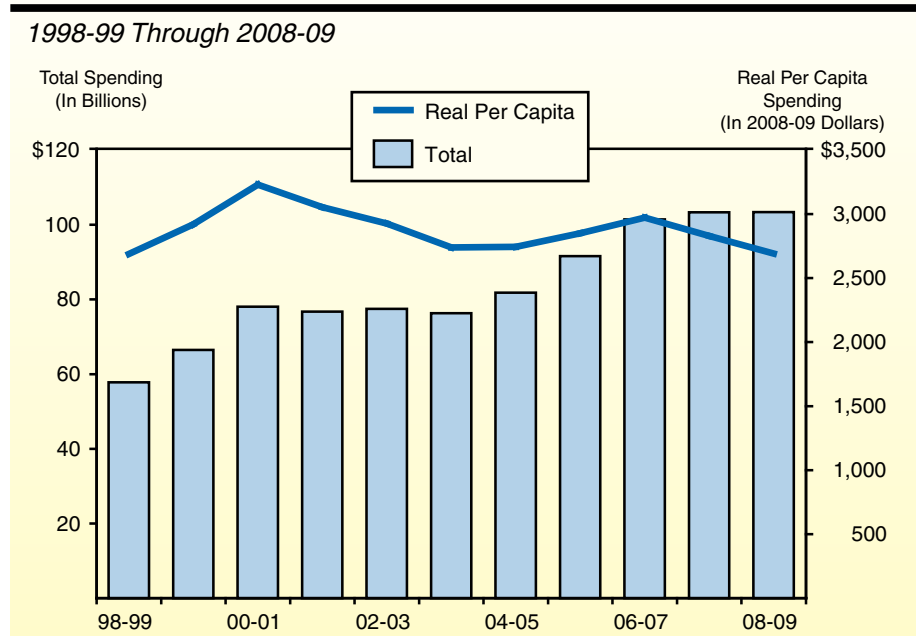
In this section, we highlight the major developments in the evolution of the 2008-09 budget, beginning with the Governor's original January budget proposal and ending in September 2008, when the budget was signed into law.

Governor's January Proposal

At the time of the 2007-08 budget's passage, it was expected that the state's persistent gap between revenues and expenditures would reemerge for 2008-09 in an amount of at least \$5 billion. By the time the Governor proposed his 2008-09 budget in January, however, that projected shortfall had grown to \$14.5 billion due to continued softness in the state's economy, delays in several 2007-08 budget solutions, and rising costs in some programs. As a result of the bleak budget outlook, the Governor declared a fiscal emergency under the State Constitution and called the Legislature into special session.

Major Proposals. The Governor's January budget proposed \$17 billion in 2007-08 and 2008-09 solutions, with a projected reserve of \$2.8 billion. Figure 7 summarizes the administration's major proposals from January. The largest components were:

Figure 6
General Fund Spending Over Time



- Raising \$3.3 billion from issuing additional ERBs.
- Changing the state’s accrual practices to count \$2 billion in 2009-10 revenues in 2008-09.
- Suspending the \$1.5 billion 2008-09 BSA transfer.
- Suspending the Proposition 98 minimum guarantee for 2008-09.
- Reducing most programs’ spending by 10 percent in an across-the-board manner. These reductions were known as BBRs.

The administration also expressed concern about the state’s ability to meet its *cash* demands. The administration proposed special session legislation to delay the timing of a series of state payments. Specifically, the administration proposed to shift \$4.7 billion from July and August 2008 to later months to increase the state’s cash-on-hand prior to the state’s issuance of revenue anticipation notes (the state’s typical external cash flow borrowing within a fiscal year).

Budget Reform. The Governor also proposed putting a constitutional amendment before the state’s voters related to the state’s budgeting practices. The measure would have limited the amount of revenues that the General Fund could receive in any year to the average revenue growth rate from the past decade. Any excess revenues were to be put into a new state reserve and could

Figure 7
January Budget—\$17 Billion in Proposed Solutions

(In Millions)

Reduce Proposition 98 spending	
2007-08 reduction	\$400
Suspend 2008-09 minimum guarantee	4,825
Issue additional deficit-financing bonds	3,313
Accrue 2009-10 revenues to 2008-09	2,001
Suspend transfer to Budget Stabilization Account	1,509
Reduce Medi-Cal spending	1,126
UC/CSU reductions (unallocated)	569
CalWORKs reforms	463
Early release of prisoners and summary parole	372
Suspend SSI/SSP COLAs	323
Other solutions	2,356
Total Solutions	\$17,257

not be accessed unless a year's revenues were below the ten-year average. In addition, the Governor proposed a system of automatic across-the-board reductions if the state's budget situation declined after a budget's passage.

Special Session

In February, the Legislature adopted a package of more than \$7 billion in solutions which brought the 2007-08 budget back into balance and began the process of balancing the 2008-09 budget. Figure 8 lists the solutions that were adopted. (Some solutions later were amended by actions taken with the passage of the *2008-09 Budget Act*.) More than \$6 billion of the adopted solutions were one-time in nature and, therefore, did not address the state's ongoing shortfall between revenues and expenditures. The Legislature also adopted the administration's proposed cash management solutions with some modifications, including making the shifts effective for 2008-09 only (rather than ongoing as originally proposed).

May Revision

Worsening Budget Outlook. Between January and May, the administration's view of the budget outlook worsened by \$8 billion, as a result of:

Figure 8

Special Session Actions

*2007-08 and 2008-09 Savings
(In Millions)*

Sale of additional deficit-financing bonds	\$3,313
Suspension of Budget Stabilization Account transfer	1,509
Reduction of Medi-Cal provider rates	508
Reduction in current-year Proposition 98 spending	507
Public Transportation Account reimbursement to the General Fund ^a	409
Regional center cost containment measures	229
Higher tideland oil revenue estimate	218
Delay of Medi-Cal checkwrite	165
Delay of SSI/SSP cost-of-living adjustment (COLA)	91
Delay of new judges	76
Shift payment schedule for mandate claims	75
Delay of CalWORKs COLA	42
Elimination of CalWORKs performance incentives	40
Recognition of CDCR program delays	40
Shift of parks maintenance to bond funds	30
Other	201
Total	\$7,452

^a The administration excludes this issue from both its problem and solution definition.

- A further deterioration of the economic and revenue outlook for 2008-09 (\$6 billion).
- Rising state expenditures in a number of state programs (\$1.7 billion).

In addition, in January, the administration assumed that many of its proposals would be adopted by March 1, 2008. For proposals which had not been adopted by the Legislature, the administration revised its savings estimates in May down by \$0.5 billion, assuming implementation by July 1, 2008. The May Revision also reversed several key January proposals. In May, the administration proposed \$1.1 billion in higher Proposition 98 spending and \$196 million in higher university spending compared to January. In addition, the administration dropped its proposals for the early release of state prisoners and the closure of 48 state parks. These developments also added to the budget problem, but were offset in part by some program savings.

New Solutions. As a result of these changes, the administration proposed more than \$8 billion in new solutions, which are summarized in Figure 9. By far the largest proposal was the sale of \$5 billion in lottery bonds which were to be paid back from future lottery profits. The administration proposed placing the lottery proposal on the November 2008 ballot. If the ballot measure failed, a one cent sales tax increase would have gone into effect. With these proposals, the May Revision had a projected reserve of \$2 billion.

Figure 9
May Revision—\$8 Billion in New Solutions Proposed

(In Millions)

Sell lottery bonds	\$5,122
Expand use of transportation funds to benefit General Fund	828
Special fund loans	564
Reduce funding for correctional officers pay offer	421
CalWORKs grant reductions and policy changes	370
Accelerate limited liability company fee payment	360
Reduce IHSS state participation to minimum wage	187
Eliminate Cash Assistance Program for Immigrants	111
Do not pass through federal SSI cost-of-living adjustment	109
Reduce health services for newly qualified immigrants	87
Defer mandates repayment	75
Other (net)	221
Total	\$8,455

Conference Committee

Following the May Revision, the Senate and Assembly took actions on the administration's revised proposals, and the budget was sent to the Conference Committee to reconcile the differences between the houses. The adopted Conference Committee version of the budget on July 8 had a projected reserve of \$1.4 billion and substantially differed from the May Revision. Specifically, it:

- Included a \$10 billion tax revenue package, including imposing 10 percent and 11 percent income tax brackets, raising the corporation tax rate, implementing a tax amnesty program, suspending NOL provisions for companies, suspending personal income tax indexing for inflation, and eliminating the dependent credit for high-income taxpayers.
- Proposed spending totaling more than \$3 billion higher than the May Revision, including \$2.2 billion more for Proposition 98 K-14 education (providing a 2.12 percent COLA).
- Rejected most of the administration's proposed reductions in health and social services.
- Provided \$600 million in alternative savings in criminal justice, through a package of inmate and parole population reductions and local public safety subvention reductions.
- Did not include revenue accrual, lottery, or budget reform proposals.

August Revision/Compromise

After the close of the Conference Committee, the Governor and the Legislature continued budget negotiations through July and August. On July 31, the Governor issued an executive order aimed at reducing state spending by paying state workers only minimum wage during the budget impasse (currently being challenged in court by the State Controller) and restricting the use of retired annuitant, temporary, and permanent intermittent employees. On August 20, the Governor released an "August Compromise" document which proposed a budget package that started with the Conference Committee version of the budget and made some key modifications. The August Compromise:

- Replaced most of the tax revenue provisions included in the Conference version of the budget. It instead included a one cent increase in the sales tax rate for three years, followed by a permanent one-quarter

cent reduction. It also included a smaller tax amnesty program, modified the NOL suspension, and included a revenue accrual proposal similar to the January budget.

- Provided no COLA for Proposition 98 programs.
- Included a smaller package of prison population reductions.
- Proposed a lottery securitization proposal that would not yield a General Fund benefit until 2009-10.
- Proposed a budget reform package that focused on increasing transfers into the BSA, limiting transfers out of the BSA, and increasing executive authority to make midyear reductions.

The August Compromise had a reserve of \$1.1 billion.

Final Budget

On the night of September 15, the Senate and Assembly passed a budget and sent it to the Governor. Key components were rejection of tax rate increases, replaced by a number of one-time revenue increases, and the final budget also included: (1) increased Proposition 98 spending to allow a COLA of 0.68 percent, (2) increased redevelopment pass-through payments to benefit the state by offsetting General Fund support, (3) redirection of transportation funds to benefit the General Fund, and (4) no prison or parolee population changes.

The Governor threatened to veto this budget plan. After further negotiations, the Legislature made two key modifications to its budget. First it replaced PIT withholding changes with increased penalties on corporations for underpayment of taxes owed. Second it modified the budget reform proposal to make it more difficult to transfer funds out of the BSA.

After making \$510 million in General Fund vetoes, the Governor signed this budget package on September 23. The Governor vetoed \$191 million in funding for low-income seniors' tax relief programs, suspending their operation for the budget year. The Governor also vetoed \$22 million from the California Department of Corrections and Rehabilitation budget and directed the department to establish a new parole program designed to divert certain parole violators from prison to community sanctions. In addition, the administration stated that it expects \$340 million in savings from its July executive order. The stated reserve of the enacted budget was \$1.7 billion. Additional details on the enacted budget package are provided throughout this publication.

BUDGET-RELATED LEGISLATION

In addition to the *2008-09 Budget Act*, the budget package includes a number of related measures enacted to implement and carry out the budget agreement. (A criminal justice bill was not passed by the Legislature as part of the budget.) The Legislature also passed a package of legislation in February 2008 during the budget special session to help bring the 2007-08 budget back into balance. Figure 10 lists these bills.

Figure 10
2008-09 Budget and Budget-Related Legislation

Bill Number	Chapter	Author	Subject
Special Session			
ABX3 3	1	Budget Committee	2007-08 budget amendments
ABX3 4	2	Budget Committee	Education
ABX3 5	3	Budget Committee	Health
ABX3 6	4	Budget Committee	Human services
ABX3 7	5	Budget Committee	Transportation
ABX3 8	6	Budget Committee	General government
Budget Package			
AB 1781	268	Budget Committee	Budget bill (conference report)
AB 88	269	Budget Committee	Budget bill revisions
AB 10	753	Budget Committee	Overtime pay
AB 158	754	Torricono	Indian Gaming Special Distribution Fund
AB 186	755	Maze	Central Valley Rural Crime Prevention Program
AB 268	756	Budget Committee	Transportation
AB 519	757	Budget Committee	Education
AB 1183	758	Budget Committee	Health
AB 1279	759	Budget Committee	Human services
AB 1338	760	Budget Committee	Resources
AB 1389	751	Budget Committee	General government
AB 1452	763	Budget Committee	Revenues
AB 1526	Vetoed	Budget Committee	Proposition 49/after school programs
AB 1654	Pending	Budget Committee	Lottery changes
AB 1741	Pending	Budget Committee	Lottery securitization
AB 1805	Vetoed	Budget Committee	Emotionally disturbed children
AB 2026	761	Villines	State property
AB 2246	762	Villines	Charter schools
AB 2784	Vetoed	La Malfa	Hospital reimbursements
ABX3 36	Vetoed	Laird	Tax withholding
SBX1 28	1	Committee on Budget and Fiscal Review	Tax accelerations and penalties
SCA 12	143	Perata	Lottery constitutional change
SCA 13	144	Ashburn	Budget reform
SCA 30	167	Ashburn	Budget reform amendments

Chapter 2

Tax-Related Provisions

The 2008-09 budget package included a significant number of tax-related changes, although no broad-based tax increases were enacted. These changes contributed \$8 billion to the *2008-09 Budget Act*. The longer-term impact of these provisions, however, is much smaller. In fact, after 2009-10, the net impacts of these changes are expected to reduce state General Fund revenues below what they would have otherwise been.

Figure 1 (see next page) summarizes the major tax-related changes adopted in the *2008-09 Budget Act*. As the figure shows, these revisions result in a combined \$8 billion in additional revenues in 2007-08 (\$1.9 billion) and 2008-09 (\$6.1 billion). In 2009-10, the additional resources generated by these changes falls sharply, bringing in an estimated \$1.6 billion. Then, starting in 2010-11, the net impact of these changes is negative, growing from -\$117 million to -\$427 million in 2011-12 (and greater amounts thereafter).

These revenue effects result from a number of major statutory provisions, which we have grouped into three categories: tax expenditure changes, revenue accelerations, and other changes. We discuss these provisions in more detail below.

Tax Expenditure Programs

As Figure 1 displays, \$1.9 billion in revenues are projected for 2008-09 from reducing or suspending existing tax expenditure programs. Tax expenditure programs are special tax provisions—such as exemptions, deductions, and credits—that attempt to encourage certain types of behavior or target relief to specific groups of people or businesses. The 2008-09 budget package includes changes to two significant tax expenditures: net operating loss (NOL) provisions and business-related credits.

Suspends NOL Deductions. The budget agreement eliminates the NOL deduction for firms with taxable business income over \$500,000. This change, which applies to tax years 2008 and 2009, is estimated to raise \$1.2 billion in

2008-09. Under current law, firms that report a taxable loss in one year can apply the loss as a deduction in a future year in which they turn a profit.

The budget package also *expands* the NOL deduction in two ways. First, it extends the period for which an NOL can be carried forward to 20 years from the current 10 years. Second, the legislation allows firms to “carry back” NOLs for up to two years to retroactively reduce their tax bills from previous years. For example, a firm that turns a profit and initially owes taxes in 2013 but records an NOL in 2014 will be able to file an amended return for 2013 and apply all or part of the 2014 NOL to reduce its 2013 tax bill. The carryback provisions are phased in beginning in 2011.

Limits Business-Related Tax Credits to 50 Percent of Liability. The budget package contains a provision that precludes firms with business income over \$500,000 from using certain tax credits to reduce their taxes by more than 50 percent. This restriction, which applies to tax years 2008 and 2009, is expected to raise \$690 million in 2008-09. Under current law, firms can

Figure 1

**Estimated Effects of the Major Tax-Related Provisions
In the 2008-09 Budget Package**

(In Millions)

	2007-08	2008-09	2009-10	2010-11	2011-12
Tax Expenditures					
Suspends net operating loss provisions for two years		\$1,190	\$660	-\$295	-\$535
Limits business-related credits to one-half of tax liability		690	295	-355	-430
Subtotals, tax expenditures		(\$1,880)	(\$955)	(\$-650)	(\$-965)
Revenue Accelerations					
Accelerates estimated payments		\$1,350	\$255	\$180	\$195
Eliminates “safe harbor” for estimated payments		955	120	55	55
Accelerates payments of limited liability corporations		360	50	50	50
Subtotals, revenue accelerations		(\$2,665)	(\$425)	(\$285)	(\$300)
Other					
Increases penalties for underpaying corporation taxes	\$1,435	\$75	\$45	\$30	\$110
Accrual accounting change	416	1,440	133	218	128
Subtotals, other	(\$1,851)	(\$1,515)	(\$178)	(\$248)	(\$238)
Totals	\$1,851	\$6,060	\$1,558	-\$117	-\$427

use tax credits to eliminate as much of their tax liability in any given year as possible. The two largest business tax credits are for research and development expenses and subsidies provided to businesses operating in special “enterprise zones.”

Similar to the expansion of the NOL deduction, the budget package also expands the value of tax credits in future years. Starting in 2009-10, a firm that is part of a unitary group will be allowed to share its unused credits with other firms in the same unitary group. (Generally speaking, unitary groups allow corporations to be taxed similarly no matter whether they are structured as a single entity with divisions or separate, but closely related, corporations.) Currently, credits must be applied against income earned by the same company. This provision is expected to increase the cost of these business credits by more than \$300 million annually beginning in 2010-11.

Revenue Accelerations

The 2008-09 budget package also includes three provisions that accelerate the collection of existing personal and corporate taxes. These changes generate an estimated \$2.7 billion in 2008-09. Because these measures do not alter the underlying amount of taxes paid by Californians (only their timing), these changes have a much smaller ongoing effect after 2008-09.

Accelerates Estimated Payments. The 2008-09 budget package requires taxpayers to pay a larger proportion of estimated tax payments in the first one-half of the calendar year. Most taxpayers have taxes withheld from their paychecks each pay period. Taxpayers also are required to make estimated payments each quarter when taxes are not withheld (typically, for income such as dividends, capital gains, or self-employed income). The general rule calls for taxpayers to pay 25 percent of their estimated annual liability that is not subject to withholding each quarter (April, June, September, and December). Under the budget agreement, however, starting in 2009, payments in April and June will increase to 30 percent of the annual liability. The September and December payments would fall to 20 percent. By shifting the timing of estimated payments, this provision is estimated to generate an additional \$1.4 billion in 2008-09.

Eliminates the “Safe Harbor” Provision for Estimated Payments. A second change in the budget package results in an increase in the amount of estimated payments high-income individuals are required to make. Under current law, taxpayers face penalties if estimated payments fall below 90 percent of the current year’s liability. One exception to this rule—called the safe harbor rule—waives these penalties if the taxpayer’s estimated payments equal at least 100 percent of the previous year’s liability. The budget pack-

age deletes this safe harbor provision beginning in 2009 for taxpayers with incomes over \$500,000 (\$1 million for married couples filing joint returns). The budget assumes an additional \$1 billion in revenues in 2008-09 due to this timing change.

Accelerates Payments From Limited Liability Companies (LLCs). The third revenue acceleration in the budget package requires LLCs to pay a fee to the state earlier than previously. Current law directs LLCs to pay an income-based fee to the state each year by April 15 (for most companies)—four months after the end of the tax year. The new provision requires most companies to make this payment 11 months earlier—by June 15th, or roughly halfway through the current tax year. This ongoing timing change is estimated to bring in \$360 million in 2008-09 and about \$50 million annually thereafter.

Other Tax Provisions

Alters Accrual Accounting Rules. The budget package redefines the way estimated tax payments are treated in the state accounting rules. Generally, the state operates under an “accrual” accounting system, which requires the state to recognize revenues and expenditures during the fiscal year in which they are realized. To implement this principle, prior law directed state agencies to recognize revenues in a fiscal year if the funds were collected within two months after the close of the fiscal year and if the underlying transaction took place in that fiscal year. The budget agreement deletes the two-month limit. Under the new rule, for example, a tax payment due in January 2010 can be “booked” in fiscal year 2008-09 if the underlying transaction that generated the taxable income took place in fiscal year 2008-09. The budget assumes this change will increase revenues in 2007-08 by \$416 million and in 2008-09 by \$1.4 billion.

Increases Penalty for Underpaying Corporate Income Taxes. The budget package establishes new penalties for significantly underpaying corporate income taxes. Currently, a corporation may be penalized when it fails to pay its full tax liability as required by law. Beginning in 2009, the state will impose a 20 percent penalty for all cases in which underpayment exceeds \$1 million. A firm can avoid the new penalty for tax years 2003 through 2007 if it files an amended return by May 31, 2009. The 2008-09 budget assumes this provision will result in an additional \$1.4 billion in revenues based on the assumption that many firms will take advantage of the penalty amnesty. Because most payments are expected to result from prior-year tax liabilities, the revenues are assigned to the prior fiscal year—2007-08.

OTHER MAJOR PROVISIONS

Tribal Gambling

Tribal Payments to General Fund Projected to Increase. The Legislature has ratified compacts in recent years that allow several tribes to expand their casino operations. Most of these compacts have increased tribes' required payments to the General Fund. The budget package relies on an administration estimate that tribal payments to the General Fund will increase from \$143 million in 2007-08 to about \$485 million in 2008-09. This figure for 2008-09 includes \$38 million from the new Red Hawk Casino in El Dorado County, which is owned by the Shingle Springs Band of Miwok Indians. Chapter 334, Statutes of 2008 (AB 3072, Price), ratifies an amended compact that expands the number of slot machines the tribe is allowed to operate. This amended compact with the Shingle Springs tribe now awaits approval by the U.S. Department of the Interior.

Grants to Non-Casino Tribes Continue to Be Funded From Distribution Fund. Several of the recent compacts ratified by the Legislature eliminated some tribes' payments to the Indian Gaming Special Distribution Fund (SDF). (The SDF is an account that funds casino regulatory activities, the state's problem gambling programs, grants to local governments affected by casino development, and budget shortfalls in another account—the Indian Gaming Revenue Sharing Trust Fund [RSTF]. The RSTF provides \$1.1 million in annual grants to dozens of tribes that have no casino or only a small casino.) The Governor's January budget proposal assumed that the General Fund—rather than the SDF—would cover the approximately \$40 million of costs to cover the RSTF's expected budget shortfall in 2008-09. The May Revision, however, proposed instead that funds from the SDF be appropriated to cover the costs of the RSTF's budget shortfall—thereby saving \$40 million of General Fund resources. The Legislature adopted the May Revision proposal with minor modifications.

Casino Mitigation Grants to Local Governments Will Resume. In 2007, the Governor vetoed a \$30 million appropriation from the SDF for grants to local governments affected by casino development. The Governor cited a Bureau of State Audits (BSA) report that was critical of several aspects of the existing grant distribution methodology. In response, the Legislature enacted Chapter 754, Statutes of 2008 (AB 158, Torrico), which includes provisions to address several of the BSA's findings. Chapter 754 also appropriates \$30 million from the SDF for local government grants in 2008-09 and extends the statutory sunset date on the methodology for distributing the grants from January 1, 2009, to January 1, 2010.

Enhanced Tax Gap Enforcement

The Board of Equalization (BOE) and the Franchise Tax Board (FTB) are among the few state departments for which the budget authorizes major expansions of funding. Each of the two departments will add about 250 new positions over the next two years for enhanced efforts to reduce the difference between owed and remitted taxes—known as the “tax gap.” The budget act assumes \$205 million of additional General Fund revenues in 2008-09 as a result of these tax gap enforcement efforts at a cost of \$28 million. Both costs and revenues are expected to increase in subsequent years.

Under the spending plan, BOE is directed to use the additional resources to improve its filing of tax liens in bankruptcy liquidations, improve use tax collections from California service businesses, and augment sales and use tax audit and collections programs activities. Enhanced tax gap enforcement activities at FTB include increased fraud detection and prevention activities, pursuit of additional audit and collections workloads, review of inactive collections accounts where new asset information is available, mandatory electronic payment of personal income tax payments above a specified dollar threshold, and increased analysis of federal audit findings for unpaid state liability.

Chapter 3

Expenditure Highlights

PROPOSITION 98

Proposition 98 funding constitutes about three-fourths of funding for education (which includes child care, preschool, K-12 schools, and community colleges). In this section, we review major Proposition 98 decisions for 2007-08 and 2008-09 and then identify outstanding Proposition 98 funding obligations. In the following sections, we discuss the K-12 and child care budgets in more detail, and in the “Higher Education” section, we discuss the community college budget in more detail.

Major Funding and Spending Decisions

Below, we recap Proposition 98 spending adjustments made during the special session, explain the effect of revenue changes on the Proposition 98 funding requirement for 2007-08 and 2008-09, and highlight the major Proposition 98 spending decisions for 2008-09.

Recap of Special Session—2007-08 Proposition 98 Spending Adjusted Downward by Approximately \$500 Million. The 2007-08 Budget Act provided \$57.1 billion in ongoing Proposition 98 funding for K-14 education. This funding level was intended to meet the Proposition 98 funding requirement, as estimated at the time the 2007-08 budget was enacted. Subsequently, state General Fund revenues came in lower than anticipated—resulting in a drop of roughly \$1.5 billion in the Proposition 98 funding requirement. In response, the state adjusted Proposition 98 funding downward by \$507 million during the Third Extraordinary Session. Specifically, Chapter 2, Statutes of 2008 (ABX3 4, Committee on Budget), adjusted 2007-08 spending downward by unappropriating a total of \$211 million from various categorical programs that had been determined to be overbudgeted and reducing ongoing monies for Targeted Instructional Improvement Grants (TIIG) by \$295 million. (Chapter 2 also appropriated \$295 million in one-time monies for TIIG, thereby backfilling the loss of ongoing monies and preventing a reduction in the program.)

Final Revenue Package Affects Proposition 98 Minimum Guarantee for 2007-08. As of February 2008, the adjustments made during the Third

Extraordinary Session left Proposition 98 spending for 2007-08 more than \$1 billion above the Proposition 98 funding requirement. However, the final budget package includes components that increase the revenue attributed to 2007-08, thereby raising the Proposition 98 funding requirement such that it roughly matches the special session spending level (\$56.6 billion). Specifically, the final budget package scores \$1.9 billion in additional revenue to 2007-08 (\$0.4 billion related to tax accrual and \$1.4 billion related to increased penalties on corporation tax underpayments). These higher revenue assumptions raise the Proposition 98 minimum guarantee for 2007-08 by about \$950 million (assuming no other changes).

Revenue Package Also Affects Proposition 98 Minimum Guarantee for 2008-09. In addition to the new revenues attributed to 2007-08, the final budget package also assumes new General Fund revenues for 2008-09. As discussed earlier in this report, the budget includes about \$6.1 billion in new tax revenues for 2008-09. Because the Proposition 98 calculation accounts for growth in General Fund revenues, the additional tax revenues increase the Proposition 98 funding requirement by roughly \$3 billion (assuming no other changes). The Proposition 98 funding provided in the *2008-09 Budget Act* is based on these higher revenue assumptions. (Although it has no effect in 2008-09, the final budget package includes a lottery component that would affect Proposition 98 in 2009-10. See the Other Major Provisions section of this report for a description.)

Proposition 98 Funding Increases by About \$1.5 Billion Year to Year. Figure 1 compares Proposition 98 funding in 2007-08 and 2008-09. As shown in the figure, ongoing Proposition 98 funding increases by \$1.5 billion (2.7 percent). The bulk of this increase (\$1.1 billion) is covered with higher local property tax revenues, with less than \$400 million of the increase covered with General Fund monies. (Approximately \$350 million of the growth in local property tax revenues is due to a one-time increase in the revenue that redevelopment agencies must pass through to schools, as discussed in the "General Government" section of this report.)

Most New Proposition 98 Spending Goes to Backfill Ongoing Programs. Not reflected in the figure, however, are several significant spending decisions that affected Proposition 98-funded programs in 2007-08. These include roughly \$1 billion in one-time funds supporting ongoing K-14 programs in 2007-08 and about \$200 million in one-time reductions made during the Third Extraordinary Session. Because most of the \$1.5 billion in new 2008-09 Proposition 98 spending is used to backfill these 2007-08 "holes," the actual amount of Proposition 98 resources available to support new activities in 2008-09 is only about \$300 million, or 0.5 percent. This is discussed in more detail below, as well as in the subsequent "K-12 Education" and "Community College" sections of this report.

