The 2008-09 Budget: Perspectives and Issues

Report From the Legislative Analyst's Office to the Joint Legislative Budget Committee

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TABLE OF CONTENTS

Figures

Part I: State's Fiscal Picture

Part II: Perspectives on the Economy and Demographics

Part III: Perspectives on State Revenues

Part IV: Perspectives on State Expenditures

Part V: Alternative Budget Approach

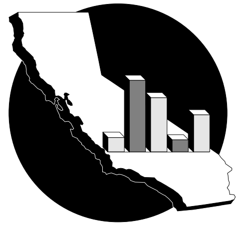
Alternative Budget Overview

LAO Revenue-Raising Proposals

Parole Realignment and the 2008-09 Budget

Alternatives to the Governor's Budgetary Reforms

Expenditure Details of the LAO Alternative Budget



INTRODUCTION

The purpose of this document is to assist the Legislature in setting its priorities and reflecting these priorities in the *2008-09 Budget Bill* and in other legislation. It seeks to accomplish this by (1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for 2008-09 and (2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement the *Analysis of the 2008-09 Budget Bill*, which contains our review of the *2008-09 Governor's Budget*.

The *Analysis* continues to report the results of our detailed examination of state programs and activities. In contrast, this document presents a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the Legislature.

The 2008-09 Budget: Perspectives and Issues is divided into five parts:

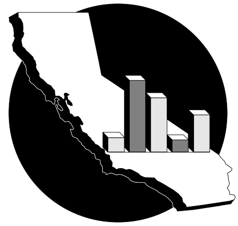
- Part I, "State's Fiscal Picture," provides an overall perspective on the fiscal situation currently facing the Legislature.
- Part II, "Perspectives on the Economy and Demographics," describes the current outlook for the economy and the administration's and our forecasts.
- Part III, "Perspectives on State Revenues," provides a review of the revenue projections in the budget and our own assessment of revenues through 2009-10.
- Part IV, "Perspectives on State Expenditures," provides an overview of the state spending plan for 2008-09.

- Part V, "Alternative Budget Approach," consists of five pieces to assist the Legislature in fashioning a budget that reflects its priorities: (1) "Alternative Budget Overview" describes our alternative's key elements and programmatic features; (2) "LAO Revenue-Raising Proposals" lays out our rationale for reducing or eliminating 12 tax credits and exemptions, and not adopting the administration's revenue accrual proposal; (3) "Parole Realignment and the 2008-09 Budget" describes our proposal to realign parole supervision of low-level criminal offenders from the state to counties, (4) "Alternatives to the Governor's Budgetary Reforms" assesses the Governor's proposal and offers an alternative approach; and (5) "Expenditure Details of the LAO Alternative Budget" lists all of the expenditure-related savings proposals encompassed in our alternative budget.

I

State's Fiscal Picture

State's Fiscal Picture



A declining economic outlook, sagging revenues, and rising costs have created bleak prospects for the state's budget. Over the current and budget years, the Governor identified a gap of $14.5 billion between revenues and expenditures and proposes more than $17 billion in solutions to bring the state's budget back into balance. These budget–balancing actions include the issuance of additional deficit–financing bonds, higher revenue accruals, and budget reductions across most state programs.

LAO Bottom Line. Primarily due to the continued deterioration of the state's revenue outlook, we project that the state's budget shortfall (prior to any corrective actions) has increased to about $16 billion. Consequently, the reserve at the end of 2008-09 under the Governor's budget policies would be $1.1 billion—$1.6 billion less than forecasted by the administration. Despite achieving a positive reserve, we conclude that the administration's budget-balancing approach is fundamentally flawed. Its across-the-board reductions reflect little effort to prioritize and determine which state programs provide essential services or are most critical to California's future. In the absence of a credible plan that prioritizes state spending and revenues, we offer an alternative approach for the Legislature's consideration. By making more targeted reductions and adding ongoing revenue solutions, we believe this approach offers the Legislature a better foundation to begin crafting a 2008-09 budget that focuses on essential services.

The Governor's Budget Proposal

Economic Forecast—Slow Growth

The budget's economic forecast for the remainder of 2007-08 and 2008-09 is for modest growth and inflation. Both the national and California economies are expected to experience slower growth in 2008 than in 2007, especially in the earlier parts of 2008. In 2009, growth is expected to be somewhat better. Continuing problems in the housing market and high energy prices are predicted as the main forces holding down growth. On an annual average basis, the budget forecasts that the U.S. gross domestic product will slow slightly from 2.1 percent in 2007 to 1.9 percent in 2008, before partially rebounding to 2.9 percent in 2009. In California, personal income is expected to fall to 4.8 percent in 2008 and then rise a bit to 5.2 percent in 2009.

Revenue Forecast—Very Modest Growth

Very modest revenue growth occurred in 2006-07 and is forecast for the remainder of 2007-08 and 2008-09. The Governor's budget forecasts that underlying revenues for 2006-07 through 2008-09 are down by a combined $9.3 billion from what was assumed at the passage of the *2007-08 Budget Act*. After accounting for one-time factors, the underlying growth rate assumed for 2007-08 is 1.6 percent, rising to about 3.5 percent in 2008-09. Including the revenue-related changes described below, General Fund revenues are forecasted to total $102.9 billion in 2008-09, up 0.6 percent from the current year.

Revenue-Related Changes. Although the budget does not include any significant tax changes, the administration proposes several proposals that would have a significant effect on General Fund revenues. Specifically, the 2007-08 revenue forecast assumes the sale of $3.3 billion of additional deficit-financing bonds. The budget also adds $2 billion to its 2008-09 revenue total by accruing dollars that are currently reflected as 2009-10 revenues. The administration proposes some increased tax enforcement and collection activities at the state's tax agencies, as well as a change in the use tax for vessels, vehicles, and aircraft. In addition, the administration assumes that tribal gambling compact payments to the General Fund will increase dramatically due to the recent passage of Propositions 94, 95, 96, and 97. In total, compact payments to the General Fund are forecasted to total $154 million in 2007-08 and $430 million in 2008-09.

Total Budget Spending

The budget proposes total state spending in 2008-09 of $128.8 billion (excluding expenditures of federal funds and bond funds). General Fund spending is projected to total $101 billion, a decrease of 2.3 percent due to various budget reductions. Special fund spending would decline by 3.7 percent to $27.8 billion.

General Fund Condition

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

Figure 1

Governor's Budget General Fund Condition

(Dollars in Millions)

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

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

Key Features

The Governor's budget plan calls on the Legislature to take actions affecting both the current and budget years. Figure 2 (see next page) summarizes the major components of the Governor's $17 billion in proposed solutions, which we describe below.

Figure 2

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

(In Millions)

	Reserve as of June 30, 2009
Administration's Definition of Shortfall	**-$14,479**
Budget Solutions	
Reduce Proposition 98 spending:	
2007-08 reduction	$400
Suspend 2008-09 minimum guarantee	4,825[a]
Issue additional deficit-financing bonds	3,313
Accrue 2009-10 revenues to 2008-09	2,001
Suspend transfer to Budget Stabilization Account	1,509
Reduce Medi-Cal local assistance spending	1,126
UC/CSU reductions (unallocated)	569
CalWORKs reforms	463
Early release of prisoners and summary parole	372
Suspend SSI/SSP cost-of-living adjustments	323
Other solutions	2,356
Governor's Budget Estimate of 2008-09 Reserve	**$2,778**

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

Special Session. On January 10, 2008, the Governor declared a fiscal emergency under the State Constitution and called a special session of the Legislature to address the state's budget problems. The Governor's budget proposes $817 million in current-year savings proposals. In many cases, these proposals would yield greater savings in 2008-09 once fully implemented. Among the major current-year proposals are:

- A reduction of $400 million in Proposition 98 K-14 education spending.
- A 10 percent reduction in Medi-Cal provider rates and a shift of $165 million in provider payments from June to July.
- California Work Opportunity and Responsibility to Kids (CalWORKs) reforms, including increased sanctions for not complying with program requirements.

- The suspension of a scheduled June 2008 Supplemental Security Income/State Supplementary Program (SSI/SSP) cost-of-living adjustment (COLA).
- The release of certain nonviolent and nonserious offenders from prison up to 20 months early and no longer actively supervising such offenders on parole.

Due to the continued decline in the state's revenue outlook, the administration has also proposed a number of actions to help the state meet its *cash* demands, in addition to its budgetary demands. The administration proposes $4.7 billion in cash solutions—primarily from delaying payments to school districts, counties, and cities by several months. At the time this analysis was prepared, the Legislature was deliberating on the administration's current-year budget and cash proposals.

Budget-Year Savings Proposals. Relative to a current-law baseline budget, the administration proposes more than $10 billion in spending-related reductions in 2008-09. While some areas of the budget were exempt, most programs are targeted for reductions by the administration. In a number of areas, these reductions are achieved through significant policy and/or funding changes to the way in which programs operate. In other cases, however, the proposed reductions are across-the-board—evenly distributed across all of a department's programs. The Governor's major budget-year reduction proposals include:

- Continued savings from current-year proposals such as Medi-Cal provider rate reductions, CalWORKs reforms, the SSI/SSP COLA suspension, and the corrections' early release and summary parole changes.
- Suspension of the Proposition 98 minimum guarantee for K-14 education by $4 billion. Revenue limits and categorical programs are generally cut by about 10 percent.
- Unallocated reductions to the budgets of the judiciary, University of California (UC), California State University (CSU), the Legislature, and constitutional officers.
- Elimination of specified Medi-Cal optional benefits for adults.
- Reduced county allocations for child welfare services and foster care grants.
- Reduced In-Home Supportive Services hours for domestic services such as meal preparation, cleaning, and errands.
- Suspension of the 2008-09 transfer to the Budget Stabilization Account—eliminating a $1.5 billion supplementary debt payment towards outstanding deficit-financing bonds.

New Spending Proposals. Despite the budget reductions, the administration makes several new spending proposals—primarily using sources other than the General Fund. For instance, the administration proposes to finance the costs of a $1.6 billion computer project to modernize the state's budgeting and accounting systems—known as the Financial Information System for California (FI$Cal). The Governor's budget also proposes to expand the state's wildland firefighting capacity through a new surcharge on property insurance policies. Regarding infrastructure, the Governor proposes placing $48 billion in general obligation bonds before the state's voters by 2010. One of the key General Fund augmentation proposals is about $260 million annually to provide a 5 percent pay raise (retroactive to July 1, 2007) to correctional officers as part of the imposition of a contract offer.

LAO Assessment of the Governor's Budget

In this section, we examine the implications of the *2008-09 Governor's Budget* proposal for the near- and longer-term General Fund condition, using our own revenue forecast and our own estimates of the impacts of the Governor's proposals on revenues and expenditures. Our estimates do not reflect any of the programmatic recommendations that we make in our companion publication, *Analysis of the 2008-09 Budget Bill*. The causes of our differences from the budget projections are limited to (1) assumptions about the economic and revenue outlook under the Governor's policies and (2) estimating differences in the level of expenditures that would be needed to fund the Governor's budget plan.

Budget Would Have Smaller Reserve Than Administration Projects

As indicated in Figure 3, we estimate that if the Governor's budget proposals were fully adopted, the state would end 2008-09 with a reserve of $1.1 billion—$1.6 billion less than the administration's forecast of its own budget. This difference largely reflects our lower estimate of revenues, as well as a slightly higher net estimate of expenditures from 2006-07 through 2008-09. In comparison to the Governor's identified budget problem of $14.5 billion, therefore, we now project the state would face roughly a $16 billion shortfall, absent corrective actions.

Lower Revenues. We forecast that General Fund revenues in 2007-08 and 2008-09 will fall below the budget forecast by a combined total of $1.5 billion. Economic conditions at both the national and state levels have deteriorated since the budget's estimates were put together. These conditions have already begun to further weaken the state's General Fund revenues compared to the Governor's budget forecast. For instance, corporate tax (CT) receipts in December, and personal income tax (PIT) and sales and use tax (SUT) receipts for the month of January were both soft. In the two years combined, our forecast of the state's three biggest tax revenues—PIT, CT, and SUT—are down $1.4 billion from the administration's forecast. In addition, the Governor's budget makes overly aggressive assumptions about the growth in Indian casinos' customer bases and slot machines. Even with the passage of Propositions 94, 95, 96, and 97, we conclude the administration's estimate of tribal payments to the General Fund is overstated by $173 million over 2007-08 and 2008-09 combined. Other revenue sources offset a portion of this effect.

Figure 3

Governor's Budget General Fund Condition Using LAO Estimates

(Dollars in Millions)

			Proposed for 2008-09	
	Actual 2006-07	Proposed 2007-08	Amount	Percent Change
Prior-year fund balance	$9,898	$4,557	$779	
Revenues and transfers[a]	95,887	99,823	102,361	2.5%
Total resources available	$105,785	$104,380	$103,140	
Expenditures	$101,228	$103,601	$101,119	-2.4%
Ending fund balance	$4,557	$779	$2,021	
Encumbrances	$885	$885	$885	
Reserve	**$3,672**	**-$106**	**$1,136**	
Budget Stabilization Account (BSA)	472	—	—	
Reserve for Economic Uncertainties	3,200	-106	1,136	

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

Our forecast also adjusts the timing of the receipt of two significant one-time payments to the state—$500 million from the sale of EdFund and $193 million in rebated penalties from the federal government as a result of implementing a child support automation system. In both cases, the administration scores the revenues in 2007-08, while we believe 2008-09 is a more realistic time line. While these adjustments do not affect the state's projected reserve at the end of the budget year, they do shift $693 million in expected revenues from 2007-08 to 2008-09.

Higher Costs. We estimate that General Fund expenditures under the Governor's budget proposals would exceed the administration's estimate by a net amount of $164 million over the prior, current, and budget years combined. This is the result of a number of factors, which tend to offset each other. The two largest factors are:

- ***Higher Property Taxes.*** Under the financing of K-14 education, increases in local school district property taxes generally offset state General Fund Proposition 98 costs on a dollar-for-dollar basis. Due to more recent data on property taxes received by schools in 2006-07, our estimate of the base amount of property taxes available is higher than the amount assumed in the Governor's budget. This is partially counteracted by lower assumed growth rates in 2007-08 and 2008-09. By 2008-09, our property tax estimate is roughly the same as the administration's. In total, our forecast includes about $300 million in higher local school property tax revenues in 2006-07 and 2007-08 combined than the administration.

- ***Public Transportation Account (PTA) Lawsuit.*** The PTA derives its revenues from diesel sales tax and a portion of the gasoline sales tax, including an amount known as the "spillover." As a solution, the 2007-08 budget used $1.3 billion of the PTA's funds to help the General Fund. In January, a superior court judge ruled that a portion of that solution was illegal. Specifically, the court found that the state could not use $409 million from the PTA to reimburse the General Fund for prior-year transportation bond debt service. At the time this analysis was prepared, the administration had not formally proposed a solution to address this issue. Our expenditure totals for the administration's plan, therefore, are $409 million higher than the Governor's budget.

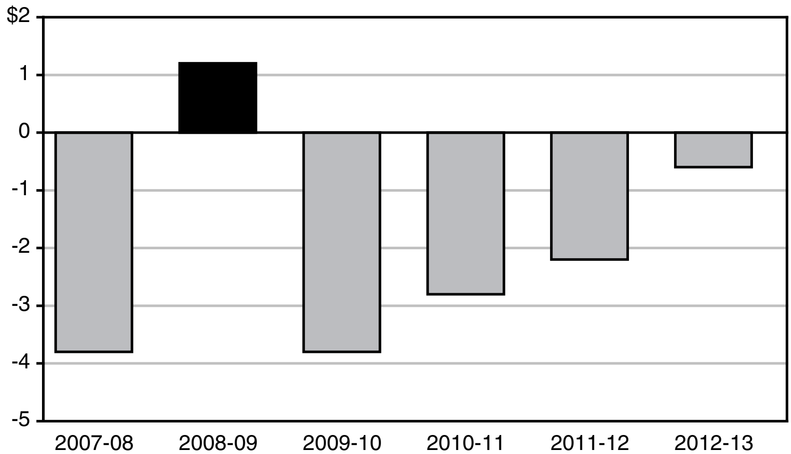
Structural Shortfalls Would Return After 2008-09

In addition to forecasting the General Fund's condition through 2008-09, we have projected the state's revenues and expenditures through 2012-13 under the Governor's policies. When the *2007-08 Budget Act* was adopted, it was widely acknowledged that the state would face multibillion dollar budget shortfalls in future years. The continued deterioration of the state's revenue outlook increases the long-term gap between revenues and spending even further than these prior estimates. In response, virtually all of the administration's $9 billion in spending reductions are intended to be ongoing. If adopted, therefore, the budget plan would reduce ongoing spending and bring total expenditures closer into line with annual revenues. Some elements of the Governor's plan, however, work against this progress. In particular, the issuance of additional deficit-financing bonds and their slower pay off pushes extra debt-service costs into the future. Taken all together, as shown in Figure 4, we project that the state would face about a $4 billion operating shortfall in 2009-10. The shortfalls would shrink to between $2 billion and $3 billion in the two following years. In 2012-13, the shortfall would remain but total less than $1 billion, as the budget would begin to reflect the benefit of the final pay off of the deficit-financing bonds in that year.

Figure 4

Operating Shortfalls Return After 2008-09 Under Governor's Budget

General Fund (In Billions)



Failure to Set Priorities

The administration's approach to have virtually all programs share in the pain of balancing the budget has some surface appeal of "fairness." Yet, it fails to differentiate between the importance of various state programs. *All state programs are not equally valuable.* The administration's budget reductions reflect little effort to prioritize and determine which state programs provide essential services or are most critical to California's future. As a result, we conclude that the administration's approach is fundamentally flawed. In many cases, there is no rationale or justification for the reductions (other than saving money). The risk with the administration's approach is that—by attempting to preserve most funding for most programs—many programs end up operating in a less than optimal manner and provide lower-quality services to the public.

Revenue Solutions Are Minimal

The administration's budget plan affects most areas of the spending side of the budget. On the revenue side, the administration makes some modest adjustments to increase ongoing revenues. For example, the administration proposes to reinstate the 12 month use tax requirement on vehicles, vessels, and aircraft, as well as to augment staff at the state's tax agencies to improve tax collections. The administration also looks to create an insurance surcharge to partially defray General Fund wildfire costs and anticipates student fees will be raised by the governing boards to defray a portion of the proposed reductions to UC and CSU. In the context of the amount of corrective actions that are proposed, however, these ongoing revenue–related changes are minimal. By focusing almost exclusively on the spending side, the administration's plan unnecessarily limits the range of budget solution options.

Missed Opportunity on Proposition 98

With the state's declining revenues, the Proposition 98 minimum guarantee—accounting for about 40 percent of the state's General Fund budget—is now well below the level estimated in the *2007-08 Budget Act*. The Proposition 98 minimum guarantee grows each year based on the amount of spending in the previous year. Consequently, the decisions that the Governor's budget makes on Proposition 98 in the current year fundamentally determine the direction of the administration's entire budget plan. As we discuss in detail in the "Education" chapter in our *2008-09 Analysis*, the administration's current-year proposal misses a critical opportunity to achieve additional budgetary flexibility. The Governor's budget proposes $400 million in current-year Proposition 98 savings. Yet, that would leave the state about $1 billion above the minimum guarantee and lock the state into a higher minimum guarantee in 2008-09 and beyond. This higher guarantee, in turn, increases pressure in 2008-09 to either suspend the guarantee or find significantly greater budget solutions in other areas.

LAO's Alternative Budget Approach

Facing a huge 2008-09 budget problem, the Governor's budget failed to put forward a plan that prioritizes state spending and makes difficult choices. We recommend the Legislature reject the administration's across-the-board approach. In the absence of a meaningful starting point for budget deliberations from the administration, we have developed an alternative approach. In contrast to the Governor's budget, we have put forth a strategic alternative that is both more balanced and targeted in addressing the state's budget shortfall. It is more balanced in that it focuses not just on program reductions, but also adds revenues in several different ways without making any broad-based tax increases. It takes a targeted approach to expenditures by attempting to determine which programs are most important and preserve their funding, if not at the current level, at least at a level that does not significantly adversely impact program accomplishments. In addition, we sought to eliminate duplicative, inefficient or ineffective programs and restructure other programs in order to achieve budgetary savings and improve service delivery.

The LAO Alternative Budget is laid out in "Part V" of this publication. Its key components are summarized in Figure 5 (see next page).

A Balanced Budget Through 2012-13

2008-09 Reserve. The LAO alternative budget would finish the 2008-09 year with a $1.3 billion reserve, about $150 million more than our forecast of the Governor's budget reserve. Although budget-year spending would be $2.5 billion higher than the Governor's budget, the higher reserve is achieved primarily through two means:

- ***More Current-Year Savings.*** Lowering Proposition 98 spending to the minimum guarantee in 2007-08 and rejecting the administration's proposed 5 percent raise for correctional officers creates greater flexibility to preserve key spending programs in the budget year. (Although the Legislature was deliberating on special session actions at the time this analysis was prepared, most of our proposed current-year savings in Proposition 98 will remain viable until the end of 2007-08.)

- ***Additional Revenues.*** We identify $2.7 billion in additional revenues that can be raised by modifying or eliminating tax credits and exemptions that are not achieving their stated purposes or are of lower priority. A portion of these increased revenues are offset by not adopting the administration's problematic proposal to accrue $2 billion in future revenues to 2008-09.

Balanced Through 2012-13. Unlike the Governor's budget, our alternative maintains a balanced budget through the end of our forecast period in 2012-13. While our plan would have small operating shortfalls in some future years, the budget remains balanced—although precariously so—using reserves carried forward from earlier years. Our alternative achieves this improved long-term outlook by slowing the rate of program growth, implementing some changes now that will yield future dividends, and providing increased revenues on an ongoing basis.

Figure 5

Key Elements of the LAO Alternative Budget

✓ **A Balanced Budget Through 2012-13**

- Provides reserve of $1.3 billion at the end of 2008-09, about $150 million more than our forecast of the Governor's budget reserve.
- Keeps budget balanced—though precariously—through our five-year forecast period. Small operating shortfalls in some years are covered by carry-in reserves.

✓ **Targeted Program Reductions**

- In contrast to an across-the-board approach, makes targeted program reductions. To the extent possible, maintains core services at their current spending levels.
- Eliminates or modifies ineffective or nonessential programs.
- Considers availability of other fund sources in order to maintain service levels.

✓ **Rethink Which Programs Are Operated or Funded by the State**

- Shifts programs to the local level when it makes programmatic sense.
- Reduces or eliminates program funding for programs that are primarily local government responsibilities.

✓ **A Better Proposition 98 Approach**

- Reduces current-year funding to the minimum guarantee to maximize budget-year flexibility but not impact school operations in 2007-08.
- Suspends the guarantee by $800 million, compared to a $4 billion suspension by the Governor. The suspension is only required because of added revenues as part of our overall solution.

✓ **Add Revenues in a Reasonable Manner**

- Selects tax credits or exemptions for reduction or elimination because they are not achieving their stated purposes or are of lower priority.
- Makes no broad-based tax rate increases.
- Does not include the administration's problematic $2 billion revenue accrual.

✓ **No Additional Borrowing or Debt**

- Does not add any new borrowing or debt to the state's credit card. However, we do restructure some repayments of existing debt.

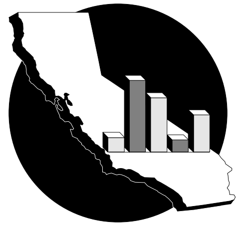
Using the LAO Alternative

We do not expect the Legislature to adopt the LAO alternative as an entire package. The alternative, of necessity, reflects judgments as to how state government could maintain essential services while achieving budgetary savings. We are sure that there are components of our alternative with which many Members of the Legislature will not agree. The Legislature's assessment of its own priorities should form the framework of the adopted 2008-09 budget. In working towards a final budget, the Legislature will have to make many tough decisions. Our hope is that the LAO alternative budget offers the Legislature a better foundation to begin crafting the budget and helps demonstrate how the state can be more strategic in bringing its revenues and expenditures into balance.

II

Perspectives on the Economy and Demographics

Perspectives on the Economy and Demographics



Summary

Both the U.S. and California experienced continued economic expansion with modest inflation in 2007. For the year as a whole, though, economic growth was slower than in recent years and less than previously forecast. The pace of growth also varied considerably within the year, making it difficult at times to discern exactly where the economy was heading. The year's fourth quarter was quite soft, however, making it clear the economy had fallen into a pronounced slow-growth mode and its performance in 2008 was likely to be very subdued.

Like most economists at this time, for 2008 we forecast that growth will continue but be very modest for the nation and California. For the year as a whole, 2008 growth will average well below its 2007 pace, but with the first half of the year especially weak. Later in the year, things should start to strengthen a bit as the housing sector begins to stabilize. However, significant improvement will likely not occur until 2009. We expect that the state's performance will generally be similar to the nation's, although somewhat weaker in those areas most directly affected by the housing market's problems.

The current economic expansion has now lasted over six years and, thus, is comparatively old by historical standards. Although most economists were still predicting slow growth but not an outright recession as of the start of 2008, continued negative economic reports caused concerns to spread that a downturn could very easily develop. By February, some economists had shifted to predicting a mild recession. Thus, the economy clearly faces downside risks. Reflecting this concern, federal policy makers adopted in February an economic stimulus package containing tax rebates and investment incentives to provide support to the economy.

Recent U.S. Developments

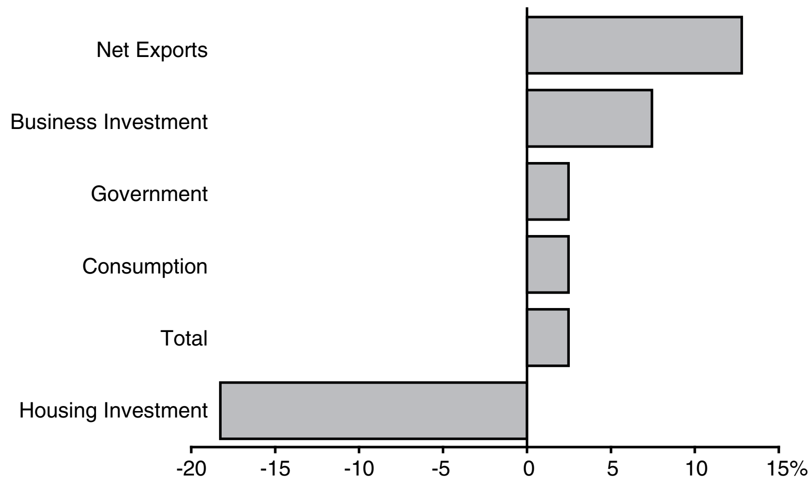
Despite Weakening Economy, Most Non-Housing Sectors Have Grown

Real gross domestic product (GDP) in the fourth quarter of 2007 grew at an annual pace of only 0.6 percent, but still rose 2.5 percent compared to the fourth quarter of 2006. Figure 1 shows that most major GDP sectors expanded in real (inflation-adjusted) terms during the year. The one exception involved residential construction—primarily housing—which fell sharply. Specifically:

Figure 1

Home Construction Major National Drag in 2007

Percent Change in Real GDP Components
Fourth Quarter of 2006 to Fourth Quarter of 2007



- ***Net exports***—which equals exports minus imports—had the greatest percentage improvement and accounted for more than one-fourth of GDP growth. Although net exports themselves remain negative, reflecting the nation's large annual merchandise trade deficit of around $700 billion, they became less negative in 2007 than in 2006. This was because the rate of growth in our exports significantly exceeded the rate of growth in our imports, due to the combination of healthy economic growth abroad (which increases foreign demand for our domestically produced exports) and a declining dollar (which also stimulates our exports and discourages imports).The decline in our trade deficit was stimulative because it created less of a drag on our economy.

- ***Business spending***—the next-fastest-growing output category—involves expenditures by firms on things like computers, software, networks, other equipment, and new facilities (this is referred to as nonresidential investment). This category increased by a healthy 7.4 percent in real terms on a fourth-quarter to fourth-quarter basis.
- ***Government spending*** rose 2.5 percent, reflecting a 1.7 percent increase at the federal level and 3 percent increase at the state and local level.
- ***Consumer spending***—which accounts for over two-thirds of total GDP—also increased 2.5 percent during the year. However, this component's growth slowed throughout 2007 from an annual rate of 3.7 percent in the first quarter to only 2.0 percent in the fourth quarter. This reflected such factors as moderating hiring and wage gains, high levels of consumer credit, reduced home-equity wealth from softening housing prices, tighter borrowing standards, and less consumption spending related to the building and sales of homes.
- On the downside, ***home construction*** (technically referred to as residential investment) fell by 18 percent, reflecting major declines in single-family home construction and moderate declines in construction of apartments.

The most striking and negative economic developments during the year involved the deepening crisis involving housing and the run-up in crude oil prices.

Housing-Related Problems Intensified

As 2007 progressed, the problems relating to the housing sector continued to deepen and took on new dimensions. Residential building activity in the U.S. contracted further, home sales weakened, housing prices continued to soften, and mortgage delinquencies and foreclosures rose. In addition, financial market problems not only intensified in the narrowly defined subprime mortgage market, but also increasingly spilled over into certain portions of the home-equity loan market, non-subprime mortgage market, equities markets involving financial firms who invested in various mortgage-backed securities, and international investors. The latter include some major foreign governments, like China, who have purchased billions of dollars of such securities. As of early 2008, lenders and investors had already written off some $120 billion of uncollectable mortgage loans.

More housing market deterioration is expected in the near future. Although certain steps such as loan modification programs have been recently taken, a large volume of subprime mortgages are scheduled to reset to higher interest rates during 2008. This will bring the threat of even more delinquencies and foreclosures. Thus, the ongoing problems relating to the housing sector are a major uncertainty and negative factor in the economic outlook for 2008 and 2009.

Oil Prices Hit New High

Oil prices experienced a sharp rise in 2007 and recently reached record highs. As shown in Figure 2, the average price of imported oil (which applies to most of the oil we consume) stood at about $30 per barrel as recently as early 2004, rose sharply in 2006 when it peaked at $68 in August, and then fell to near $53 as of the close of 2006. Prices then dropped further during the first three weeks of January 2007, to $50, but then moved back up significantly throughout 2007. In the fourth quarter of 2007, Figure 2 shows that the real price of oil surpassed its all-time quarterly peak that was reached more than 25 years ago. In early January, its price even briefly topped $100 on the futures market, but since then has bounced around and retreated a bit into the low $90s as of late January.

The high oil prices experienced in 2007, while not causing a major downturn or recession, have been one of the factors contributing to the sluggish economy by adversely affecting consumption spending, business investment, corporate profits, and our trade balance.

Inflation—Modest But Still a Threat

One of the major concerns over the past couple of years has been that continued economic expansion and rising energy prices might result in a significant increase in inflation. One reason is that higher energy prices directly affect such items as gasoline prices. A second is that higher energy costs can spill over into the rest of the economy as businesses, no longer able to absorb such costs, start to pass them along to consumers by raising the prices of their products and services.

Figure 3 shows that during 2007, the Consumer Price Index (CPI) trended up significantly toward the end of the year, largely reflecting the direct effects of sharply increased energy-related prices. For example, the December 2007 CPI stood 4.1 percent above one year earlier. The good news, however, is that "core" inflation (as measured by the GDP consumption deflator *excluding* food and energy costs) remained fairly stable over the year, suggesting that prices at large generally remained under control. Factors contributing to this were relatively good productivity gains and only modest increases in unit labor costs.

Figure 2

Real Oil Prices Reached New High

Average Per-Barrel Price of Imported Crude Petroleum
1974 Through 2007

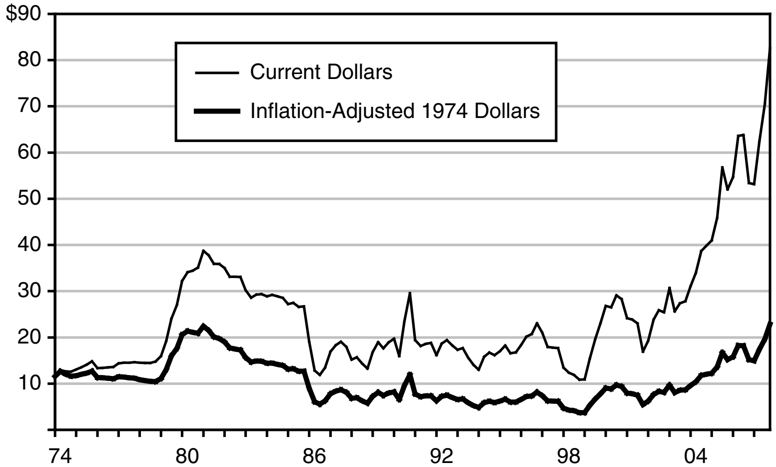
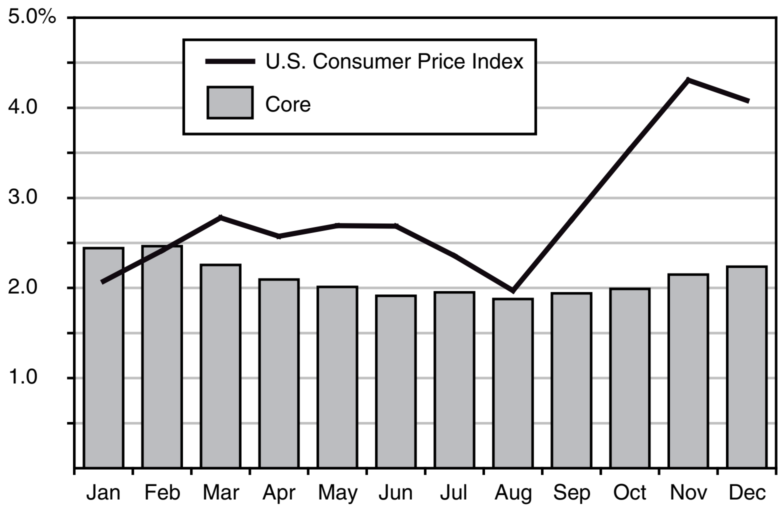


Figure 3

Core Inflation Remained Under Control in 2007

Year-to-Year Percent Change, by Month



As 2008 starts, the general outlook for inflation is favorable. However, a key challenge will be to see if a "balancing act" can be maintained by policymakers between providing necessary stimulus to the economy through tax incentives and reduced interest rates without triggering additional inflation, especially given the inflationary threat that high energy prices continue to pose.

Profits Have Softened

U.S. after-tax profits soared by 35 percent in 2004 and 32 percent in 2005, followed by a modest but still healthy increase of 14 percent in 2006. These gains, which reflected significant increases across a wide variety of industries, reflected such factors as major increases in oil-related profits and the ongoing benefits of high productivity and sales growth on businesses' bottom-line earnings.

In 2007, however, national profit growth slowed markedly, to less than 5 percent. Although profits in many industries continued to be relatively good for the year, earnings were soft or negative in several areas, including for many financial firms caught up in the subprime mortgage market's problems and companies related directly and indirectly to housing-related activities. In addition, as noted in "Part III" of this volume, California profits appear to be somewhat less robust than what the national figures would indicate, possibly reflecting the greater negative impact that the housing downturn and its related developments are having in our state.

Economic Momentum Weak at Year-End

Real GDP growth appears to have decelerated sharply and dropped to less than 1 percent in the fourth quarter of 2007, well below its pace in the preceding two quarters. Quarterly job growth also continued to be soft, the number of unemployed in December had risen to 7.7 million (up 13 percent in one year), and housing activity plummeted. Preliminary data for the month of January showed an actual modest decline in employment. Given this, the prospects for near-term growth are weak. Most economists were concerned that the economy was vulnerable to a downturn—especially if hit with a strong shock, such as from further oil price hikes. Although some were predicting an outright recession, the general view was that even if a recession did occur, it would likely be fairly mild by historical standards. This was due to the lack of major imbalances involving such things as excessive inventories. Also, amidst the negative news, some good things were reported, such as a decent jump in late January involving durable goods orders. In addition, the nation's monetary authorities reduced interest rates in two steps by 1.25 percentage points in January. A federal economic stimulus package containing tax rebates and investment incentives was adopted in February to provide further support for the economy. Thus, the consensus view as of early 2008 was for subdued, but continued, national economic growth for the year as a whole.

The Current Situation in California

Economy Still Growing Despite Major Problems

Like the nation, California saw continued economic expansion in 2007. However, it too experienced considerable economic slowing compared to 2006 and ended the year on a soft note. Job growth, for example, slowed to a crawl at year-end and was under 1 percent for the year as a whole. Like the nation, the biggest drags for the state were from the housing downturn and higher energy costs.

Housing Market—No Immediate Recovery Likely

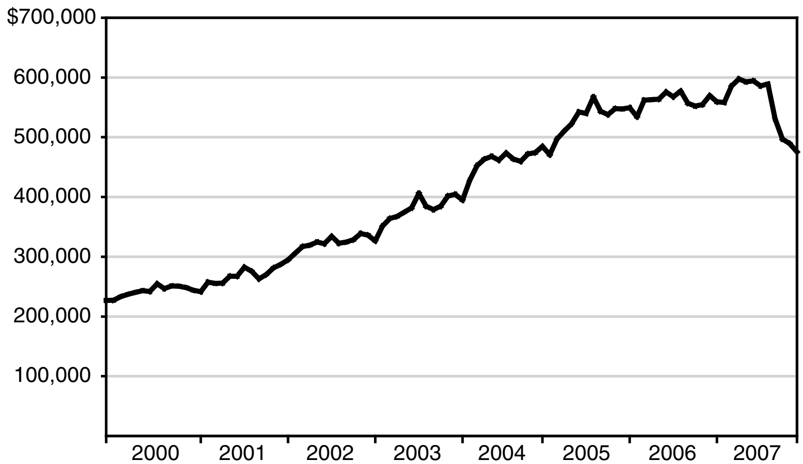
The adverse impacts of the housing downturn on overall economic growth have been particularly severe for California, given its well-above-average dramatic run-up in housing prices and large volume of real estate activity that occurred between 2001 and 2005. In retrospect, much of this above-average activity related to subprime lending transactions and other types of speculative real estate behavior. This speculative bubble has now popped and the housing market is currently in the painful process of deflating. Based on past experience with real estate bubbles of this sort in the state, the full process of adjustment can take a number of years until housing prices return to sustainable levels and excessive housing inventories are worked off. Thus, the state's housing market will likely remain weak for some time.

How Far Have Home Prices Dropped? Figure 4 (see next page) shows the upward trend in median California housing prices that occurred since 2000 and what has happened to them during the housing downturn. It indicates that the statewide median price rose from about $227,000 at the start of 2000 to a peak of over $598,000 in April 2007. Since then, however, the median price has dropped by over 20 percent, to roughly $475,000. Despite this substantial reduction, the current median price is still equal to about what it was at the start of 2005 and more than double that of 2000. As Figure 5 (see page 11) indicates, however, the recent price drops have varied significantly by geographic area, with some seeing declines of more than 25 percent and others well under 10 percent. Given that the housing market is still correcting, further price declines are likely, at least in many areas of the state. It also is the case that despite the recent price declines, housing affordability remains a major problem in California.

Figure 4

California Median Home Prices Declining After Sustained Increase

Median Home Price



Gasoline Prices Hit New Highs

Figure 6 (see page 12) shows that California's average gasoline prices, largely reflecting the record level of crude oil prices experienced in 2007, trended up during the year and, at one point, reached a new record of nearly $3.50 per gallon. As a result, gasoline prices have nearly tripled in recent years. The fact that gasoline consumption, despite some softening, has thus far proved fairly resistant to these higher prices means that they have had the effect of putting increasing pressure on consumers' pocketbooks and their spending on other types of goods and services.

But Many Sectors Remain Strong

The housing downturn and high energy prices caused weaknesses during the year to spill over into a number of different industries. For example, retail spending on automobiles, home furnishings, and a number of other durable goods was soft, as were finance-related activities associated with real estate generally and home sales specifically. However, many of the economy's other sectors performed relatively well. For example:

Figure 5

Housing Price Reductions Vary by County

December 2007 Median Home Price Decline From Peak

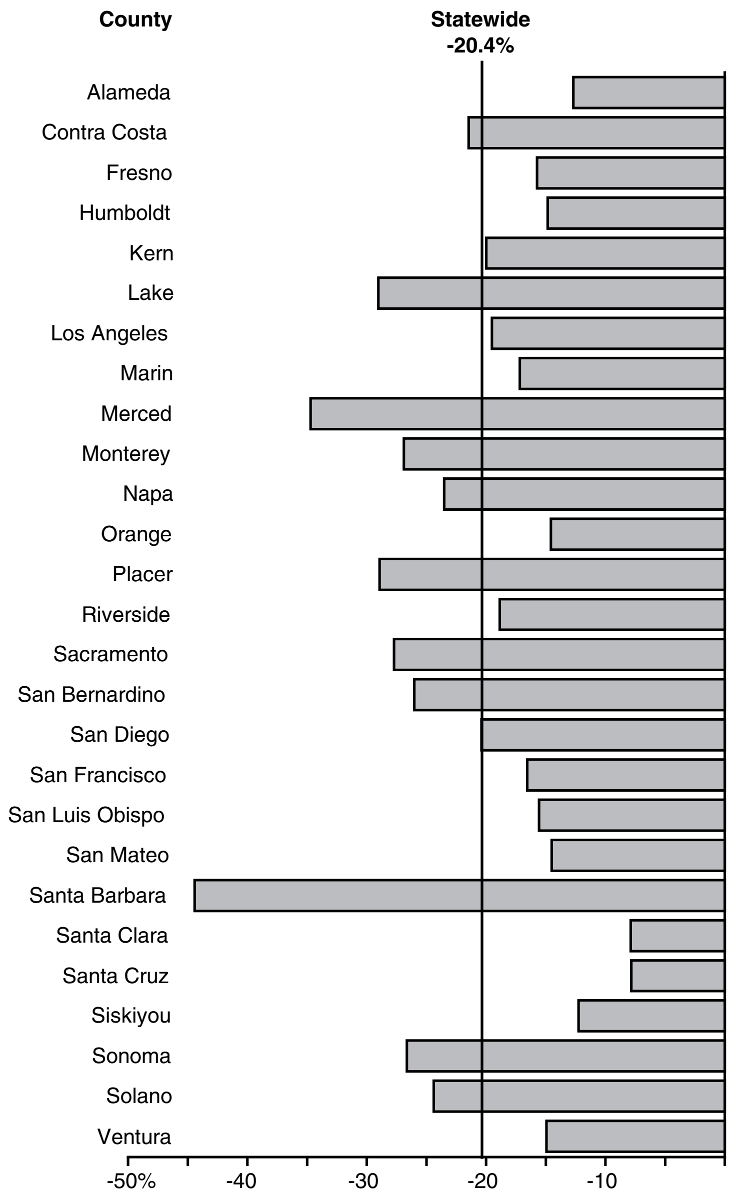
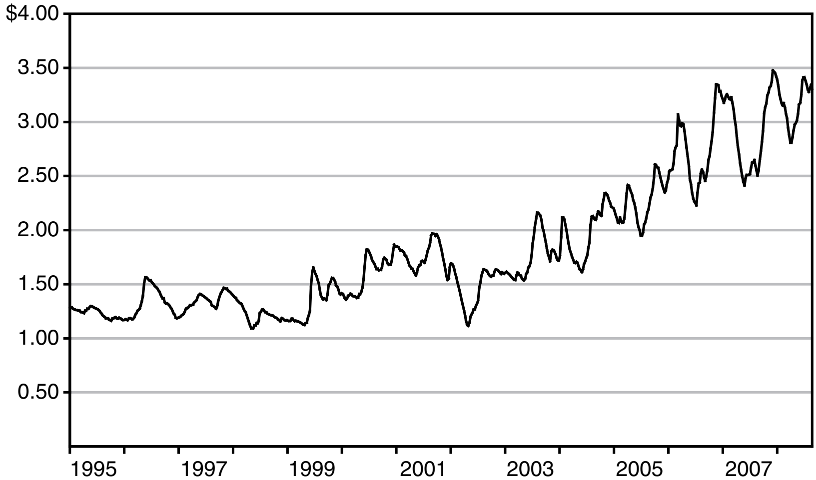


Figure 6

California Gasoline Prices Have Tripled In Recent Years

Price Per Gallon



- Continued growth occurred in California's high-tech and related professional services industry. This high-paid sector includes software development, computer systems and design, biotechnology, and pharmaceuticals.
- Continued strength also was present in information-related industries (including motion pictures, broadcasting, sound recordings, publishing, and Internet service providers).
- Solid growth occurred in international trade, which is benefiting California manufacturers and farmers that sell abroad, as well as transportation, warehousing, and distribution activities associated with trade activity passing through California's ports.
- Nonresidential construction, though having slowed from 2006, was still doing relatively well at year-end 2007.

These positive factors suggest that, despite its housing downturn and other problem areas, the state's overall economy is still in decent shape and likely to continue growing in 2008, though at a subdued pace.

THE BUDGET'S ECONOMIC OUTLOOK

The budget's economic forecast for the remainder of 2007-08 and 2008-09 is for modest growth and inflation. Both the national and California economies are expected to experience slower growth in 2008 than in 2007—especially in the earlier parts of 2008—followed by somewhat better but still modest growth in 2009. As was true in 2007, continuing problems in the housing sector and high energy prices are seen as the main forces holding down growth.

Figure 7 displays the administration's economic forecast. It shows that for the nation, U.S. GDP growth on an annual average basis is projected to decline from an estimated 2.1 percent in 2007 to 1.9 percent in 2008, before rebounding to 2.9 percent in 2009. Quarterly growth is expected to bottom out at a 0.7 percent annual rate in the first quarter of 2008, then trend back up to 2.9 percent by the fourth quarter. In terms of job growth, it is projected to bottom out at 0.8 percent in 2008, while inflation is forecast to remain modest.

Figure 7

Summary of the Budget's Economic Outlook

		Estimate	Forecast	
	2006	2007	2008	2009
U.S. Forecast				
Percent change in:				
Real gross domestic product	2.9%	2.1%	1.9%	2.9%
Personal income	6.6	6.5	4.9	5.0
Wage and salary employment	1.9	1.3	0.8	1.2
Consumer Price Index	3.2	2.8	2.2	2.0
Unemployment rate (%)	4.6	4.6	5.0	5.0
Housing starts (000)	1,812	1,346	1,021	1,295
California Forecast				
Percent change in:				
Personal income	6.5%	5.6%	4.8%	5.2%
Employment:				
Payroll survey	1.7	0.8	0.7	1.0
Household survey	1.5	1.2	1.0	1.5
Taxable sales	4.0	0.9	3.4	4.6
Consumer Price Index	3.9	3.3	2.6	2.7
Unemployment rate (%)	4.9	5.3	5.7	5.6
Housing permits (000)	163	117	95	104

The administration's forecast assumes that California's economy will generally grow in line with the rest of the nation, though just a little slower. It projects that personal income—the broadest single measure readily available of state-level economic activity—will slow from a growth rate of 5.6 percent in 2007 to 4.8 percent in 2008 and then rise some to 5.2 percent in 2009. Job growth is forecast to drop to 0.7 percent in 2008 before firming up a bit to 1 percent in 2009. Housing activity is expected to be very weak, with new residential building permits of only 95,000 in 2008. This compares to an annual average of 160,000 over the past ten years.

LAO's Economic Outlook

We also expect the national and state economies to continue to experience growth over the forecast period, but at a bit slower pace than does the administration. We also share the view that the economy will be weakest in the first half of 2008, and then start to firm up as the year progresses. Our forecast incorporates more up-to-date information than the administration's forecast could take into account, given that the budget's figures had to be prepared a couple of months ago.

National Outlook

As shown in Figure 8, we forecast that real GDP growth will ease from 2.2 percent in 2007 to 1.6 percent in 2008, before strengthening to 2.7 percent in 2009 and 2.9 percent in 2010. This compares to an average of a bit over 3.1 percent for the past decade. The 2008 slowdown reflects substantial weakness in housing activity as well as a slightly slower pace for consumer spending and nonresidential investment activity. Specifically:

- ***Housing-related investment***, after declining by 17 percent in 2007, is projected to fall by even more—over 20 percent—in 2008, before stabilizing and turning up modestly by 5 percent from this low base in 2009. On a quarterly basis, this sector has been in decline since late 2005, and is expected to continue declining through the end of 2008.

- ***Real consumer spending*** is expected to slow from 2.9 percent in 2007 to about 1.7 percent in 2008, before rising to 2.4 percent in 2009. The 2008 figure is well below the projected growth in real disposable income, reflecting declines in consumer confidence, vehicle sales, and other durable goods purchases.

- ***Business-related fixed investment*** growth is expected to ease, from 4.5 percent in 2007 to only 2.6 percent in 2008 and 2.5 percent in 2009. This reflects steady growth in business spending on equipment and software—especially information processing and computers—but weaker spending on structures. The ongoing spending on information technology (IT) equipment is a positive force in California's outlook, because many high-tech products are designed in California.

Figure 8

Summary of the LAO's Economic Outlook

	Estimate	Forecast		
	2007	2008	2009	2010
U.S. Forecast				
Percent change in:				
Real gross domestic product	2.2%	1.6%	2.7%	2.9%
Personal income	6.2	4.7	4.8	5.3
Wage and salary employment	1.2	0.7	1.1	1.4
Consumer Price Index	2.9	2.8	2.5	2.2
Unemployment rate (%)	4.6	5.2	5.2	5.0
Housing starts (000)	1,339	980	1,200	1,500
California Forecast				
Percent change in:				
Personal income	5.9%	4.7%	5.1%	5.5%
Payroll employment	0.8	0.6	0.9	1.3
Taxable sales	0.8	3.6	3.8	5.3
Consumer Price Index	3.3	2.5	2.8	2.7
Unemployment rate (%)	5.3	6.1	6.0	5.8
Housing permits (000)	110	90	95	115

- The ***trade deficit*** is projected to decline through 2009, with export growth significantly outpacing growth in imports. This reflects the positive impacts of a weaker dollar on exports and lower (though still high) prices for oil imports. (Nevertheless, despite this improvement, the trade deficit still will remain in excess of $600 billion by 2010, suggesting that there will be further downward pressures on the dollar.)

What Will Happen to Oil Prices?

Given the recent volatility in the world oil markets, a key question for both the U.S. and California economic outlooks is whether oil prices will remain roughly where they are, rise further, or drop down. There is currently a wide range of forecasts for future oil prices. Some energy analysts believe that the recent factors driving prices upward are largely transitory, related to political factors and speculative forces unrelated to underlying supply and demand factors. Others, however, believe that high and rising prices are here to stay, due to limited refining capacity and investment, and growing worldwide oil demand. Although short-term oil price volatility is likely to continue, we are assuming that prices will remain high but retreat somewhat from their current level, averaging roughly $80 per barrel in 2008.

Inflation and Interest Rates—Some Decline Expected

Reflecting the weak economy, both inflation and interest rates should soften in 2008 from their 2007 levels. For example, we expect CPI inflation to average 2.8 percent in 2008 and 2.5 percent in 2009.

Impact of Federal Economic Stimulus Package

In February, a federal economic stimulus package was adopted to provide additional support to the economy. This package will likely be largely preventative in nature, reducing the odds that the economy will slide into a significant downturn due to its housing and other problems, as opposed to leading to significantly higher economic growth. Thus, even with the package in place, 2008 economic growth will likely be subdued.

California Outlook

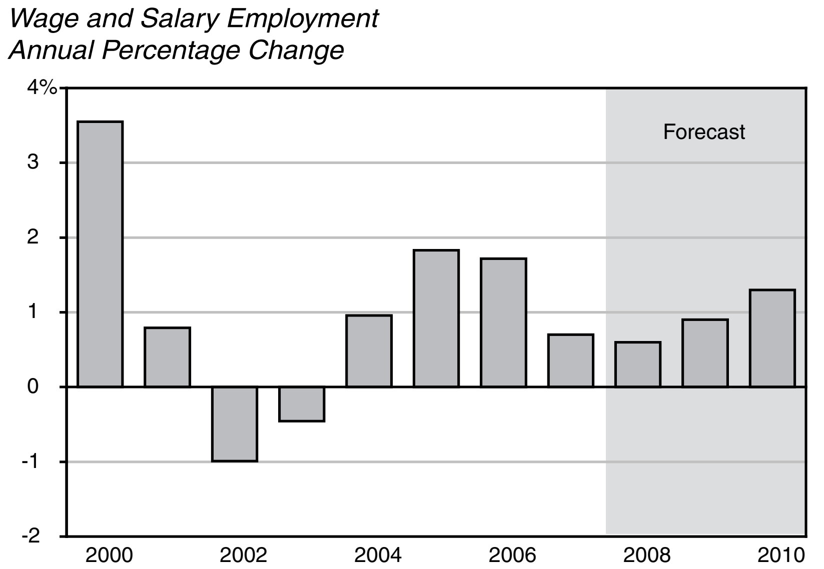
We forecast that the recent slowdown in California's economy will continue through 2008, reflecting ongoing softness in real estate and some sluggishness in retail spending. By the end of the year, however, real estate-related sales and construction are expected to have bottomed out, providing a foundation for a partial rebound in economic growth in 2009 and thereafter. In terms of our specific forecast:

- ***Personal income growth*** is projected to slow from 5.9 percent in 2007 to 4.7 percent in 2008, before picking up to 5.1 percent in 2009 and 5.5 percent in 2010. The 2008 slowing is heavily influenced by a decline in jobs, wages, and profits related to real estate activity.

- ***Wage and salary employment growth*** (see Figure 9) is projected to slow from an already-weak 0.8 percent in 2007 to an even lower 0.6 percent in 2008, with only minor strengthening to 0.9 percent in 2009, before improving to 1.3 percent in 2010. The main factor behind the slower job growth is soft construction-related activity. In contrast, job growth in most other sectors is expected to remain fairly steady, although in many cases only modest.

Figure 9

Modest Job Growth Expected for State



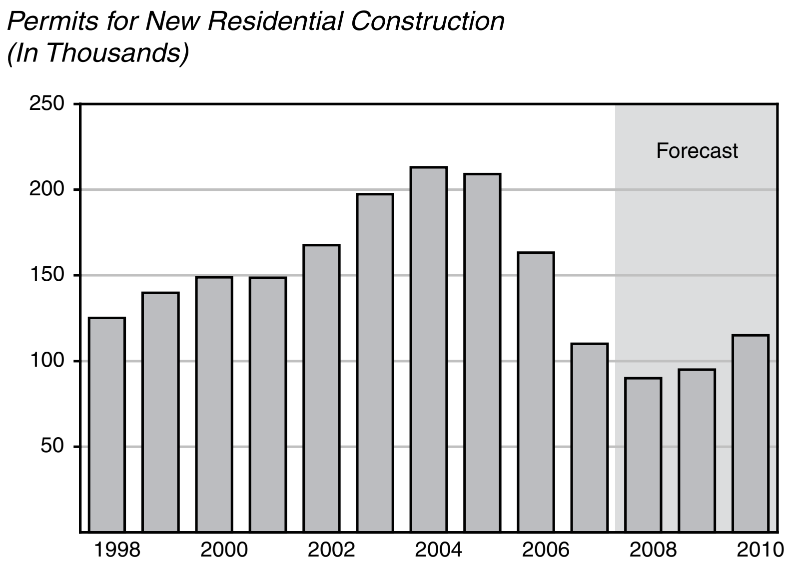
- As discussed in "Part III" of this volume, *taxable sales* are projected to grow to a modest 3.6 percent in 2008 and 3.8 percent in 2009, before rising to 5.3 percent in 2010. These rates are all less than personal income growth, and largely relate to reduced sales of building-related materials, home furnishings, and light vehicles.
- Reflecting the housing market's current downturn, *new residential building permits* issued in California—a key measure of forthcoming residential construction activity—are expected to total only 90,000 in 2008 and 95,000 in 2009 (see Figure 10 on next page).
- Regarding ***nonresidential building permits***, we expect their dollar volume to continue modestly expanding through 2008 and 2009, reflecting ongoing needs for the construction of industrial facilities and office buildings to service the state's growing population.

Key Forecast Risks

The key risks to our current national and state economic forecasts remain the same as for the past three years—housing and energy prices. Although the housing market has been undergoing considerable adjustment, it still does not appear to have stabilized and, in fact, more adjustments are likely. Thus, there remains the risk that home sales, construction, and prices could fall considerably more before the market starts to rebound. In addition, the financial markets are still unsettled, related to the mortgage market meltdown and its spillover effects on financial institutions and investors. Similarly, despite some recent improvement, world oil markets remain tightly balanced, and supply disruptions or faster-than-anticipated growth in energy demand could result in significantly higher oil and gasoline prices than we are anticipating. Foreign growth could also slow, especially if energy costs rose, which would hurt our economy because exports have been a key source of our growth in recent years.

Figure 10

Subdued Outlook for California Housing Activity



There is also, of course, some upside potential. For example, oil prices could retreat, given that current prices are well above that needed to operate profitably in the industry. In addition, certain sectors continue to perform well, suggesting that the underlying economy is both resilient and in decent shape, and this could lead to somewhat more growth. Likewise, productivity growth could come in a bit faster and closer to the average of recent years, versus the reduced level that most forecasts, including ours, assume. This would result in lower inflation, greater corporate earnings, and higher real personal income growth.

Comparison to Other Forecasts

Figure 11 compares our economic forecasts for the nation and California to our November 2007 forecast, as well as to a variety of other economic projections made in recent months by other forecasters. These include the projections made by the University of California,

Figure 11

Comparisons of Recent Economic Forecasts[a]

(Percent Changes)

	Forecast		
	2007	**2008**	**2009**
United States Real GDP:			
LAO November	2.1%	1.9%	2.9%
UCLA December	2.1	1.9	2.9
DOF January	2.1	1.9	2.9
Blue Chip "Consensus"[b] January	2.2	2.2	2.7
LAO February	2.2	1.6	2.7
California Payroll Jobs:			
LAO November	1.1%	1.0%	1.3%
UCLA December	1.3	0.5	0.9
DOF January	0.8	0.7	1.0
Blue Chip "Consensus"[c] February	0.7	0.6	1.1
LAO February	0.7	0.6	0.9
California Personal Income:			
LAO November	5.3%	4.9%	5.3%
UCLA December	5.6	3.5	4.6
DOF January	5.6	4.8	5.2
Blue Chip "Consensus"[c] February	5.9	4.3	5.1
LAO February	5.9	4.7	5.1
California Taxable Sales:			
LAO November	3.2%	3.8%	4.7%
UCLA December	3.0	3.2	4.0
DOF January	0.9	3.4	4.6
Blue Chip "Consensus"[c] February	0.8	2.7	3.7
LAO February	0.8	3.6	3.8

a Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).

b Average forecast of about 50 national firms surveyed by *Blue Chip Economic Indicators*.

c Average forecast of organizations surveyed by *Western Blue Chip Economic Forecast*.

Los Angeles (UCLA) Business Forecast Project in December 2007, the consensus forecast published in the *Blue Chip Economic Indicators* (January 2008), the consensus outlook forecast in the *Western Blue Chip Economic Forecast* (February 2008), and the *2008-09 Governor's Budget* forecast.

Our 2008 projections for most variables shown are generally less optimistic than our November forecast. This is because of the additional information that recently became available in time for our update. Certain of the other forecasts shown also will be revised to incorporate these recent developments when they are next updated. To varying degrees, however, all of the projections shown in Figure 11 currently call for slowing growth in 2008 and a partial rebound in 2009.

The Demographic Outlook

California's demographic trends both directly and indirectly affect the state's economy, revenue collections, and expenditure levels. For example, they influence the size of the labor force, the demand for homes and automobiles, the volume of taxable sales, and the amount of income taxes paid. Similarly, the population and its age distribution affect school enrollments and public programs in many other areas, such as health care and social services. Consequently, the state's demographic outlook is a key element both in estimating economic performance and in assessing and projecting the state's budgetary situation.

State Population to Exceed 38 Million in 2008

Figure 12 summarizes our updated state demographic forecast. We project that California's total population will rise to 38.2 million in 2008, 38.6 million in 2009, and 39.1 million in 2010. These population projections use as their starting point published 2000 Census data for California, and incorporate developments since then regarding births, deaths, and migration flows.

Weak Economy Causing Slower Growth. Due to subdued economic performance, California's population growth has recently slowed and we project that this will continue for the next few years. The state's population is projected to grow at an average rate of a bit over 1.1 percent annually over the next three years. As can be seen from Figure 13, this is down from the 1.5 percent average for the 2002-through-2005 period and substantially less than the 2-percent-plus growth characterizing the 1980s and early 1990s.

Figure 12

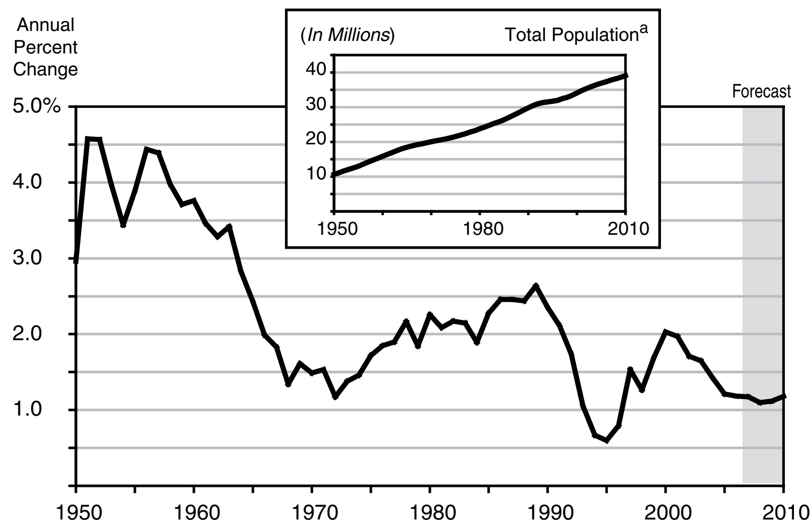
Summary of LAO's California Demographic Forecast

(Population in Thousands)

	2008	2009	2010
Total population (July 1 basis)	38,186	38,613	39,068
Changes in population:			
Natural increase (births minus deaths)	330	327	335
Net in-migration (in-flows minus outflows)	85	100	120
Total Changes	**415**	**427**	**455**
Percent Changes	1.1%	1.1%	1.2%

Figure 13

State's Population to Grow at Modest Pace



[a] LAO projections for 2008 and beyond.

In numeric terms, 1.3 million new Californians will be added over the next three years. Figure 12 shows that this reflects an average of 432,000 yearly—about the size of such cities as Long Beach, Fresno, and Sacramento, and very similar to many smaller states. Although a sizable number, Figure 13 indicates that this amount (like the percentage growth rate) is well below that of certain earlier years. In 2000, for example, the state's annual population growth peaked at 677,000.

Population Growth Components

California's population growth can be broken down into two major components—*natural increase* (the excess of births over deaths) and *net in-migration* (persons moving into California from other states and countries, minus people leaving the state for other destinations). The population growth associated with natural increase is predicted to account for somewhat over three-fourths of California's projected annual growth over the forecast period and is assumed to be fairly stable. Net in-migration accounts for the other approximately one-fourth of the growth over the period. Historically, however, this component has varied greatly in response to changing economic conditions in the state and, in previous years, has accounted for as much as one-half of the state's annual growth. Our specific projections for these demographic components are summarized below.

Natural Increase. We project that the natural increase component will contribute an average of about 330,000 new Californians annually over the forecast period. This reflects both some increase in birth rates and growth in the female population of child-bearing age groups. Regarding birth rates, these are predicted to rise somewhat from their historically low levels of recent years, based on recent preliminary information showing that a "baby boomlet" has been taking place in the country reflecting somewhat increased birth rates among essentially all age and ethnic categories. These reports suggest that in 2006, there were nearly 4.3 million births in the nation—the most since the end of the baby boom in 1961, 45 years earlier. This development has reportedly increased the nation's fertility rate to 2.1—a significant fact since that is the rate required for population to replace itself over time.

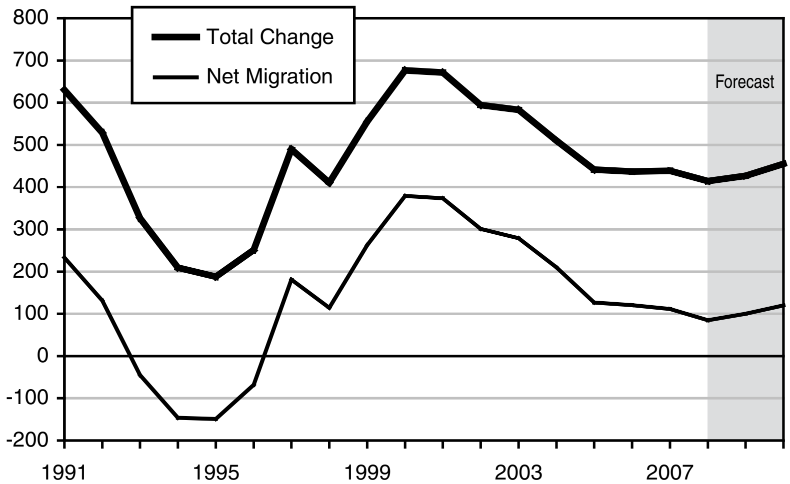
Net In-Migration. As shown in Figure 14, this component dropped by 70 percent—from 379,000 as recently as 2000 to only 111,000 in 2007—due mainly to softness in the state's economy. As the figure also shows, variations in migration largely explain variations in total population change over time.

The net migration component has two parts—foreign net migration (people coming into California from other nations minus people leaving California for other countries) and domestic migration (people coming into California from other states minus people leaving California for other states). The domestic migration element is by far the most volatile and is the reason for the sharp migration drop in recent years. Specifically:

Figure 14

Less Net Migration Slowing California Population Growth

(In Thousands)



- ***Foreign Migration.*** The positive net migration we are projecting is entirely attributable to net migration from other nations. Although it has dropped about 30 percent in recent years largely due to the economy, it still has proved to be much less sensitive to the economy than domestic population flows between states. We forecast net foreign migration will average 190,000 over the next three years, after which it will start to trend back upward as the economy strengthens. Included in the foreign migration forecast is an estimate, based on federal sources, that there are slightly over 50,000 net undocumented immigrants arriving in California annually.

- ***Domestic Migration.*** This is arguably the single most difficult demographic variable to forecast at this time. The available data indicate that this component totaled over 100,000 in 2001, started dropping in 2002, turned negative by 2005 (that is, more people left California for other states than flowed-in from them), and became even more negative in the following couple of years—with net outflows reaching nearly 90,000 in 2007. In large part, this appears attributable to California's overall economic slowing, only modest job growth, and high relative home prices. Our economic forecast is not strong enough to induce significantly more net domestic in-migration from other states in the near future. Thus, although we do expect the net domestic outflows to bottom-out in 2008 at 105,000 and then taper off and eventually reverse themselves as the economy and housing sector strengthen, we do not foresee a return to net interstate population in-flows for several years.

Given the above, we expect migration's overall contribution to California's population growth over the next few years to be relatively modest by historical standards.

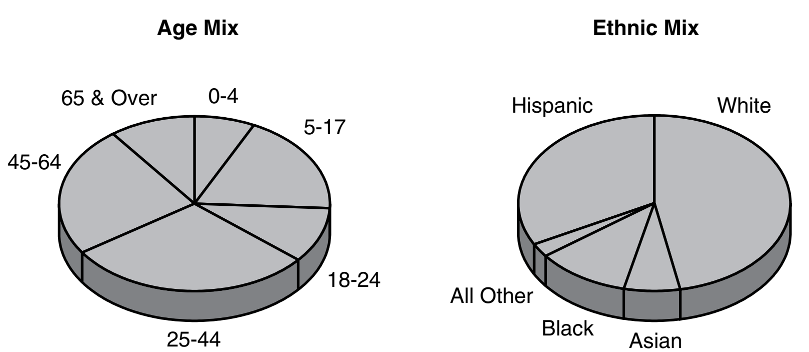
Population Characteristics

The implications of demographic trends for the budget depend not only on the total number of Californians, but also on their characteristics. California is well known for having one of the world's most dynamic and diverse populations, including a balanced age distribution, an increasingly rich ethnic mix, and a large number of in-migrants. The state's age and ethnic mix are shown in Figure 15.

Figure 15

The Age and Ethnic Mix of Californians

July 1, 2008



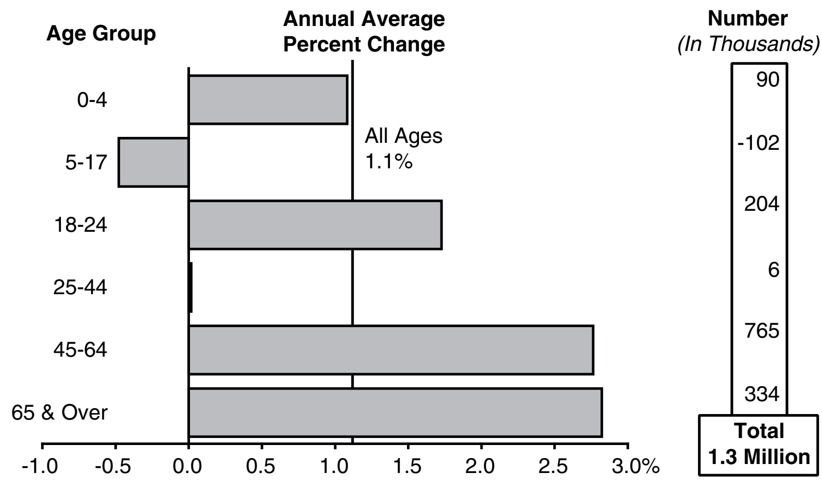
Hispanic Population Share Rising. Regarding race and ethnicity, the amounts and rates of population growth along these dimensions will differ significantly for different groups. The Hispanic population is forecast to experience especially strong growth, averaging over 2.3 percent annually, and accounting for nearly two-thirds of California's total population growth between 2007 and 2010.

Growth to Vary by Age Group. The age-related characteristics of California's population growth are especially important from a budgetary perspective, given their implications for such program areas as education, health care, and social services. Figure 16 shows our forecasts for both the percentage and numeric changes in different population age groups.

Figure 16

California's Population Outlook by Age Group

Population Change
2008 Through 2010



- ***"Baby Boomers" Swelling 45-to-64 Age Group.*** The 45-to-64 age group (largely the baby boomers) continues to be by far the fastest growing segment of the population numerically and the second-fastest percentage wise. Nearly 765,000 new people are expected to move into this age category over the next three years for an annual average growth of 2.8 percent, as the tail-end of the baby boom generation moves into its mid-40s. In contrast, the leading edge of the baby boomers will be only 64 years of age by the end of the forecast period, and thus still are occupants of this age category.

- ***Slow Growth for Children.*** At the other extreme, slow three-year average growth—only about 1 percent—is anticipated for preschoolers, while the K-12 school-age population is expected to decline slightly. This reflects several factors. One is the movement of children of the "baby-boom" generation beyond the upper-end of the 5-to-17 age group, which partially explains the above-average growth in the 18-24 age category. Other factors include the slower rate of net in-migration, and the decline in birth rates in recent years that has reduced the number of children moving into the preschool and school-age categories.
- ***Rapid Growth for the Elderly.*** The single-fastest-growing age group percentage wise and second-fastest numerically is the 65-and-over category, reflecting the well-known "graying" of the population. This cohort is expected to increase at an annual average pace of over 2.8 percent.

Geographic Population Growth Variation

Rates of growth over the forecast period will also differ by region of the state. They will be above average for the state's Central Valley, Inland Empire, and foothills areas. This will occur as the availability of land allows population to continue to "fill in" and attract migrants both from outside of California and intrastate migrants from the more-congested coastal areas where growth will necessarily be constrained. Such high-growth regions will increasingly face new challenges in providing the public services and infrastructure to accommodate growth.

Overall Budgetary Implications of the Demographic Forecast

California's continued population growth—including its age, ethnic, and migratory characteristics—can be expected to have many implications for the state's economy and public services in 2008-09 and beyond. For example, strong growth of the 45-to-64 age group generally benefits tax revenues since this is the age category in which people normally earn their highest wages and salaries. Alternatively, the lack of growth statewide in the 5-to-17 age group translates into significant declines in enrollment for many school districts. Regarding the strong growth in the elderly population, this will be putting upward pressures on health-related program costs.

More general examples of demographic influences include the following:

- The prospects for continued economic growth will benefit from an expanded labor force, due to a stronger consumer sector and the increased incomes that accompany job growth.
- However, overall demographic growth will also produce additional strains on the state's physical and environmental infrastructure, including demands on the energy sector, transportation systems, parks, and water-delivery systems.
- Similarly, the graying of the baby boomers will eventually place strains on the state's health programs and related services, including the portion of Medi-Cal related to the elderly and disabled.
- The increasing ethnic diversity of the state's population will also mean that many public institutions, especially schools, will serve a population that speaks a multitude of languages and has a wide range of cultural backgrounds. Currently, for example, more than one-third of students in kindergarten and first grade are English-language learners.

III

Perspectives on State Revenues

Perspectives on State Revenues

Summary

As discussed in "Part II" of this volume, significant economic slowing occurred in 2007 and very subdued economic performance is expected for the nation and state in 2008 and 2009. Given this, as shown in Figure 1 (see next page), very modest revenue growth occurred in 2006-07 and is forecast for the remainder of 2007-08 and 2008-09. As a result, the Governor's budget forecasts that underlying revenues for these three years are down by a combined $9.3 billion from what was forecast in the *2007-08 Budget Act*. To partially offset this weakness in state income, the administration has proposed $5.5 billion in additional revenues, largely from borrowing and accounting changes. This leaves the administration's revenues down $3.8 billion from what was projected at the time the 2007-08 budget was enacted. Our own estimate of revenues is down another $1.5 billion from the budget forecast.

In this part, we provide background information relating to the revenue outlook, discuss recent revenue developments, summarize the budget's revenue projections, and present our own revenue forecast.

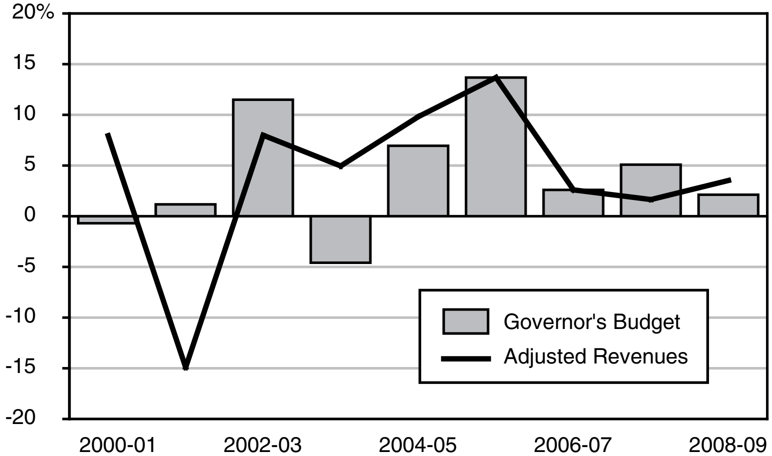
The Budget's Forecast for Total State Revenues

The *2008-09 Governor's Budget* projects that California state government will receive $129.8 billion in revenues in 2008-09. These revenues are deposited into either the General Fund or a variety of special funds. Figure 2 (see page 49) shows that:

Figure 1

Budget's Underlying Revenue Growth to Be Modest

Percentage Change in Revenues and Transfers[a]



[a] Excludes transfers between the General Fund and the Budget Stabilization Account. Adjusted revenues do not include economic recovery bond proceeds, energy loans, and the administration's proposal to accrue $2 billion of 2009-10 revenues into 2008-09.

- ***General Fund Revenues.*** Nearly 80 percent of total state revenues are deposited into the General Fund. These revenues are then allocated through the annual budget process for such programs as education, health, social services, and criminal justice.
- ***Special Funds Revenues.*** The remaining roughly 20 percent of revenues are received by special funds and are primarily earmarked for specific purposes, such as transportation, local governments, and targeted health and social services programs.

As the figure shows, some revenues—namely, personal income and sales tax receipts—support both the General Fund and special funds.

Sources of General Fund Revenues. Figure 2 also indicates that about 95 percent of total General Fund receipts in the budget year are attributable to the state's "Big 3" taxes—the personal income tax (PIT), the sales and use tax (SUT), and the corporation tax (CT). The remainder is related to a variety of smaller taxes (including insurance, tobacco, and alcoholic beverage taxes), investment earnings, tribal gambling compacts, state lands' royalties, fees, and various transfers from special funds.

Figure 2

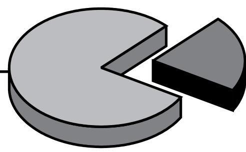
State Revenues in 2008-09

(In Billions)

General Fund Revenues

Personal Income Tax	$56.5
Sales and Use Tax	29.2
Corporation Tax	11.9
Insurance Tax	2.3
All Other	3.0
Total	**$102.9**

Total State Revenues $129.8 Billion



Special Funds Revenues

Motor Vehicle-Related Revenues	$9.5
Sales and Use Tax[a]	5.9
Personal Income Tax[b]	1.6
Tobacco-Related Taxes	1.0
All Other	9.0
Total	**$26.9**

Detail may not total due to rounding.

[a] Includes $3 billion to Local Revenue Fund, $1.5 billion redirected to pay off deficit-financing bonds, and $1.3 billion for transportation-related purposes. Excludes $3 billion allocated to Local Public Safety Fund, which is not included in the Governor's budget totals.

[b] For mental health services per Proposition 63.

Proposed Revenue-Related Changes

Although the budget does not include any significant tax changes to help deal with the budget problem, it does contain several proposals that would have significant impacts on state General Fund revenues. As shown in Figure 3 (see next page), these proposals would generate roughly $5.5 billion in 2007-08 and 2008-09, and include:

- $3.3 billion in proceeds from the sale of additional deficit-financing bonds, which are available in 2007-08.
- A one-time gain of $2 billion in 2008-09 from accruing a portion of the September 2009 PIT ($1.2 billion) and CT ($0.8 billion) estimated payments to June 2009. Under current accounting treatment, these revenues would be scored in 2009-10. Revenues in future years also would be accrued in this same manner.
- Increased revenues of about $150 million in 2008-09, and growing amounts thereafter, from augmenting Franchise Tax Board (FTB) and Board of Equalization (BOE) tax enforcement and compliance activities.

- Reinstatement of the 12-month rule for applying the use tax to out-of-state purchases of vessels, vehicles, and aircraft, to generate $5 million in 2007-08 and $21 million in 2008-09 and thereafter.

Figure 3

2008-09 General Fund Revenue Changes Proposed in the Governor's Budget

(In Millions)

	Fiscal Impact		
	2007-08	**2008-09**	**2009-10**
Sale of Deficit-Financing Bonds	$3,313	—	—
Accrual Change			
Personal Income Tax	—	$1,154	$58
Corporation Tax	—	847	42
Subtotals	—	($2,001)	($100)
Enforcement and Revenue-Enhancing Measures	—	$151	$252
Use Tax			
One-year test for Vessels, Vehicles, and Aircraft	$5	$21	$21
Totals	**$3,318**	**$2,173**	**$373**

The Budget's General Fund Revenue Outlook

The updated budget forecast assumes that underlying General Fund revenue growth (that is, growth after adjusting for the proceeds of the deficit-bond sale and accrual change) will be modest in both 2007-08 and 2008-09, as it was in 2006-07. The budget's General Fund revenue projections are summarized in Figure 4.

2006-07 Actual. The budget shows that 2006-07 General Fund revenues and transfers totaled $95.9 billion, a 2.6 percent increase from 2005-06. This revised estimate is down $125 million from the level assumed in the *2007-08 Budget Act*. This decline relative to the budget act is the net result of a variety of factors, including accrual adjustments by the State Controller and "settle-up" transfers from the General Fund to the Mental Health Fund relating to Proposition 63 (November 2004).

Figure 4

Summary of the Budget's General Fund Revenue Forecast

(Dollars in Millions)

	Actual 2006-07	2007-08 Estimated Amount	2007-08 Percent Change	2008-09 Projected Amount	2008-09 Percent Change
Taxes					
Personal income	$51,943	$52,681	1.4%	$56,458	7.2%
Sales and use	27,445	27,689	0.9	29,215	5.5
Corporation	11,158	10,675	-4.3	11,937	11.8
Insurance	2,178	2,075	-4.7	2,276	9.7
Other	485	481	-0.9	491	2.3
Other Revenues, Transfers, and Loans					
Deficit-financing bond proceeds	—	$3,313	—	—	—
Other revenues	$2,225	3,096	39.2%	$2,470	-20.2%
Transfers	453	749	—	57	—
Totals	**$95,887**	**$100,759**	**5.1%**	**$102,904**	**2.1%**

Detail may not add due to rounding.

2007-08 Estimate. The administration's forecast assumes that current-year General Fund revenues and transfers will be $100.8 billion, a 5.1 percent increase from the prior year. Although this growth rate reflects the revenue-reducing effects of such economic factors as a slowdown in profits, taxable spending, and capital gains, it also is buoyed by the $3.3 billion in proceeds from the sale of additional deficit-financing bonds. Absent this one-time factor, the underlying growth rate is a very modest 1.6 percent. The revised current-year revenue figure is down $1.5 billion from the *2007-08 Budget Act*.

2008-09 Forecast. The budget forecasts that budget-year General Fund revenues and transfers will be $102.9 billion, a 2.1 percent increase from 2007-08. After adjusting for one-time factors in both the current and budget years (the deficit-financing bonds and revenue accrual change), the underlying growth rate is about 3.5 percent. The revised budget-year revenue figure is down $2.2 billion from that assumed in the *2007-08 Budget Act*.

THE LAO'S GENERAL FUND REVENUE OUTLOOK

We Expect Lower Revenues—Down $1.5 Billion

Figure 5 shows our projections of General Fund revenues for 2007-08 through 2009-10. These projections are based on our economic and demographic forecasts presented in "Part II" of this volume and incorporate the impacts of the Governor's revenue-related policy proposals. For the current and budget years combined, we are estimating that General Fund revenues will fall below the budget forecast by $1.5 billion. We specifically forecast that:

Figure 5

Summary of the LAO's General Fund Revenue Forecast

(Dollars in Millions)

		Estimated 2007-08		Projected 2008-09		Projected 2009-10	
	Actual 2006-07	Amount	Percent Change	Amount	Percent Change	Amount	Percent Change
Taxes							
Personal income	$51,943	$52,965	2.0%	$55,967	5.7%	$58,875	5.2%
Sales and use	27,445	27,529	0.3	29,013	5.4	30,387	4.7
Corporation	11,158	10,253	-8.1	11,534	12.5	11,483	-0.4
Insurance	2,178	2,085	-4.3	2,251	8.0	2,386	6.0
Other	485	478	-1.3	487	1.7	495	1.7
Other Revenues, Transfers, and Loans							
Deficit-financing bond proceeds	—	$3,313	—	—	—	—	—
Other revenues	$2,225	2,452	10.2%	$3,053	24.5%	$2,445	-19.9%
Transfers	453	749	—	57	—	60	—
Totals	**$95,887**	**$99,823**	**4.1%**	**$102,361**	**2.5%**	**$106,131**	**3.7%**

Detail may not total due to rounding.

- ***In 2007-08,*** General Fund revenues and transfers will total $99.8 billion, a 4.1 percent increase from 2006-07. Absent the deficit-financing bond proceeds, however, our revenue growth is very weak—only 0.6 percent. Our estimate is down $935 million from the administration's. The biggest piece of this involves a timing difference regarding when the assumed $500 million from the sale of EdFund will be received. Most of the remainder reflects the net effects of a variety of differences involving the Big 3 taxes—each of a few hundred million dollars in magnitude. Compared to the administration, we are down for the SUT and CT and higher for the PIT.

- ***In 2008-09***, General Fund revenues and transfers will total \$102.4 billion, a 2.5 percent increase from the current year. After adjusting for special factors, our growth is around 4 percent. Our forecast is down by \$543 million from the budget projection, but over \$1 billion when the EdFund timing difference is removed. We are lower by hundreds of millions of dollars for each of the Big 3 taxes, as well as being down for tribal gambling revenues and interest income.
- ***In 2009-10***, revenues and transfers will total \$106.1 billion, an increase of 3.7 percent. Excluding various one-time factors, the underlying growth rate is roughly 5.8 percent.

Consistent with the soft growth we are projecting for such key revenue-determining variables as taxable sales, corporate profits, and capital gains, our underlying revenue growth rates for each of the years are below our estimate of the change in statewide personal income.

Key Factors Underlying Our Lower Estimates

Deterioration in the Economy. The single most important factor explaining our lower revenue estimates is that economic conditions at both the national and state levels have deteriorated since the budget's estimates were put together. As discussed in the following pages, this has reduced our projections for all key revenue-determining economic variables.

Mixed, Though on Balance Negative, Recent Revenue Receipts. The budget forecast is largely completed by the administration in early December, prior to when key information about year-end economic and revenue activity becomes available. Especially important is the strength of the PIT and CT estimated and miscellaneous tax payments that come in just before the end and right after the start of the calendar year. The performance of these payments has often been an early indicator of the strength of final PIT and CT payments remitted in the upcoming spring. The year-end December receipts include estimated and other payments made before 2007 ends in order to qualify for being deducted on 2007 federal PIT and CT tax returns. January revenues include the remainder of estimated payments on 2007 PIT liabilities, due on the 15th of that month. For 2007-08, the budget's projected revenue collections for these two months was very substantial—over \$20 billion. The available information, as of this writing, indicates that the performance of these recent revenue receipts and the SUT, while mixed, was on balance negative:

- On the positive side, cumulative receipts through January for the PIT and CT combined were up slightly from the January budget estimate—by $29 million. On the negative side, however, cumulative SUT revenues were down $166 million and PIT withholding came up short in January.
- The most striking recent revenue development, however, involved December corporate tax receipts. They fell short of the *2007-08 Budget Act* estimate by about $600 million. This weakness does not show up in the administration's scoring of December cash because it took this shortfall into account when it prepared its revised monthly cash projections once its revised full-year revenue estimates had been finalized. However, when doing this, it also assumed that most of the shortfall was a cash-flow anomaly and would be recouped as final corporate tax payments in March 2008 when final returns are due. Its rationale is that because corporate profits have been soft, many taxpayers may have already met most of their 2007 prepayment obligations before December, thus explaining that month's weakness.

Although only time will tell if the department is correct, Figure 6 shows that the size of the administration's CT receipts expected in March is very large compared to recent years, and thus an optimistic assumption.

Lower Estimate for Tribal Gambling Revenues. The administration is assuming $584 million in revenues from tribal gambling compacts in the current and budget years combined, primarily from the amended compacts approved by the voters earlier this month. We believe this amount is optimistic, by $173 million. This results from using more realistic assumptions than the administration about both the speed with which new slot machines would be put in place and the amount of revenues generated per machine.

Interest Income and Oil-Related Differences. As discussed later, we also are lower than the administration for interest income on invested General Fund balances, but higher on state lands' royalties. When these partially offsetting factors are combined with the tribal gambling difference above, we are down on these three items from the administration for the current and budget year combined by $61 million.

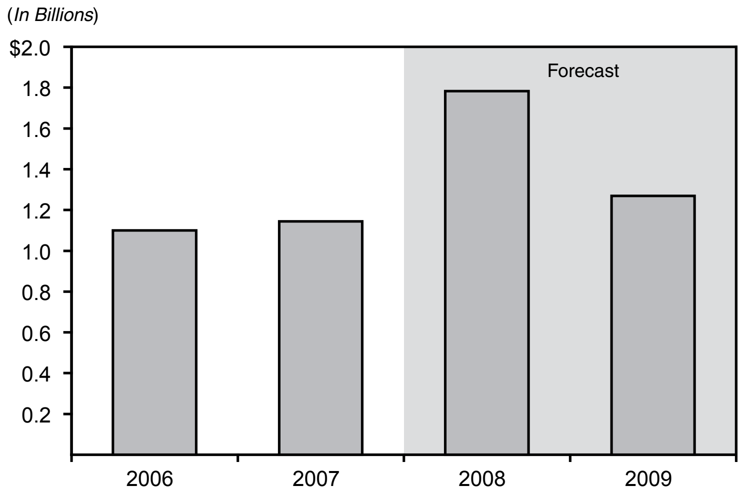
The LAO's Forecast for Major Revenue Sources

As indicated above, the great majority of General Fund revenues are attributable to the state's three major taxes—the PIT, SUT, and CT. The performance of these taxes will have a dominating influence on the overall

Figure 6

Optimistic Assumption for March 2008 Corporate Tax Payments

Final and Miscellaneous Tax Payments in March



revenue outlook. In the following sections, we discuss in more detail recent developments and the outlook for each of these key revenue sources.

Personal Income Tax

Background

The PIT is, by far, the state's largest revenue source, accounting for 55 percent of total estimated General Fund revenues in 2008-09. In general, the PIT is patterned after federal law with respect to reportable types of income, deductions, exemptions, exclusions, and credits. Under the PIT, taxable income is subject to marginal rates ranging from 1 percent to 9.3 percent, with the top rate applying to taxable income in excess of $89,628 for joint returns in 2007 (or $44,814 for taxpayers filing single returns). An additional 1 percent rate is imposed on the portion of incomes in excess of $1 million (for a total marginal rate of 10.3 percent for affected taxpayers). The proceeds of this surcharge, which was implemented following approval of Proposition 63 in November 2004, are allocated to a special fund to support various mental health programs. California also imposes a PIT Alternative Minimum Tax (AMT) of 7 percent along the lines of the federal AMT.

PIT Revenue Forecast

We forecast that PIT receipts will total $53.0 billion in 2007-08, a 2 percent increase from the prior year. We also forecast that PIT receipts will increase by 5.7 percent, to $56.0 billion, in 2008-09 and by an additional 5.2 percent, to $58.9 billion, in 2009-10. Compared to the budget forecast, our current projection of PIT revenues is up by $284 million in the current year and down by $491 million in 2008-09, or below the administration by $208 million for the two years combined.

Key Forecast Factors

The main determinants of PIT collections in a given fiscal year are the annual tax liabilities for the two income years falling within the fiscal year, any special adjustments that have to be made to these liabilities, and the timing of the cash payments associated with them. The latter include withholding, quarterly estimated payments, final payments, and refunds.

As noted at the outset, our forecast is based on the Governor's policies. Therefore, our revenue estimates assume the Governor's proposal to accrue a portion of the revenues associated with the September 2009 PIT prepayment into 2008-09, and to continue this thereafter. This increases our 2008-09 revenues by somewhat over $1 billion. Without this accrual change, PIT revenue growth in 2008-09 would be much lower—less than 4 percent.

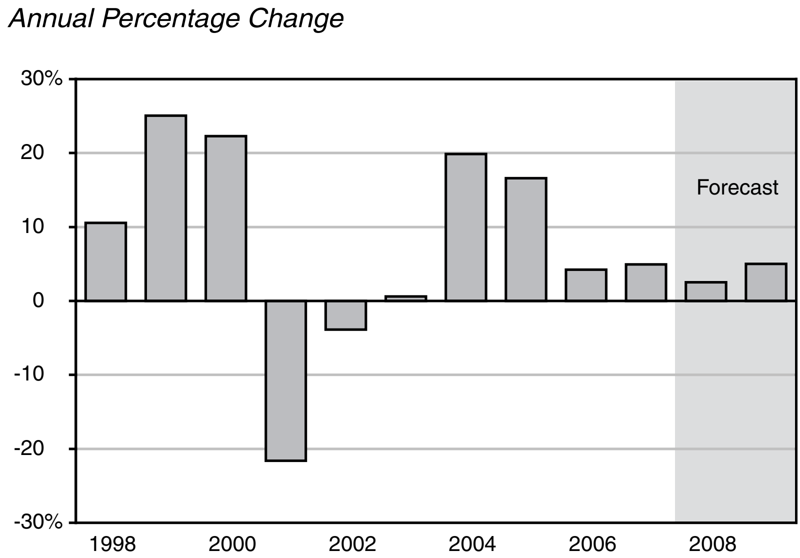
We also include in our projections the administration's adjustments totaling $74 million for the various PIT revenue-generating tax enforcement and compliance activities by FTB that the Governor has proposed.

Lastly, our projections, like the administration's, include transfers out of the General Fund of PIT revenues equal to a bit over $400 million in both 2007-08 and 2008-09, to settle-up the Proposition 63 amount due to the Mental Health Fund.

Liability Growth. Figure 7 shows that, after growing quite rapidly in both 2004 and 2005, PIT liability growth eased in both 2006 and 2007 to under 5 percent. These reduced growth rates are consistent with the slowing in California's economy and the state's housing market downturn. These developments have especially taken a toll on real estate-related profits and capital gains. For example, we estimate that, after booming by 60 percent in 2004 and over 45 percent in 2005, capital gains grew by only 4 percent in 2006 and were flat in 2007. This, in turn, has had a magnified negative effect on California's PIT liabilities, since business-related profits and capital gains tend to accrue to high-income taxpayers, which are subject to California's top income tax rates.

Figure 7

Modest PIT Liability Growth Forecast



We project that PIT liability growth will drop to below 3 percent in 2008 when the economy will be at its weakest, before rising back to 5 percent in 2009. An important element in our forecast is our outlook for capital gains and stock options. Together, these items totaled close to $160 billion and accounted for more than $14 billion in PIT liabilities in 2006. Figure 8 (see next page) shows that while we do not expect a major decline in their combined amount in the following three years, they will be fairly flat.

Sales and Use Tax

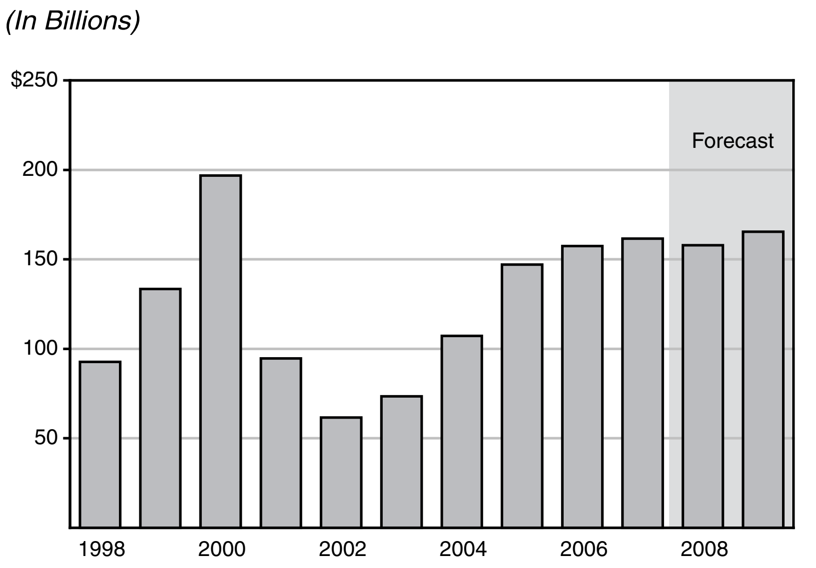
Background

The SUT is the General Fund's second largest revenue source, accounting for 28 percent of estimated total revenues in 2008-09. The main SUT component is the *sales* tax, which is imposed on retail sales of tangible goods sold in California. Some examples of sales tax transactions include spending on clothing, furniture, computers, electronics, appliances, automobiles, and motor vehicle fuel. Purchases of building materials that go into the construction of homes and buildings are also subject to the sales tax, as are purchases of computers and other equipment used by businesses. The largest exemption from SUT is for most food items consumed at home. The great majority of services are not directly subject to the sales tax in California.

The second component of the SUT—the *use* tax—is imposed on products bought from out-of-state firms by California residents and businesses for use in this state. With the exception of purchases of vessels, vehicles, and aircraft (which must be registered), out-of-state purchases are difficult to monitor, and the state is prohibited under current federal law from requiring most out-of-state sellers to collect the use tax for California. As a result, use tax receipts account for only a small portion of total SUT revenues.

Figure 8

Capital Gains and Stock Options–Little Growth



SUT Rates

The total SUT rate levied in California is a combination of several different individual rates imposed by the state and various local governments. These include:

- ***State Rate.*** The basic state SUT rate is currently 6.25 percent. The largest single component is the 5 percent state General Fund rate. Also included in the overall state rate are two half-cent rates whose proceeds are deposited into (1) the Local Revenue Fund, which supports health and social services program costs associated with the 1991 state-local realignment, and (2) the Local Public Safety Fund, which was approved by the voters in 1993 for the support of local criminal justice activities. The final component of the state's SUT rate involves Proposition 57. Under that measure, which was approved by the voters in March 2004, 0.25 percent of the Bradley-Burns rate (discussed below) is diverted to a state special fund for purposes of repayment of the deficit-financing bonds. These bonds were issued in 2004 and more recently in 2008 to help deal with the state's budget problem. (The diverted local sales taxes are being replaced by a shift of property taxes from schools, which are in turn reimbursed by Proposition 98 payments to schools by the state General Fund. As a result of these various steps, state government is ultimately responsible for the bonds' repayment.) The diversion of sales tax revenues will remain in effect until the bonds are paid off, which the administration is projecting to do in 2012-13.

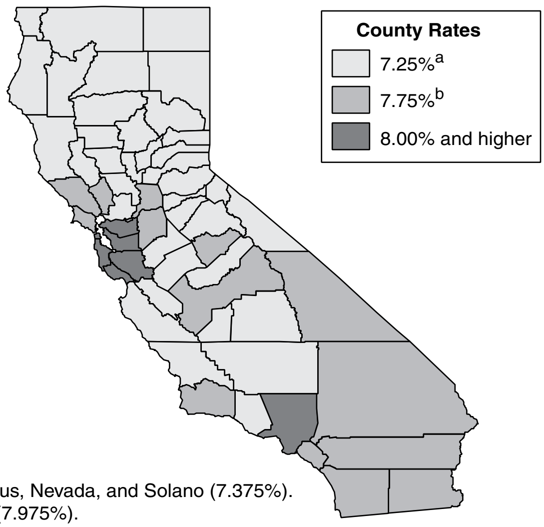
- ***Uniform Local Rate.*** This is a uniform local tax rate of 1 percent levied by all counties (the so-called Bradley-Burns rate). Of this total, 0.25 percent is deposited into county transportation funds, while the remaining 0.75 percent is allocated to city and county governments for their general purposes. This latter rate will return to 1 percent once the deficit-financing bonds are paid off.
- ***Optional Local Rates.*** The final overall SUT rate component involves optional local tax rates, which local governments are authorized to levy for any purpose. These taxes, which require local voter approval, are normally levied on a countywide basis—primarily for transportation-related purposes. They are generally levied in 0.25 percent or 0.5 percent increments and cannot exceed 1.5 percent in total (except in San Francisco and San Mateo Counties).

Combined SUT Rates Throughout California. The combined state and local SUT rate varies significantly across California due to differences in the local optional rates that are levied (see Figure 9 on the next page). The combined SUT rate currently ranges from 7.25 percent (for those counties with no optional rates) up to 8.75 percent. On a weighted-average basis, calculated using the amount of taxable sales in different counties and their respective SUT rates, the statewide rate is currently 7.94 percent.

Figure 9

Sales Tax Rates Vary by County

January 1, 2008



[a] Includes Stanislaus, Nevada, and Solano (7.375%).
[b] Includes Fresno (7.975%).

SUT Revenue Forecast

We forecast that SUT receipts will total $27.5 billion in 2007-08, a weak 0.3 percent increase from the prior year. Revenues from this source are projected to increase to $29.0 billion in 2008-09 (up 5.4 percent from the current year) and to $30.4 billion in 2009-10 (a 4.7 percent increase). Compared to the budget forecast, our SUT revenue estimate is down $160 million in 2007-08 and by $202 million in 2007-08, for a two-year shortfall of $362 million.

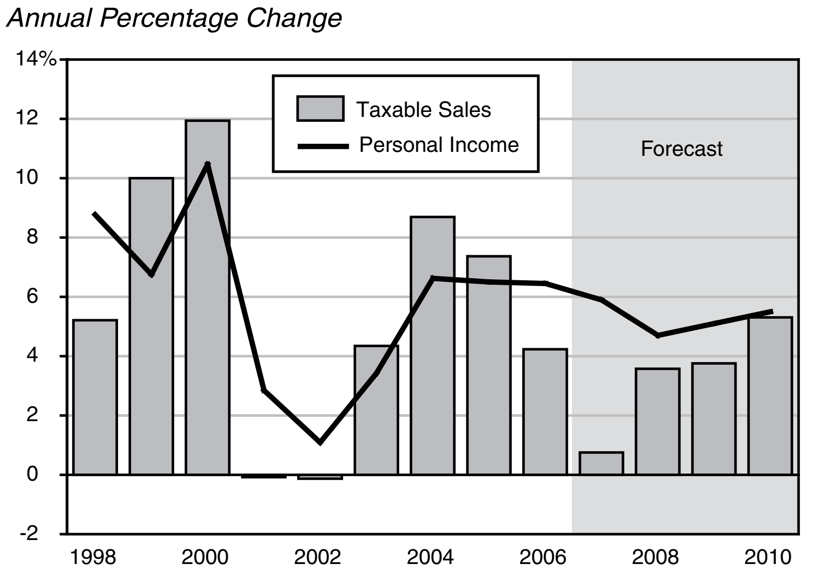
Key Forecast Factors

The key factors behind our forecasted General Fund SUT collections are (1) modest increases in taxable sales and (2) large amounts are deposited in transportation-related special funds.

Taxable Sales. Figure 10 shows that taxable sales generally experienced strong growth in 2004 and 2005, but slowed sharply in 2006 as the economy started decelerating. Then, in 2007, growth dropped to only 0.8 percent. This deterioration has been especially driven by the decline in California's real estate market and its adverse impact on sales of building materials, home furnishings, and related household items. However, it also is related to the negative impacts of higher gasoline prices on consumer spending on big-ticket items, particularly light vehicles sales (cars, smaller trucks, and SUVs). California also appears to have experienced a fairly soft holiday shopping season, which added to the underlying weakness related to housing and autos.

Figure 10

Taxable Sales Growth to Trail Personal Income



We expect that taxable sales growth will be a modest 3.6 percent in 2008, with the first one-half of the year especially weak. Then, we forecast that taxable sales growth will pick up a bit in 2009, averaging 3.8 percent, as the housing market continues to stabilize. As Figure 10 indicates, we expect taxable sales growth to trail growth in personal income in both years. Our taxable sales forecasts consider the effects of a variety of factors including personal income, housing activity, employment, the savings rate, unemployment, general inflation, and gasoline prices and consumption.

Public Transportation Account (PTA)-Related Revenues. A second factor depressing sales tax revenues to the General Fund in the current and budget years is a large and growing amount of revenues from gasoline and diesel fuel sales tax that goes to the PTA instead of the General Fund. These revenues include the so-called spillover of SUT revenues, gasoline sales tax revenue associated with Proposition 111, and diesel sales tax revenues. Currently, the largest of these items, the spillover, is based on a formula established in the early 1970s that basically compares taxable sales of gasoline to taxable sales of all other products. (This formula was established at the time California extended the SUT to gasoline sales and in exchange reduced the SUT rate, with the aim of the formula being to ensure that any extra monies raised by this action would go to transportation.) Under this formula, the transfer increases when the share of total taxable sales that is attributable to gasoline increases. Thus, it is sensitive to both gasoline prices and consumption. In practice, the spillover has tended to increase during periods of high gasoline prices, and decrease, or disappear, during periods of low gasoline prices. We forecast that PTA-related SUT revenues totaled $947 million in the prior year and will reach $1,137 million in 2007-08 and $1,247 million in 2008-09. These amounts are based on our forecasts for taxable sales and the prices and consumption of fuel. (As we discuss in a write-up in the *Analysis of the 2008-09 Budget Bill*, beginning in 2008-09, one-half of all spillover will be used each year to offset General Fund expenditures on transportation. Please see "Funding for Transportation Programs" in the "Transportation" chapter of the *Analysis*.)

Other Adjustments. Our SUT forecast also includes $58 million in budget-year revenues for the various SUT revenue-generating tax enforcement and compliance activities by BOE that the Governor has proposed. In addition, it includes revenues of $5 million in 2007-08 and $21 million in 2008-09 due to the Governor's proposal to reinstate the 12-month rule for applying the use tax to out-of-state purchases of vessels, vehicles, and aircraft.

Corporation Tax

Background

The CT is the third largest state revenue source, accounting for 12 percent of total estimated revenues in 2008-09. The tax is levied at a general rate of 8.84 percent on California taxable profits. Banks and other financial institutions subject to the CT pay an additional 2 percent tax, which is in lieu of most other state and local levies. Corporations that qualify for California Subchapter "S" status are subject to a reduced 1.5 percent corporate rate. In exchange, the income and losses from these corporations are "passed through" to their shareholders where they are subject to PIT. Similarly, businesses that are classified as Limited Liability Companies (LLCs) pay a minimum tax and fee at the corporate level. Their income and losses are passed through to their owners, where they are subject to the PIT. California also imposes a corporate minimum tax and a 6.65 percent AMT.

Approximately two-thirds of all CT revenues come from multistate and multinational corporations. These companies have their consolidated U.S. income apportioned to California based on a formula involving the share of their combined property, payroll, and sales that is attributable to this state.

California's CT allows for a variety of exclusions, exemptions, deductions, and credits, many of which are related to, similar to, or identical to those provided under the federal corporate profits tax. Key examples include the research and development (R&D) tax credit and net operating loss carry forward provisions. Under the latter, companies can use operating losses incurred in one year as a deduction against earnings in subsequent years. Under legislation enacted in 2002, corporations were not able to use these losses to offset their income in tax years 2002 and 2003. However, such deductions were allowed again beginning in 2004, and the percentage of losses which may be carried forward and deducted against future tax liabilities jumped from 65 percent under prior law to 100 percent for losses incurred starting in 2004. In "Part V" we propose limiting allowable net operating loss deductions again, as well as R&D credits that may be claimed, to help deal with the budget problem.

Revenues Have Been Slowing. After many years of near-stagnant growth, revenue collections from the CT grew rapidly between 2001-02 and 2005-06. In 2006-07, however, growth slowed to around 8 percent, as corporate profits started to slow along with the economic activity generally.

CT Revenue Forecast

We forecast that CT receipts will be $10.3 billion in 2007-08, an 8 percent drop from the prior year. Thereafter, we forecast that revenues will grow to $11.5 billion in 2008-09 (a 12 percent increase) and remain at that level in 2009-10.

Our estimates take into account our projected changes in taxable business profits, as well as such factors as tax credits and audit collections. Our CT forecast also includes $14 million in budget-year revenues for the various CT revenue-generating tax enforcement and compliance activities by FTB that the Governor has proposed. Finally, as for the PIT, our revenue estimates assume the Governor's proposal to accrue a portion of the revenues associated with the September 2009 CT prepayment into 2008-09, and to continue this thereafter. This latter factor increases our 2008-09 revenues by a bit over $760 million. Without this accrual change, our CT revenue growth in 2008-09 would be much lower—about 5 percent.

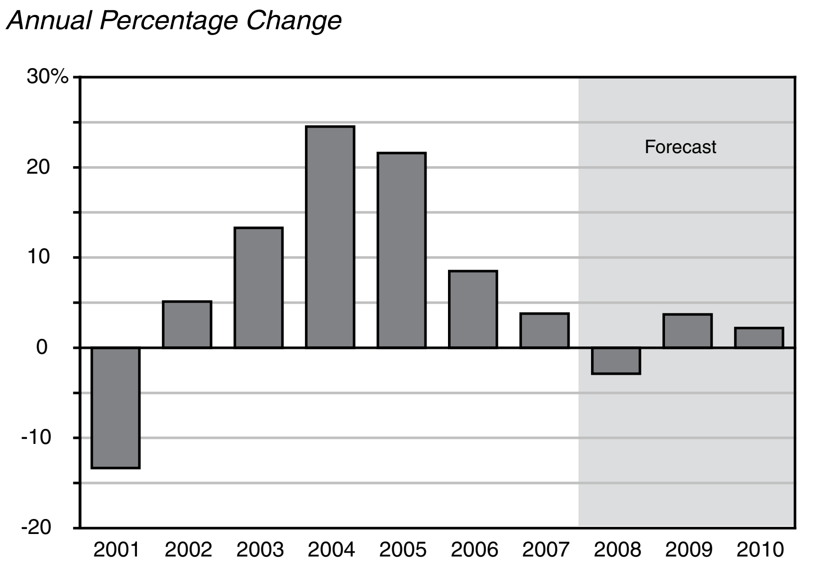
Our CT revenue forecast is below the budget estimate by $422 million for the current year and $403 million for the budget year, or $825 million for the two years combined.

Key Forecast Factors

The key determinant of CT tax revenues is California taxable profits. As shown in Figure 11, these profits were up by a strong 25 percent in 2004 and 22 percent in 2005, reflecting widespread earnings increases. Profits growth then started to drop off, coming in at a still healthy, but much slower, 8 percent in 2006 as the economy started to cool and the housing market's problems started to emerge. In 2007, as these trends continued, profits growth slowed sharply to an estimated 4 percent.

Figure 11

Weakness in California Corporate Profits Expected



Further Profits Slowing Expected. Looking ahead, we forecast that taxable California corporate profit growth will deteriorate even more and experience an actual decline in 2008 of 3 percent, before returning to a modest growth of 4 percent in 2009 off of this lower base. Although some industry sectors will continue to experience gains, many others will not—especially those relating to the housing sector, real estate-related financial activities, manufacturing operations providing home construction materials, and financial firms associated with the mortgage market's problems. Our California profits forecast considers the impacts of such factors as national profit trends (given that so many of our firms are multinational and multistate enterprises), proprietor's income (which is closely related to profits and for which very timely data are available), employment activity, and financial market performance such as stock market developments.

Other Revenues and Transfers

The remaining 5 percent of total 2008-09 General Fund revenues and transfers consists primarily of taxes on insurance premiums, alcoholic beverages, and tobacco products. It also includes interest income; tribal gambling receipts; oil-related royalties; and a large number of fees, loans, and transfers.

We forecast that combined revenues from all of these other sources will rise from $5.3 billion in 2006-07 to $9.1 billion in 2007-08, before falling to $5.8 billion in 2008-09 and $5.4 billion in 2009-10. These totals and their year-to-year variation are affected by a variety of factors, some of a unique one-time nature and others of a more ongoing nature. Relative to the administration, our revenues in this category are down $637 million in the current year but up $553 million in the budget year, or down $84 million for the two-years combined.

Deficit-Financing Bonds—
$3.3 Billion Included in the Revenue Totals

As noted earlier, 2007-08 revenues include $3.3 billion in one-time deficit-financing bond proceeds that will be used to help address the budget problem. These proceeds, which are borrowed money and not revenues in the true sense, are nevertheless included in the revenue totals for budgetary accounting purposes.

Insurance Taxes—Moderate Growth

This is the state's fourth largest individual revenue source and involves a tax of 2.35 percent on most types of insurance premiums written. We project that revenues will reach $2.1 billion in 2007-08, $2.3 billion in 2008-09, and $2.4 billion in 2009-10. This moderate growth reflects steady increases in taxable insurance premiums for homeowners, automobiles, and other types of coverage, partially offset by declines for workers' compensation. The projections include downward adjustments to revenues of $175 million in 2007-08 and $100 million in both 2008-09 and 2009-10 associated with a BOE appeals case. For the current and budget years combined, our projections are very close to the administration's—down $15 million.

Interest Income—Downward LAO Adjustment

We project that the interest income the state will receive from investing its idle funds on a short-term basis will be $478 million in 2007-08 and $420 million in 2008-09. This compares to $533 million in 2006-07. The drop reflects the combination of (1) declining interest yields earned on the state's invested funds and (2) the state's tighter fiscal situation, which affects its fund balances available to invest at any given time. For the current and budget years combined, our projections are down $104 million compared to the administration.

Tribal Gambling Proceeds—Also Overstated

The Governor's budget assumes that tribal gambling compact payments to the General Fund will total $154 million in 2007-08 and $430 million in 2008-09. (The 2008-09 figure does not include $40 million of tribal payments to be transferred to the account that distributes funds to noncompact tribes.) We believe that these estimates are overstated. The administration has assumed that five Southern California tribes—including the four tribes affected by the recent approval of Propositions 94, 95, 96, and 97—grow their casinos' customer bases and expand slot machine operations much more rapidly than we expect to be the case. For the current and budget years combined, we estimate that General Fund compact revenues will be below the budget forecast by $173 million.

State Lands Royalties—Upward LAO Adjustment

These monies, which largely represent the proceeds the state receives under profit-sharing agreements with the oil field operators, are projected to total $320 million in 2007-08 and $304 million in 2008-09 and thereafter. This high level of revenues compared to earlier years reflects the recent rise in world crude oil prices and, thus, the value of the oil that our properties produce. For the current and budget years combined, our projections are up $217 million above the administration's. This reflects an updated revenue projection by the State Lands Commission since the budget came out to capture the effects of recent oil price increases.

The Budget's Forecast for Special Funds Revenues

Special funds revenues are related to a variety of sources:

- About $9.5 billion (or 35 percent of the budget-year total) is related to motor vehicle-related revenues. These include the vehicle license fee, which is assessed in lieu of the property tax and whose proceeds are distributed to local governments. They also include fuel taxes and registration fees, which support transportation-related spending.
- Another $5.9 billion is related to the SUT. Of this total, (1) about $3 billion is used to fund health and social services programs that were realigned from the state to local governments beginning in the early 1990s, (2) $1.5 billion is related to the diversion of local sales taxes for deficit-financing bond debt service, and (3) about $1.3 billion is used for transportation programs.
- Roughly $1.6 billion is related to the high-income PIT surcharge for mental health programs under Proposition 63.

- $976 million is from tobacco taxes that have been approved by voters in various elections.
- The remaining special funds revenues are related to a wide variety of sources, including an energy resource surcharge and beverage container redemption fees. The special fund totals are also affected by various transfers and loans between funds.

Modest Underlying Growth Expected

As shown in Figure 12, the Governor's budget assumes that special funds revenues will total $25.3 billion in the current year (a 2 percent

Figure 12

Summary of the Budget's Special Funds Revenue Forecast

(Dollars in Millions)

		2007-08		2008-09	
	Actual 2006-07	Estimated Amount	Percent Change	Projected Amount	Percent Change
Motor Vehicle Revenues					
License fees (in lieu)	$2,270	$2,332	2.7%	$2,392	2.6%
Fuel taxes	3,433	3,504	2.1	3,565	1.8
Registration, weight and miscellaneous fees	2,850	2,969	4.2	3,545	19.4
Subtotals	($8,553)	($8,805)	(2.9%)	($9,503)	(7.9%)
Sales and Use Tax					
Realignment	$2,862	$2,887	0.8%	$3,013	4.4%
Deficit-financing bonds	1,411	1,443	2.2	1,522	5.5
Transportation	951	1,158	21.8	1,343	16.0
Subtotals	($5,225)	($5,488)	(5.0%)	($5,878)	(7.1%)
Other Sources					
Personal income tax surcharge	$1,375	$1,493	8.6%	$1,565	4.8%
Cigarette and tobacco taxes	963	952	-1.1	976	2.5
Interest earnings	474	379	-20.1	339	-10.4
Other revenues	8,109	8,285	2.2	8,692	4.9
Transfers and loans	77	-130	—	-70	—
Totals	**$24,776**	**$25,271**	**2.0%**	**$26,884**	**6.4%**

Detail may not total due to rounding.

increase) and $26.9 billion in 2008-09 (a 6.4 percent increase). A variety of factors are affecting the year-to-year growth rates, including varying amounts of sales tax spillover revenues going to transportation and other transfers between funds. Special funds revenues from ongoing tax sources are projected to increase by roughly 4 percent in 2007-08 and 7 percent in 2008-09. The budget-year growth rate reflects moderate increases in SUT and PIT special funds tax revenues, and modest increases in vehicle license fees, motor vehicle fuel taxes, and tobacco taxes.

IV

Perspectives on State Expenditures

Perspectives on State Expenditures

Proposed Total Spending in 2007-08 and 2008-09

The Governor's budget proposes total spending in 2008-09 of $128.8 billion, including $101 billion from the state's General Fund and $27.8 billion from its special funds (see Figure 1). This total budget-year spending is $3.4 billion lower than current-year spending—a decrease of 2.6 percent—due to the Governor's proposed budget reductions. Of total budget-year spending, General Fund spending accounts for about 78 percent. This proposed total spending level translates into $3,351 for every Californian, or $353 million per day.

Figure 1

Governor's Budget Spending Totals

(Dollars in Millions)

			Change	
	2007-08	**2008-09**	**Amount**	**Percent**
Budget Spending				
General Fund	$103,373	$100,998	-$2,375	-2.3%
Special Funds[a]	28,836	27,774	-1,062	-3.7
Totals	**$132,209**	**$128,772**	**-$3,437**	**-2.6%**

[a] Reflects LAO adjustments as detailed in text.

Detail may not add due to rounding.

Spending Totals Reflect Budget Reductions. The Governor's proposed 2008-09 budget includes $10.7 billion ($9.1 billion General Fund) in budget-balancing reductions, which touch most areas of state government. In some of the administration's budget summaries, these reductions are excluded from program spending totals or shown as a separate line item. In contrast, the displays in this publication always allocate the reductions to their respective program area. This helps provide an accurate reflection of how each program's spending would change under the Governor's proposals. With respect to special funds, the budget's published information shows 2008-09 budget-balancing reductions of $1.5 billion. However, nearly all of the proposed reductions would not impact the amount of spending from special funds. Instead, the reductions would reduce the amount of *federal* funds received by the state, which are excluded from most state budget summaries. (The administration reports that it did not have sufficient time in preparing the budget documents to break out the reductions between state special funds and federal funds.) Under the Governor's proposals, federal funds would be reduced by $1.7 billion, partially offset by about $200 million in increased special funds and reimbursements. The displays in this publication make adjustments to the spending totals to accurately reflect the proposed split of the reductions and, thus, do not tie to the budget's published spending information tables.

Allocation of Total State Spending

Figure 2 shows the allocation of the proposed $128.8 billion of total state spending in 2008-09 among the state's major program areas. Both General Fund and special fund expenditures are included in order to provide a meaningful comparison of state support among broad program categories, since special funds provide the bulk of support in some areas (such as transportation).

The figure shows that K-12 education receives the largest share of spending—30 percent of the total. (K-12 education also receives additional funding from the local property tax and State Lottery.) When higher education is included, education's share rises to 39 percent. Health and social services programs account for 29 percent of proposed total spending, while transportation (8 percent) and criminal justice (12 percent) account for the major portions of the remainder.

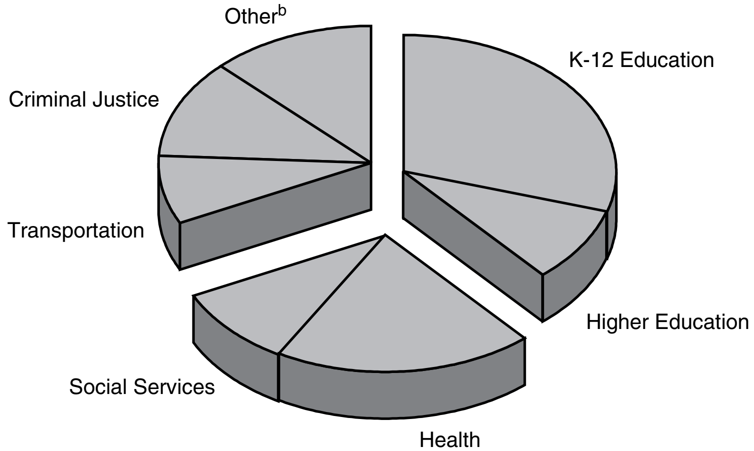
General Fund Spending

Background. The General Fund is the main source of support for state programs, funding a wide variety of activities. For example, it is the major funding source for K-12 and higher education programs, health and

Figure 2

Proposed Total State Spending by Major Program Area[a]

2008-09



[a] Excludes bond funds, federal funds, and the Local Public Safety Fund.
[b] Includes expenditures on resources, environment, and shared revenues.

social services programs, criminal justice programs, as well as tax relief provided through the budget.

Proposed Spending. The Governor proposes General Fund spending of $101 billion for 2008-09, a decrease of 2.3 percent. As has been the case in recent years, the year-to-year changes in many programs are being affected by special factors, such as funding redirections and one-time actions. As shown in Figure 3 (see next page):

- General Fund spending for K-12 Proposition 98 programs is proposed to be $35.5 billion, a 5.4 percent decline from the current year. This reflects the administration's proposal to suspend the Proposition 98 minimum guarantee by $4 billion. Accounting for local property tax revenue growth, total combined state and local funding for K-12 Proposition 98 would decline by 2.2 percent.
- General Fund Proposition 98 spending for community colleges is proposed to total $4 billion, a 2.2 percent decline from the current year. This reduction reflects the proposed suspension of Proposition 98, partially offset by budget-year funding to restore current-year apportionment reductions and accommodate enrollment growth. Accounting for local property tax growth, community college funding would rise slightly in 2008-09, up 0.9 percent.

Figure 3

General Fund Spending by Major Program

(Dollars in Millions)

	Actual 2006-07	Estimated 2007-08	Proposed 2008-09 Amount	Proposed 2008-09 Percent Change
Education				
K-12 Proposition 98	$37,264	$37,473	$35,461	-5.4%
Community Colleges Proposition 98	4,030	4,116	4,027	-2.2
UC/CSU	5,883	6,231	6,035	-3.1
Other	4,120	6,027	5,587	-7.3
Health and Social Services				
Medi-Cal	$13,406	$14,064	$13,585	-3.4%
CalWORKs	2,018	1,481	1,547	4.5
SSI/SSP	3,534	3,641	3,748	2.9
In-Home Supportive Services	1,474	1,630	1,633	0.2
Other	8,580	8,762	8,786	0.3
Criminal Justice	$11,802	$13,036	$13,122	0.7%
Transportation	$2,980	$1,439	$1,485	3.3%
All Other	$6,323	$5,474	$5,983	9.3%
Totals	**$101,413**	**$103,373**	**$100,998**	**-2.3%**

- University of California and California State University combined funding is proposed to be $6 billion, a 3.1 percent decline from the current year. Most of the reduction is unallocated by the administration and would be partially offset by student fee increases.
- Medi-Cal funding is proposed to total $13.6 billion, a 3.4 percent decline from the current year. The reduction reflects a number of budget reduction proposals, including a 10 percent provider payment reduction and the elimination of some optional benefits for adults.
- California Work Opportunity and Responsibility to Kids (CalWORKs) spending would increase by 4.5 percent to $1.5 billion in the budget year. This reflects rising costs due to the granting of a 4.25 percent cost-of-living adjustment (COLA) and one-time savings in 2007-08, partially offset by budget-year savings from a CalWORKs reform package.

- Supplemental Security Income/State Supplementary Program spending is proposed to total $3.7 billion, an increase of 2.9 percent. The Governor proposes to suspend the June 2008 and June 2009 COLAs provided for in current law.
- In-Home Supportive Services (IHSS) spending is proposed to total $1.6 billion, a 0.2 percent increase from the current year. Higher costs from increased caseload are offset by proposed reductions in domestic service hours.
- Criminal justice funding is proposed to increase by 0.7 percent to $13.1 billion. The relatively flat amount reflects some rising costs offset by the Governor's correctional early release and summary parole proposals.
- Transportation spending from the General Fund is proposed to total $1.5 billion, an increase of 3.3 percent from the current year. This reflects the expected growth in the General Fund transfer of gasoline sales tax revenues to transportation programs required under Proposition 42 (March 2002).

Growth in Spending. Since 1997-98, General Fund spending has averaged about 7 percent annual growth. Figure 4 (see next page) illustrates that this annual growth rate varies considerably by major state program. For instance, General Fund spending on transportation has increased at the fastest rate due to the passage of Proposition 42. Several health and social services programs—IHSS, developmental services, and mental health—have averaged double-digit growth over the past decade. Resources and environmental protection spending has increased an average of almost 9 percent due to increased debt-service payments attributable to the passage of a number of general obligation bonds over the period. On the other hand, General Fund spending on CalWORKs has fallen slightly since 1997-98 (the program's first year of spending as part of welfare reform)—due to declining caseloads and various funding shifts.

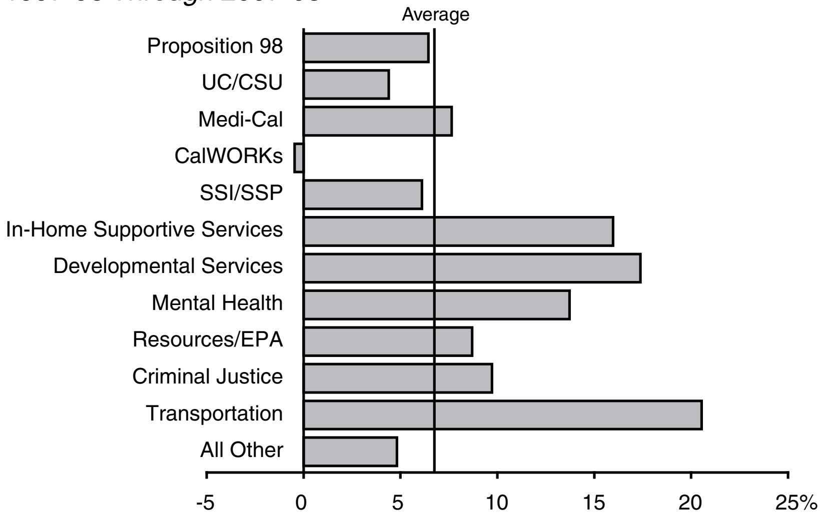
Special Funds Spending

Background. Special funds are used to allocate certain tax revenues (such as gasoline and certain cigarette tax receipts) and various other income sources (including many licenses and fees) for *specific* functions or activities of government designated by law. In this way, they differ from General Fund revenues, which can be allocated by the Legislature among a variety of programs. About 35 percent of special fund revenues come from motor vehicle-related levies and another 22 percent come from sales taxes. The remainder comes from numerous source—including a 1 percent surcharge on personal income taxes, tobacco taxes, charges, and fees.

Figure 4

Growth in General Fund Spending by Program Area

Average Annual Percent Change
1997-98 Through 2007-08



Proposed Spending. In 2008-09, the Governor proposes special fund spending of $27.8 billion. This is a 3.7 percent decrease from the current-year total. As shown in Figure 5, the budget includes a 12 percent decrease in special fund spending on transportation between the current and budget year. This decline mainly reflects a much lower level of motor fuel sales tax revenues projected to be available in the Public Transportation Account for local transit projects. (Per existing law, some of this funding is instead being used to offset transportation expenses previously supported by the General Fund.) The spending decline is also related to one-time capital outlay expenditures by the California Highway Patrol and the Department of Motor Vehicles in 2007-08. A budget-year decrease of 11 percent for the California Public Utilities Commission results from reductions in supplemental payments to telephone companies, which are made to reduce the price difference of telephone service between high- and lower-cost areas. The large current-year increase in the Department of Mental Health reflects the ramp-up of spending associated with voter approval of Proposition 63 in November 2004.

Figure 5

Special Funds Spending by Major Program Area

(Dollars in Millions)

	Actual 2006-07	Estimated 2007-08	Proposed 2008-09 Amount	Percent Change
Transportation	$5,866	$8,120	$7,138	-12.1%
Local government subventions	6,368	5,985	6,819	13.9
Resources related	2,634	3,651	3,418	-6.4
Public Utilities Commission	1,211	1,383	1,231	-11.0
Department of Mental Health	371	1,531	1,528	-0.2
All other	6,104	8,164	7,639	-6.4
Totals	**$22,554**	**$28,836**	**$27,774**	**-3.7%**

Local Public Safety Funds Excluded. The budget's special funds spending total for 2008-09 excludes expenditures of roughly $3 billion from the Local Public Safety Fund (LPSF). Such spending is also excluded from the current- and prior-year totals. Our view is that LPSF revenues are state tax revenues expended for public purposes, and *should* be counted. This treatment is consistent with how the budget treats other dedicated state funds, such as the Motor Vehicle License Fee Account (which, like the LPSF, is constitutionally dedicated to local governments) and the Cigarette and Tobacco Products Surtax Fund (Proposition 99). In both of these cases, the budget *does* include these funds in its spending totals. Although we believe that spending from the LPSF constitutes state spending, we do not include it in our figures in order to facilitate comparisons with the Governor's budget.

Spending From Federal Funds and Bonds

In addition to the $128.8 billion of proposed 2008-09 spending from the General Fund and special funds, the budget also proposes $56 billion in spending from federal funds and another $14 billion from bond proceeds. If expenditures from bond proceeds and federal funds are included in total state spending, proposed 2008-09 spending exceeds $198 billion.

Federal Funds

About $56 billion in federal funds are proposed to be spent through the state budget in 2008-09. (This is about one-fourth of the $242 billion in total federal funds allocated to California. The remaining three-fourths are allocated directly to local governments, businesses, or individuals within the state.) About $33 billion (59 percent) of the total federal funds in the budget are for various health and social services programs, such as Medi-Cal, CalWORKs, and IHSS. Education receives another $10 billion (18 percent) of the total, and transportation is expected to receive $4 billion (7 percent). As noted earlier, the Governor's budget reductions would reduce federal funds spending in 2008-09 by $1.7 billion.

Infrastructure Bonds

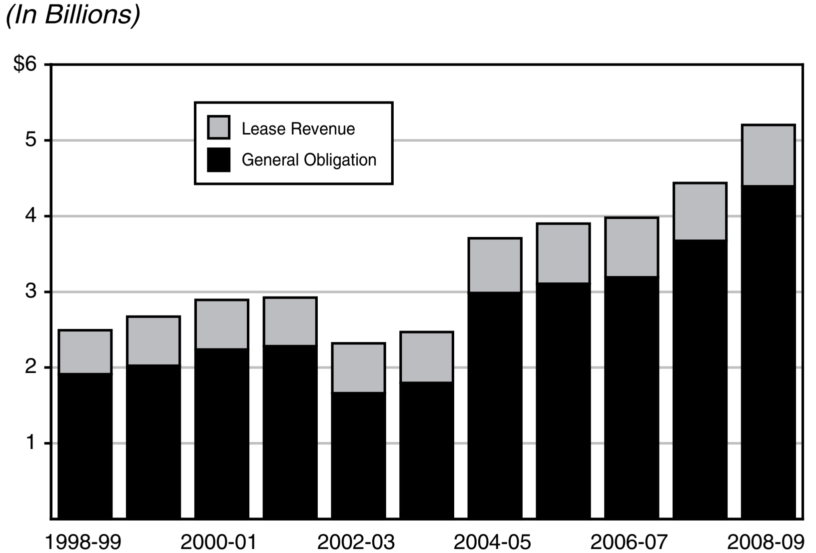
Bonds are primarily sold by the state to finance large infrastructure projects, such as school facilities, water projects, and state buildings. From a budgetary perspective, the cost of bonds is reflected when the actual debt-service payments (comprised of bond-related principal and interest payments) are made. From a programmatic perspective, bond spending is tracked when the bond proceeds are used, such as for construction projects or grant funding. Below, we discuss infrastructure bond spending from both of these perspectives.

Infrastructure Debt Service. For 2008-09, the budget proposes General Fund debt-service expenditures of $5.2 billion, of which $4.4 billion is for general obligation bonds and about $810 million is for lease-revenue bonds. The use of bond financing has risen sharply in recent years, especially with respect to general obligation bonds. Since 1970, voters have authorized a total of $122 billion in general obligation bonds. Of this amount, $85 billion has been authorized since 2000—with $43 billion approved by the state's voters in 2006 alone. The increase in bond financing has led to a sharp increase in the amount of spending on infrastructure debt service (see Figure 6). Specifically, total infrastructure debt service has doubled over the past decade, from $2.5 billion in 1998-99 to $5.2 billion in 2008-09. These costs will continue to rise as additional bonds are sold to fund the November 2006 general obligation bond package and the AB 900 (Solorio) lease-revenue prison construction bond package. If adopted, the Governor's proposal for $48 billion in additional general obligation bonds would push these costs even higher.

Spending of General Obligation Bond Proceeds. The Governor's budget proposal estimates that the state will spend $13.8 billion in general obligation bond proceeds for capital projects in 2008-09. This includes $6.7 billion for education, $3.9 billion for transportation, and $3.2 billion for resources and other areas. This total is up 5.8 percent from the $13.1 billion in current-year spending. More than $10 billion in spending in each year is associated with the November 2006 bond package.

Figure 6

Total Infrastructure Bond-Debt Service



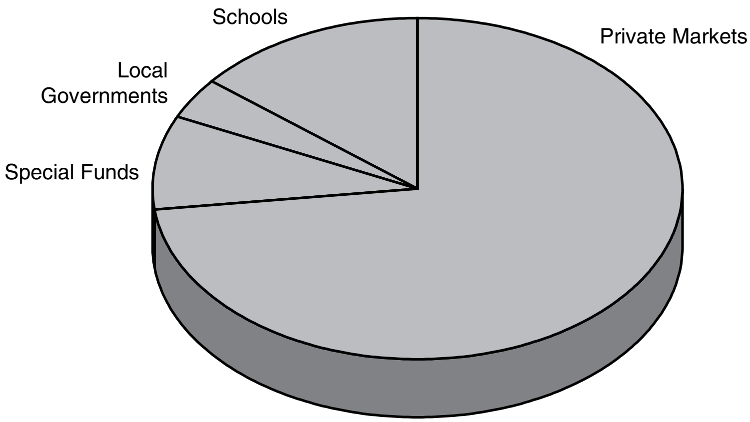
Spending of Lease-Revenue Bond Proceeds. In addition to general obligation bonds, the state also uses lease-revenue bonds to finance the construction and renovation of capital facilities. Lease-revenue bonds do not require voter approval, and their debt service is paid from annual lease payments made by state agencies using the facilities financed by the bonds (funded primarily through General Fund appropriations). For 2008-09, the budget proposes $319 million in new spending from lease-revenue bond proceeds for such purposes as the construction of correctional facilities and forest fire stations.

Budgetary Borrowing

In addition to borrowing for capital outlay purposes, the state has undertaken significant borrowing in recent years to help address budgetary shortfalls. Including the proposed sale of $3.3 billion in deficit-financing bonds in 2007-08, the state will begin 2008-09 with $25 billion in budget-related debt outstanding from private investors, schools, local governments, transportation, and other special funds. As illustrated in Figure 7 (see next page), this consists of:

Figure 7

Budgetary Borrowing Entering 2008-09



Total: $25 Billion

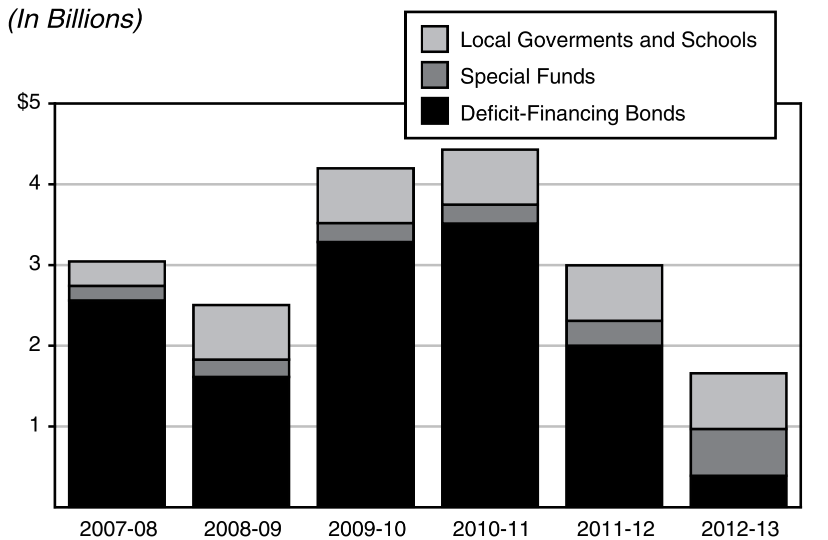
- About $18 billion from private credit markets, with roughly $10 billion from the deficit-financing bonds and the remainder from tobacco-related bonds. The basic mechanism for repayment of the state's deficit-financing bonds is the "triple flip" which diverts one-quarter of a cent of sales tax revenues to debt payments. Supplementary payments on the deficit-financing bonds are made through the Budget Stabilization Account (BSA).
- Around $2.3 billion from deferred transportation payments and various special fund loans, primarily in the resources areas.
- About $1 billion from local governments related to deferred reimbursements of noneducation state-mandated costs.
- About $3.6 billion in obligations related to Proposition 98 education—from the settle-up of past minimum guarantee payments and legislation regarding the 2004-05 suspension of the guarantee.

As shown in Figure 8, scheduled repayments of this budgetary borrowing will decline in 2008-09. This reflects the Governor's proposal to suspend the 2008-09 BSA transfer on a one-time basis—which eliminates the supplementary deficit-financing bond repayment in the budget year.

The resumption of supplementary repayments in 2009-10 results in total General Fund budgetary borrowing debt-service costs of $4.2 billion, rising to a peak of $4.4 billion in 2010-11. After 2010-11, the deficit-financing bond payments decline significantly in two consecutive years—reflecting the end of BSA supplementary payments in 2011-12 pursuant to constitutional provisions (reaching a $5 billion cap on total BSA repayments) and the complete pay off of the bonds early in 2012-13.

Figure 8

Annual General Fund Costs Related to Budgetary Borrowing



State Appropriations Limit

Background. In 1979, California's voters established a state appropriations limit (SAL) when they approved Proposition 4. The SAL places an "upper bound" on the amount of tax proceeds that the state can spend in any given year, and grows annually by a population and cost-of-living factor. Most state appropriations are subject to SAL. Certain appropriations, however, are exempt—including those for subventions to schools and local governments, capital outlay, and tax relief. If actual tax proceeds exceed SAL over a two-year period, the excess must be divided among taxpayer rebates and Proposition 98 education funding.

Expenditures Projected to Be Well Below the Limit. Due to the downturn in the state's economy and its adverse effects on the state's revenues, expenditures supported by taxes fell during the early years of this decade. (Spending supported by borrowed funds in those years does not count against SAL.) Although tax-supported spending has rebounded in recent years, a large gap still remains between the limit and spending subject to it. In 2007-08, appropriations subject to the limit are $16 billion below the limit, and in 2008-09, the gap narrows to $11 billion.

COLAs in the Budget

Statutory and Discretionary COLAs. Each year, the budget includes funds for cost-of-living adjustments, commonly referred to as COLAs. The purpose of these adjustments is to compensate for the adverse effects of inflation on the purchasing power of the previous year's funding level. Existing law authorizes automatic COLAs for over two dozen programs, mostly in the areas of K-12 education, social services, health, and the judiciary. These are generally referred to as statutory COLAs. These COLAs are based on a variety of different formulas. For example, the COLAs that are applied to social services programs are based on the California Necessities Index, COLA adjustments for the trial courts are related to growth in the SAL factor, and general apportionments and some categorical programs in Proposition 98 are currently linked to the U.S. gross domestic product price deflator for state and local governmental purchases. Other programs receive COLAs on a discretionary basis, through decisions made during the annual budget process.

In a number of cases as the 2008-09 budget was being prepared, programs were provided COLAs in the workload budget but then reduced or eliminated by across-the-board or other types of reductions. For instance, the workload budget provided K-12 education with a 4.94 percent COLA in accordance with statute. Yet, K-12 education was then subject to an across-the-board reduction which eliminated the COLA. Please see departmental or program write-ups in the *Analysis* for discussion of specific COLA issues, including a discussion in the "Education" chapter regarding a proposed change to the K-12 education COLA.

A Historical Perspective on Spending

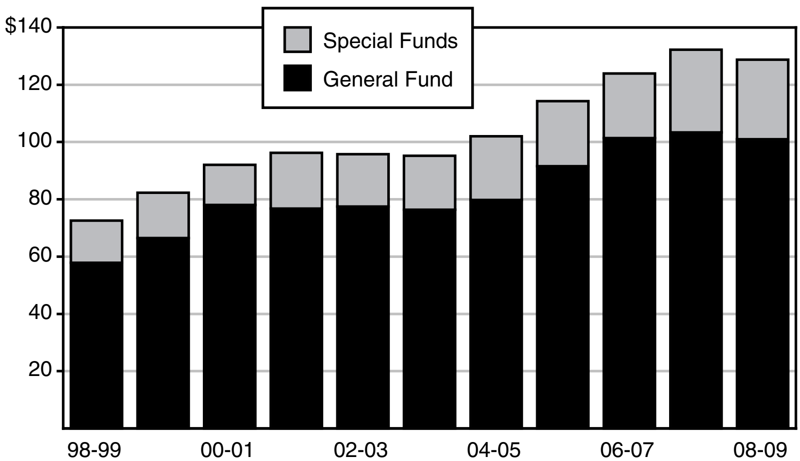
Total Spending. Figure 9 shows total state spending over the decade 1998-99 through 2008-09 (as proposed) by General Fund and special fund categories. Total spending grows over this period from $72.6 billion to

$128.8 billion—an average annual growth rate of roughly 6 percent. In the early part of the period, spending surged as rapid increases in capital gains and stock options increased available revenues. Beginning in 2001-02, however, total state spending flattened for several years as the state faced drops in revenues and consistent budget shortfalls. Despite the shortfalls, spending did not significantly decline due to numerous one-time funding shifts, deferrals, and other forms of budgetary borrowing. The one-time factors included an accounting change to Medi-Cal, increased federal funds (which temporarily offset state spending), savings related to a restructuring of debt-service payments, and a two-year shift of property taxes from local governments to schools (resulting in savings to the General Fund). As revenues rebounded, spending grew sharply in 2005-06 through 2007-08, reflecting such factors as funding increases primarily in education and criminal justice, the conclusion of the property tax shift, and repayments of budgetary debt.

Figure 9

Total State Spending Over Time[a]

1998-99 Through 2008-09
(In Billions)



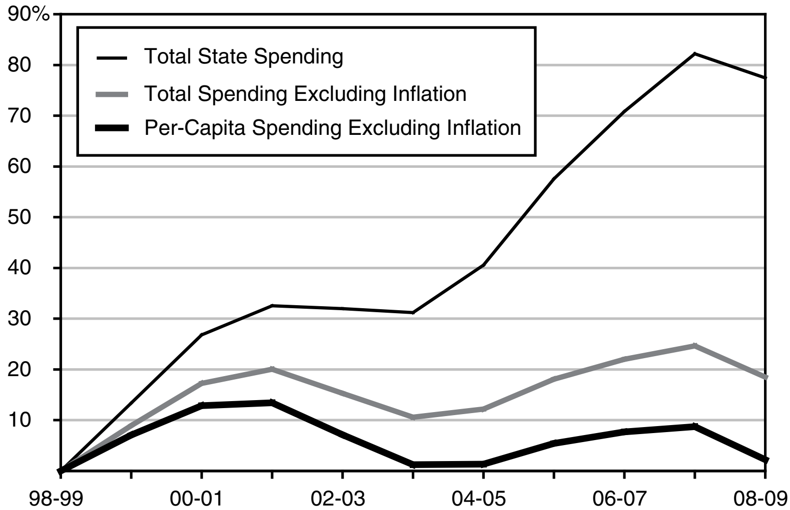
[a]Excludes bond fund expenditures, federal funds, and Local Public Safety Fund expenditures.

Inflation-Adjusted Spending. Part of the spending growth discussed above is related to the effects of a growing population and rising prices over time. Figure 10 (see next page) shows total state spending after adjusting for these factors. It indicates that:

Figure 10

Spending Adjusted for Inflation and Population

Percent Increase Since 1998-99



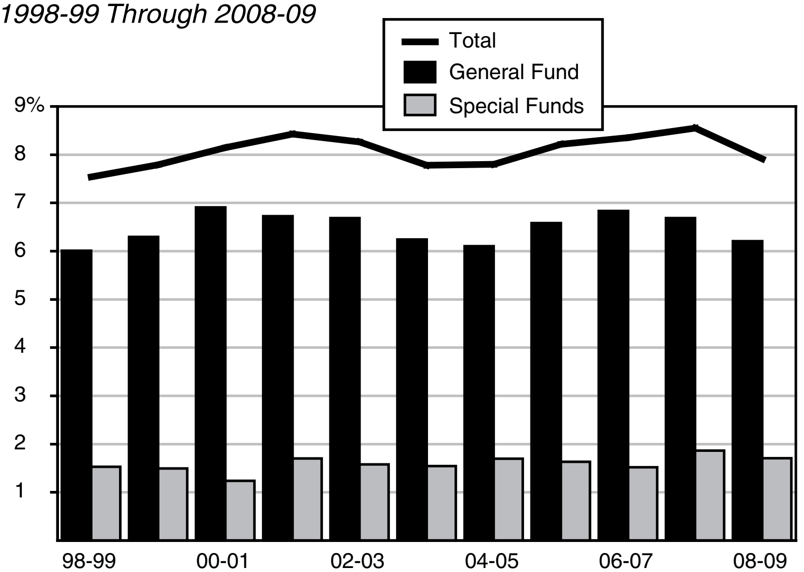
- After adjusting for inflation, real spending has grown by roughly 18 percent over the entire period, or an annual average growth rate of roughly 1.7 percent.
- Real per-capita spending—which adjusts for both inflation and population growth—would increase by about 2.2 percent over the period under the Governor's plan, for an average annual rate of 0.2 percent.

Spending Relative to the State's Economy. Figure 11 shows how state spending has varied over recent years as a percentage of total California personal income (which is a broad indicator of the size of the state's economy). Spending increases in recent years pushed this ratio to a peak of 8.6 percent in 2007-08. Under the Governor's budget, however, the ratio of total state spending to California personal income would decline to 7.9 percent in 2008-09, as personal income is projected to rise modestly while spending would decline.

Figure 11

State Spending as a Percent of Personal Income

1998-99 Through 2008-09



V

Alternative Budget Approach

Alternative Budget Overview

How Should the Legislature Approach Closing the 2008-09 Budget Shortfall?

Summary

In contrast to the administration's across-the-board reduction budget-balancing approach that fails to prioritize state spending, we offer an alternative approach for the Legislature's consideration. By making more targeted reductions; eliminating or modifying ineffectiveness or nonessential programs; and adding ongoing revenue solutions, we believe this approach offers the Legislature a better foundation to begin crafting a 2008-09 budget that focuses on essential services. This piece provides an overview of the key components of this alternative approach. Our alternative budget would end the 2008-09 fiscal year with a $1.3 billion reserve, and remain balanced through 2012-13.

INTRODUCTION

As we discuss in "Part I" of this publication, we recommend that the Legislature reject the Governor's approach of across-the-board reductions. The administration's approach to have virtually all programs share in the pain of balancing the budget has some surface appeal of "fairness." Yet, it reflects little effort to prioritize and determine which state programs provide essential services or are most critical to California's future.

In doing so, the administration has shifted much of the responsibility for crafting a workable budget to the Legislature. In the absence of a plan that prioritizes state spending, we offer an alternative approach for the Legislature's consideration. By making more targeted reductions and adding ongoing revenue solutions, we believe our approach offers the Legislature a better foundation to begin crafting a 2008-09 budget.

We are sure that there are components of our alternative with which many Members of the Legislature will not agree. As such, we do not expect the Legislature to adopt the LAO alternative as an entire package. Rather, our hope is that the alternative approach helps demonstrate how the state can bring its revenues and expenditures into line without resorting to across-the-board reductions but rather using targeted expenditure reductions and revenue increases.

Organization of Alternative Budget. All of "Part V" of this publication relates to components of the LAO alternative budget.

- This piece provides an overview of the alternative, describes its key elements and programmatic features, and assesses what the state's fiscal condition would look like under the alternative—both in the near- and longer-term.
- The second piece describes in detail the revenue increases upon which our alternative relies. It lays out our rationale for (1) reducing or eliminating certain tax credits and exemptions and (2) not adopting the administration's proposal to add $2 billion in 2008-09 revenues by accruing dollars that are currently reflected as 2009-10 revenues.
- The third piece describes our recommendation to shift parole supervision of low-level criminal offenders from the state to counties, along with the funding to pay for it.
- The fourth piece assesses the Governor's proposals for budgetary reform and offers an alternative approach.
- Finally, "Part V" concludes with a listing of all the expenditure-related savings proposals encompassed within the LAO alternative budget. Most of these proposals are discussed in more detail in our companion publication, *Analysis of the 2008-09 Budget Bill*.

Overview of LAO's Alternative Budget Approach

In this section, we provide an overview of the LAO alternative budget approach. The key elements are summarized in Figure 1 and described

Figure 1

Key Elements of the LAO Alternative Budget

✓ **A Balanced Budget Through 2012-13**

- Provides reserve of $1.3 billion at the end of 2008-09, about $150 million more than our forecast of the Governor's budget reserve.
- Keeps budget balanced—though precariously—through our five-year forecast period. Small operating shortfalls in some years are covered by carry-in reserves.

✓ **Targeted Program Reductions**

- In contrast to an across-the-board approach, makes targeted program reductions. To the extent possible, maintains core services at their current spending levels.
- Eliminates or modifies ineffective or nonessential programs.
- Considers availability of other fund sources in order to maintain service levels.

✓ **Rethink Which Programs Are Operated or Funded by the State**

- Shifts programs to the local level when it makes programmatic sense.
- Reduces or eliminates program funding for programs that are primarily local government responsibilities.

✓ **A Better Proposition 98 Approach**

- Reduces current-year funding to the minimum guarantee to maximize budget-year flexibility but not impact school operations in 2007-08.
- Suspends the guarantee by $800 million, compared to a $4 billion suspension by the Governor. The suspension is only required because of added revenues as part of our overall solution.

✓ **Add Revenues in a Reasonable Manner**

- Selects tax credits or exemptions for reduction or elimination because they are not achieving their stated purposes or are of lower priority.
- Makes no broad-based tax rate increases.
- Does not include the administration's problematic $2 billion revenue accrual.

✓ **No Additional Borrowing or Debt**

- Does not add any new borrowing or debt to the state's credit card. However, we do restructure some repayments of existing debt.

throughout this piece. In building our alternative, we have begun with the Governor's "workload" budget. We describe our method of scoring the savings included within our alternative in nearby box.

General Fund Condition

Figure 2 (see page 94) shows the General Fund's condition from 2006-07 through 2008-09 under the alternative budget's assumptions and proposals. As shown, the alternative would end 2007–08 with a reserve of about $1.5 billion. For the budget year, the state would spend just over $200 million more than it received. Consequently, the state would close 2008-09 with a reserve of $1.3 billion.

Targeted Program Reductions and Additional Revenues

Our approach to balancing the 2008-09 budget contrasts sharply with that of the Governor's budget.

Scoring the LAO Alternative Budget

How the Governor Built His Budget. Departmental appropriations within the Governor's proposed *2008-09 Budget Bill* (introduced in the Legislature as SB 1067 [Ducheny] and AB 1770 [Laird]) reflect a "workload" budget. In other words, it represents the administration's projections of how state programs' costs would grow in 2008-09 based on current law (supplemented with a limited number of policy augmentations). Then, the administration added a "control section" to the back of the budget bill (Control Section 4.44) that lists the amount that each appropriation would be reduced under its budget-balancing reductions (totaling $9.1 billion for the General Fund).

LAO Alternative Scored From Governor's Workload Budget. As described elsewhere in this publication and the *Analysis of the 2008-09 Budget Bill*, the administration's across-the-board reductions fail to prioritize among the state's programs. Moreover, having proposed reductions separate from departmental appropriations is confusing and lacks transparency. We therefore recommend rejecting Control Section 4.44. If the Legislature were to reject the control section, it would be left with a budget bill that reflects the Governor's workload budget. This is the starting point from which we began building the LAO alternative budget. All of our budget solutions, therefore, are scored from the Governor's workload budget. We do not always agree with the administration's characterization of what constitutes

- In contrast to across-the-board reductions, we make targeted reductions. This involves protecting funding for the state's most important programs to the extent possible. Consequently, funding for ineffective, duplicative, and nonessential programs are reduced much more than under the Governor's budget, or eliminated entirely. When we felt that the proposed reductions were reasonable, our alternative adopts the administration's proposals.
- In contrast to the Governor maintaining virtually all existing state programs (at a reduced service level), we question whether the state should be operating or funding all existing programs. As a result, we target some programs for reform. In other cases, we recommend program responsibility be transferred to local government.
- In contrast to the Governor's minimal inclusion of new ongoing revenues, we target those tax exemptions and credits for reduction or elimination that are not achieving their stated purposes.

workload spending. In cases of disagreement, we have reflected our different approach as a budget solution when our costs are lower or as an augmentation when our costs are higher.

Other Ways to Build an Alternative Budget. There are other ways in which an alternative budget could be built. For instance, one could start with each department's 2007-08 budget appropriation and make any necessary adjustments from that level. No approach is perfect, and all approaches would create some confusion about how much monetary "solution" should be shown for any given change. Since the Governor's proposed budget bill is already before the Legislature, we have chosen the approach of using the bill as our starting point.

Current-Year Decisions Were in Process. Further complicating our presentation of the LAO alternative budget is that—at the time this analysis was prepared—the Legislature was deliberating in special session on the Governor's proposed current-year actions. We therefore were unable to include any final decisions by the Legislature on the current-year budget as part of our alternative. In some cases, such as our proposed reduction of Proposition 98 spending to the minimum guarantee in 2007-08, the Legislature would still have this option available until the end of the fiscal year (if it chose not to take this step in February). In other cases, the alternative budget would need to be updated to reflect these decisions.

Figure 2

LAO Alternative Budget: General Fund Condition

(Dollars in Millions)

	Actual 2006-07	Proposed 2007-08	Proposed for 2008-09 Amount	Proposed for 2008-09 Percent Change
Prior-year fund balance	$10,348[a]	$5,007	$2,379	
Revenues and transfers	95,887	99,823	103,418	3.6%
Total resources available	$106,235	$104,830	$105,797	
Expenditures	$101,228	$102,451	$103,626	1.1%
Ending fund balance	$5,007	$2,379	$2,171	
Encumbrances	$885	$885	$885	
Reserve	**$4,122**	**$1,494**	**$1,285**	
Budget Stabilization Account	472	—	—	
Reserve for Economic Uncertainties	3,650	1,494	1,285	

a Due to the way that costs associated with the Quality Education Investment Act are scored by the administration as a prior-year expenditure, our proposed suspension of the act in 2008-09 increases the prior-year fund balance by $450 million (rather than reduces 2008-09 spending).

Figure 3 captures where the major dollar savings are achieved under the LAO alternative approach.

A Balanced Budget Through 2012-13

As we did with the Governor's budget, we forecasted state revenues and expenditures through 2012-13 under our alternative's policies. For each year between 2009-10 and 2012-13, revenues and expenditures are relatively in balance under the LAO alternative. In some years, there is a small surplus (up to $800 million). In other years, there is a small shortfall (up to $1.3 billion). However, throughout the forecast period, the budget remains balanced—using available carry-in reserves from the prior year when necessary. At the same time, the budget is precariously balanced—meaning that slower revenue or faster spending growth than our current projections would push the plan somewhat out of balance.

Key Programmatic Features

In this section, we provide more detail on the LAO alternative budget within each program area. For each program area, we highlight the key features and provide a comparison to the Governor's budget. Figure 4 (see next page) summarizes the General Fund support that would be provided to major programs.

Figure 3

LAO Alternative Budget: Major Savings Proposals in 2007-08 and 2008-09

(In Millions)

	Savings
Deficit-Financing Bonds	
Issue additional bonds (Governor's proposal)	$3,313
Suspend Budget Stabilization Account transfer (Governor's proposal)	1,551
Revenues	
Reduce dependent credit	$1,330
Limit research and development credit	335
Limit net operating loss carry forwards	330
Other revenue changes	660
Proposition 98 K-14 Education	
Fund flat year-to-year budget	$2,769
Reduce current-year spending to minimum guarantee	950
Suspend Quality Education Investment Act in 2008-09	450
Use Public Transportation Account for 2007-08 Home-to-School costs	409
Prepay 2008-09 settle-up	150
Parole Realignment	$483
Other Key Spending Solutions	
Reject pay raise for correctional officers in 2007-08	$521
Delete SSI/SSP cost-of-living adjustments (Governor's proposal)	329
Reduce, shift, or eliminate public safety local assistance funding	278
Change crimes from wobblers to misdemeanors	250
Shift wildland fire costs to fire protection fee	239
Cost containment for regional centers (Governor's proposal)	229
Increase university student fees by 10 percent	215
Fund UC and CSU nondiscretionary cost increases, but not compact	207

Deficit-Financing Bonds

Key Features of LAO Alternative. The administration recently sold an additional $3.3 billion in deficit-financing bonds. That action brings the total proceeds from these bonds to within about $400 million of the

$15 billion maximum allowed under Proposition 57 (March 2004). Our alternative accounts for this sale. The basic mechanism for repayment of these bonds is the "triple flip," which diverts one-quarter of a cent of sales tax revenues to debt payments. Supplementary payments on the deficit-financing bonds are made through the Budget Stabilization Account (BSA). The Governor may suspend this annual BSA transfer through an executive order. The Governor has indicated his intent to suspend this supplementary payment for 2008-09, reducing General Fund costs by more than $1.5 billion. In future years, we continue this policy of suspending the BSA supplementary payments in any year in which the state would otherwise face a year-end deficit. Even with additional suspensions, we estimate that the bonds would be paid off by the end of 2012-13.

Figure 4

LAO Alternative Budget: General Fund Spending by Major Program Area

(Dollars in Millions)

	2007-08	2008-09	Percent Change
Education Programs			
K-14 Proposition 98	$40,333	$41,671	3.3%
University of California	3,100	3,029	-2.3
California State University	2,916	2,881	-1.2
Health and Social Services Programs			
Medi-Cal	$14,110	$14,289	1.3%
SSI/SSP	3,641	3,653	0.3
Developmental Services	2,655	2,842	7.1
Mental Health	1,914	2,117	10.6
In-Home Supportive Services	1,599	1,717	7.4
CalWORKs	1,515	1,920	26.8[a]
Criminal Justice Programs			
Corrections and Rehabilitation	$9,448	$8,652	-8.4%
Judiciary	2,236	2,286	2.2
Transportation	$1,431	$1,489	4.1%
All Other	$17,554	$17,080	-2.7%
Totals	**$102,451**	**$103,626**	**1.1%**

[a] Growth reflects Governor's workload budget including General Fund backfill for reduced federal carry-in balance and cost-of-living adjustment.

Comparison to Governor's Budget. As noted above, we incorporate into our alternative the administration's actions to issue the additional bonds and suspend the 2008-09 BSA transfer. In contrast to our approach, the administration has indicated its intent to reinstate the BSA transfer for 2009-10 and beyond. Under the administration's plans, the deficit-financing bonds would also be paid off in 2012-13, though much earlier in that year.

Revenue Solutions

Key Features of the LAO Alternative. As we have done with respect to direct expenditure programs, we have reviewed the state's tax-related programs—what are referred to as tax expenditure programs (TEPs)—and recommend changes to those that are not achieving their stated purposes or are of lower priority. These TEPs are special tax provisions in the law—such as exemptions, deductions, and credits—that attempt to encourage certain types of behavior or target relief to specific groups of people or businesses. Our proposals affect each of the state's largest three taxes and are discussed in detail in the next piece of "Part V." Although there are many other TEPs worthy of modification not on our current list, we have focused on changes that would not involve difficult federal conformity issues, implementation problems, or significant time lags before their fiscal benefits are realized. Figure 5 shows that our changes would generate revenues of $2.7 billion in 2008-09 and $2.5 billion in 2009-10. Our largest changes are to reduce the personal income tax dependent credit, limit the research and development credit for income taxes, and limit net operating loss deductions for corporations.

Figure 5

LAO Alternative Budget: Revenue Solutions

(In Millions)

	Revenue Gain	
Revenue Proposal	**2008-09**	**2009-10**
Reduce dependent credit	$1,330	$1,070
Limit research and development credit	335	290
Limit net operating loss carry forwards	330	410
Other changes	660	715
Total Changes	**$2,655**	**$2,485**

Comparison to Governor's Budget. The Governor's budget proposes to reinstate the one-year standard regarding use tax on out-of-state purchases ($21 million in added revenues). Our alternative includes this proposal. We, however, do not include the administration's proposal to add $2 billion to 2008-09 revenues by accruing revenues that are currently reflected as 2009-10 revenues.

K-14 Education

Key Features of LAO Alternative. Our alternative would provide K-12 schools and community colleges with roughly the same amount of ongoing program support in 2008-09 as in the current year ($57.7 billion). Within that funding level, it would support growth in child care programs and enrollment growth at community colleges. It also would cover the ongoing costs of mandated education activities. It would not provide a cost-of-living adjustment (COLA), and it would make targeted reductions (totaling almost $180 million) to programs that are poorly structured, duplicative, or technically overbudgeted.

Our alternative also achieves substantial savings from elsewhere in the K-14 budget. Specifically, it achieves current-year savings of almost $1 billion by capturing funds that likely will not be spent by the end of the fiscal year and an additional $409 million by funding more of the Home-to-School transportation program from the Public Transportation Account. Our current-year alternative also results in the state prepaying a $150 million settle-up payment scheduled for 2008-09, thereby achieving a like amount of budget-year savings. Lastly, we recommend suspending the Quality Education Investment Act (QEIA) in 2008-09 for $450 million in savings. To ramp up QEIA at the same time as not providing a COLA to base programs supporting QEIA schools would be counterproductive.

Comparison to Governor's Budget. Whereas the Governor's budget proposes across-the-board cuts that reduce virtually all K-14 programs, our alternative takes a more strategic approach—weighing the merits of various programs and funding certain core costs while making selective reductions to other programs. The Governor's plan also offers school districts little fiscal flexibility in responding to potentially tight budgets. On the other hand, our alternative includes a major categorical reform component that would greatly expand districts' ability to use available funds to meet local needs. In addition, our alternative relies on adjusting current-year Proposition 98 spending down to the minimum guarantee to generate substantial budget-year benefits. Relative to the Governor's plan, our alternative provides about $2 billion more for K-14 education in the budget year and results in a Proposition 98 suspension amount of about $800 million, rather than $4 billion.

Higher Education

Key Features of LAO Alternative. Our alternative for higher education seeks to fund costs consistent with the state's *Master Plan for Higher Education*. It would fund anticipated enrollment growth of 1.8 percent at the University of California (UC) and 1.6 percent at the California State University (CSU). It would not fund COLAs, but would include augmentations equal to about 1.5 percent of the universities' base General Fund budgets for nondiscretionary cost increases. Under our alternative, student fees at the universities would be increased by 10 percent, while funding for financial aid programs would be increased to cover the higher fee costs for financially needy students. As shown in Figure 6, our alternative would result in total General Fund savings of $553 million relative to the Governor's workload budget.

Figure 6

LAO Alternative Budget: Higher Education

2008-09 Savings Relative to Governor's Workload Budget (In Millions)

University of California and California State University	
Fund LAO estimate of enrollment growth (rather than compact's level)	$38.4
Instead of compact's 5 percent base increase, fund only nondiscretionary cost increases (such as utilities)	206.5
Increase student fees by 10 percent and increase campus-based financial aid	215.2
Reduce administrative support costs by 10 percent (Governor's budget-balancing reduction)	75.5
California Student Aid Commission	
Restore funding for Cal Grant competitive program that was eliminated in workload budget	-$58.3
Fully fund Cal Grant entitlement program assuming LAO fee levels (which are lower than Governor's budget assumes)	74.3
Other Savings Proposals	$1.3
Total	**$552.8**

Comparison to Governor's Budget. The Governor's workload budget for the public universities is based on his "compact" with UC and CSU, and includes substantial augmentations for enrollment growth and base increases. However, the budget also includes unallocated General Fund reductions that exceed the workload augmentations. Because allocating these reductions would be left to the segments, it is unclear what specific costs would be funded under the Governor's proposal. In contrast, our alternative budget specifically funds enrollment growth and nondiscretionary cost increases. Our alternative also specifically links fee revenue to higher education funding needs. In contrast, the Governor's proposal leaves student fee decisions to the universities, and ignores the contribution of fee revenue toward workload funding. Finally, while the Governor's proposal would phase out a critical state financial aid program, our proposal maintains and funds all existing state financial aid programs.

Health

Key Features of LAO Alternative. Our overall approach in identifying health savings was to adopt cost-cutting measures that are least likely to result in either the elimination or severe reduction to programs that provide direct medical services. We also avoided making reductions when reduced program funding would result in increased costs in another program. Regarding rate reductions, we analyzed the rate histories of providers and generally only reduced the rates of those providers that had received rate increases in recent years. We also identified federal fund sources to backfill General Fund shortfalls when possible. In total, as shown in Figure 7, the LAO budget alternative would reduce costs in health services programs by more than $800 million below the Governor's workload budget.

Comparison to Governor's Budget. Our budget adopts many of the budget-balancing reductions proposed by the Governor. For example, our budget adopts cost containment measures intended to control regional center expenditures for a savings of $229 million. (We would continue these cost containment measures for the next few years but not implement them permanently as proposed by the administration.) Our budget also adopts the administration's proposal to achieve savings of almost $42 million in the Healthy Families Program through a rate reduction for managed care plans, a cap on annual dental benefits, and increases in premiums and co-pays.

We however did not adopt other of the administration's budget-balancing reduction proposals. For example, we did not include a 10 percent rate reduction to Medi-Cal providers because our analysis indicates that it could severely limit the access of Medi-Cal beneficiaries to providers. We did not adopt some of the administration's proposals to reduce rates for some mental health programs for similar reasons. Overall, our approach requires fewer reductions likely to affect access to direct medical services that the administration's budget plan.

Figure 7

LAO Alternative Budget: Health

(In Millions)

	Savings	
Proposal	**2007-08**	**2008-09**
Developmental Services		
Cost containment for regional centers	—	$229.0
Other	$1.0	41.9
Health Care Services, Including Medi-Cal		
Increase shift of federal funds from public hospitals to other state health programs	—	$91.1
Reinstate quarterly status reporting and eliminate continuous eligibility for children	—	69.0
Discontinue payments for Medicare Part B premiums for beneficiaries with shares of cost	$5.5	65.5
Reduce certain payments to hospitals	—	54.0
Eliminate county cost of doing business	—	32.3
Other	1.0	120.5
Healthy Families Program	—	$54.2
Other	$15.6	$64.4
Totals	**$23.1**	**$821.9**

Social Services

Key Features of LAO Alternative. Most of the savings in the LAO alternative come from deleting the June 2008 and June 2009 state Supplemental Security Income/State Supplementary Program (SSI/SSP) COLAs, reducing the grants for SSI/SSP couples down to 125 percent of the federal poverty level, delaying CalWORKs performance incentives and the restoration of the Temporary Assistance for Needy Families reserve, and canceling the Integrated Statewide Automated Welfare System migration computer project. We also achieved savings by rejecting proposals for service level increases or start-up costs for recently created programs. In general, our proposed reductions do not reduce services, grants, or county administration for social services programs below the levels in place on July 1, 2007, unless there was a specific policy rationale for doing so. Figure 8 (see next page) summarizes the major reductions.

Figure 8

LAO Alternative Budget: Social Services

(In Millions)

Proposal	Savings 2007-08	2008-09	2009-10
SSI/SSP			
Delete June 2008 cost-of-living adjustment (COLA)	$23.3	$271.0	$271.0
Delete June 2009 COLA	—	34.6	415.2
Reduce grants for couples to 125 percent of FPL	—	89.5	89.5
CalWORKs			
Delay performance incentive payment until 2008-09	$40.0	—	—
Gradually restore federal TANF reserve	—	$47.0	$20.0
County Administration/Automation			
Extend IHSS redetermination period by six months	—	$10.2	$10.2
Cancel ISAWS Migration project	$4.2	44.0	43.2
Foster Care			
Rescind January 2008 rate increase and reduce FFA rate by 5 percent	—	$23.6	$23.6
All other solutions	—	$29.0	$52.6
Totals	**$67.5**	**$548.9**	**$925.3**

SSI/SSP = Supplemental Security Income/State Supplementary Program; FPL = federal poverty level; CalWORKs = California Work Opportunity and Responsibility to Kids; TANF = Temporary Assistance for Needy Families; IHSS = In-Home Supportive Services; ISAWS = Interim Statewide Automated Welfare System; FFA = foster family agency.

Comparison to Governor's Budget. Compared to the Governor's budget, we have a greater reduction in SSI/SSP with substantially smaller reductions for California Work Opportunity and Responsibility to Kids (CalWORKs), In-Home Supportive Services, child welfare services, and foster care. With respect to income maintenance programs, we lowered grants for SSI/SSP couples because their grant is 131 percent of the federal poverty level (FPL) whereas SSI/SSP individuals and CalWORKs families are at 100 and 75 percent of FPL, respectively. In child welfare services, our reductions are limited to counties that have declining caseloads or more generous funding compared to the rest of the state. Finally, the LAO alternative provides current law workload funding for CalWORKs. While action will be required for the state to meet federal work participation requirements, it does not reflect either the Governor's, or the LAO's, CalWORKs policy proposals discussed in the *2008-09 Analysis*.

Criminal Justice

Key Features of the LAO Alternative. There are a number of separate components to the LAO alternative in the criminal justice area. The major components are:

- Funding for various criminal justice local assistance programs would be reduced or eliminated because they do not have demonstrated results or serve a statewide purpose. Other programs are consolidated or funded from sources other than the General Fund.
- Certain crimes affecting lower-level drug and property offenders that sometimes result in state prison sentences—known as "wobblers"—would become misdemeanors punishable by county jail and probation.
- Our alternative budget reflects significant prison cost savings (not reflected in the Governor's budget) that will result from recent juvenile and adult inmate and parole population trends and delays in implementing various new programs funded in the *2007-08 Budget Act*.
- Funding for the judicial system would be reduced by suspending State Appropriations Limit adjustments on a one-time basis and using significant existing fund balances at the trial court level to buffer against the loss of state funding.

As shown in Figure 9 (see next page), the combined fiscal effect of these proposals in 2008-09 would be almost $1 billion in savings.

Comparison to Governor's Budget. The LAO alternative for reducing prison inmate and parole populations would achieve comparable savings to the Governor's plans for early release and summary parole of offenders—at a reduced risk to public safety. Under our approach, the vast majority of offenders would face some criminal sanctions in the form of jail time or active probation supervision, rather than serving only minimal time in either prison or parole.

The administration proposes largely 10 percent across-the-board reductions in criminal justice local assistance programs. Our approach, which results in a greater level of General Fund savings overall, is based on a more comprehensive review of these programs that applies standard criteria for deciding which should be funded and at what level.

Figure 9

LAO Alternative Budget: Criminal Justice

(In Millions)

	Savings	
Proposal	**2007-08**	**2008-09**
California Department of Corrections and Rehabilitation		
Change crimes from wobblers to misdemeanors	—	$250.0
Account for additional savings from reduced population[a]	—	118.0
Adjust budget to reflect adult population trends	$55.0	55.0
Implement "earned discharge" policy for parolees	—	50.0
Adjust budget to reflects delays in new programs	28.0	—
Adjust budget to reflect juvenile population trends	4.0	9.0
Judicial Branch		
Suspend court State Appropriations Limit adjustments	—	$126.2
Increase civil filing fees to reflect growing court costs	—	21.4
Adjust the budget for likely delays in appointing judges	—	15.2
Begin to phase in electronic court reporting	—	12.6
Department of Justice		
Target vacant positions for elimination	—	$13.0
Various Criminal Justice Agencies		
Reduce, eliminate, or shift local assistance funding	$10.0	$268.0
Other	—	18.4
Totals	**$97.0**	**$956.8**

a Reflects additional savings from implementing proposals to change crimes from wobblers to misdemeanors and for earned discharge policy.

Parole Realignment

Key Features of LAO Alternative. As we discuss in a later piece in "Part V," our alternative budget includes a major realignment of responsibility for supervision of low-level criminal offenders released from state prison. Under our proposal, counties would receive slightly more resources than the state currently dedicates to this purpose ($495 million instead of $483 million). Counties would have broad authority to use these resources to reduce recidivism and improve public safety. Funding for parole realignment would come from a reallocation of: waste and water enterprise special district property taxes ($188 million), city Proposition 172 sales taxes ($178 million), and vehicle license fees retained by the DMV for administrative purposes ($130 million).

Comparison to Governor's Budget. The administration does not propose any major program realignments.

Resources

Key Features of LAO Alternative. A common theme throughout the majority of the LAO resources-related proposals is taking advantage of opportunities to shift funding from the General Fund to fees (either by increasing existing fees or creating new ones)—by applying the "beneficiary pays" or "polluter pays" funding principles. Our major General Fund savings proposals related to fees are in the following program areas:

- Wildland firefighting ($239 million in savings).
- Flood management ($40 million in savings).
- Water quality management and water rights regulation ($30 million in savings).
- Timber harvest plan review and enforcement ($23 million in savings).
- State parks ($13 million in savings, the amount of the Governor's reduction achieved largely by closing 48 state parks).

Our remaining savings proposals mainly involve shifting funding from the General Fund to bond funds (such as in the case of $21 million to support the Habitat Conservation Fund and $13 million for Colorado River management) or to available special fund balances.

Comparison to Governor's Budget. With the exception of the Governor's proposal to shift a portion of the state's General Fund wildland firefighting costs to a new insurance policy surcharge, the Governor's approach for budget-balancing actions in the resources area was generally to reduce General Fund program activities by 10 percent. Under the Governor's approach, proposed reductions include activities that the Legislature has considered to be a priority and/or face substantial unmet funding requirements. These activities, often regulatory in nature, range from the development of public health goals for the state's drinking water standards to the review of timber harvesting and coastal development proposals. In contrast to the Governor's budget, our alternative budget takes advantage of alternative funding sources—including fees and bond funds—to create General Fund savings (frequently at a level much higher than proposed by the Governor's budget) without reducing the level of program activity.

General Government and Transportation

Key Features of LAO Alternative. In the general government area, savings in the LAO alternative principally come from three areas:

- ***Employee Compensation and Retirement.*** The LAO alternative fully funds all existing financial obligations to state employees but provides no additional employee compensation funds for 2008-09. This includes rejecting the Governor's proposal to provide a 5 percent pay raise to correctional officers retroactive to July 1, 2007 (reducing costs by about $500 million in 2007-08 and 2008-09 combined). Our forecast assumes that employees would begin to receive salary increases in 2009-10. Regarding the state's retirement programs, making changes to achieve short-term budgetary savings almost always involves either legal risks or higher costs in the long term. Consequently, we propose no changes to retirement programs.
- ***Gambling Revenues.*** As we discuss in "Part III" of this publication, the Governor makes overly aggressive assumptions about the amount of General Fund tribal revenues that will be received. Our alternative adjusts those revenues to a more realistic level, but uses $141 million in tribal payments to benefit the General Fund. The Governor proposes these payments go to special funds (including a $101 million loan repayment to transportation).
- ***Tax Gap.*** Our alternative builds upon the Governor's proposals to increase tax collection and enforcement. We redirect resources away from Board of Equalization activities which have low revenue benefits per dollar spent and towards the Franchise Tax Board.

Comparison to Governor's Budget. Our proposed rejection of a pay raise for correctional officers is a large departure from the Governor's spending plan. A recent LAO report found that current compensation levels for correctional officers are sufficient to meet personnel needs at the present time. In addition, our alternative rejects two administration proposals to reduce required funding to the California State Teachers' Retirement System. Both proposals are legally risky and may not produce the intended savings. Our redirection of tribal payments reduces transportation funding on a one-time basis by $101 million. Like the Governor, however, we fully fund the $1.5 billion Proposition 42 transfer for transportation purposes. Regarding the tax gap activities, we spend slightly less than the administration—yet with the benefit of tens of millions of additional General Fund dollars.

Conclusion

The alternatives presented throughout this publication and the *2008-09 Analysis* reflects, of necessity, judgments as to which programs are of higher priority, which are ineffective, and which are not essential for state government to administer. The Legislature's assessment of its own priorities should form the framework of the adopted 2008-09 budget. As illustrated by our alternative, the Legislature will be forced to make many tough decisions as it crafts the 2008-09 budget. Making those tough decisions in a rational and thoughtful manner can bring the state's revenues and spending into balance for the long term.

LAO Revenue-Raising Proposals

What Tax Expenditure Programs Could Be Modified or Eliminated to Help Address the State's Fiscal Situation?

Summary

The Governor's budget includes almost no new revenue-raising proposals. Given the magnitude of the budget problem, we examine the state's existing tax structure in the same way as the spending side—with an eye towards reducing inefficient or ineffective provisions. Accordingly, we have examined the state's numerous tax expenditure programs and recommended that several of them be eliminated or modified. Adoption of our recommended changes would increase state General Fund revenues by $2.7 billion in 2008-09.

The Governor has also proposed a change in the way the state accrues certain tax revenues, which results in a one-time budgetary solution of $2 billion in 2008-09. We examine the administration's proposal, noting issues about both the basis for doing the additional accrual and the potential amount which could be properly accrued. As a result of these concerns, we do not include this proposal in our alternative budget plan.

The Governor proposes to balance the 2008-09 General Fund budget primarily with expenditure savings—current-year reductions and significant budget-year, across-the-board reductions to virtually all state programs. Two other large solutions—the selling of remaining economic recovery bonds and an accrual accounting change—increase 2008-09 revenues even though California residents would make no additional payments to state government.

There are, in fact, only a handful of provisions in the Governor's budget-balancing package that increase payments to the state:

- ***Vessels/Recreational Vehicles/Aircraft.*** The Governor proposes to reinstate the 12-month standard for applying the use tax to out-of-state purchases of these goods, for an annual revenue increase of $21 million.
- ***Enforcement.*** The budget adds personnel to the tax agencies to increase the amount of existing liabilities collected from taxpayers, for a 2008-09 gain of $150 million.
- ***Insurance Surcharge.*** The administration proposes to levy a surcharge on all homeowner policies to provide enhanced state firefighting capabilities, with the General Fund benefiting about $45 million each year.
- ***Fees.*** The budget also assumes some fee increases—at the state universities and registration fees—but these are not counted as budget solutions. (In our alternative plan, we discuss a number of potential fee increases and how they can be used to address the state's fiscal problem by offsetting General Fund spending.)

Thus, the Governor's plan has no significant proposals that increase tax liabilities on state residents.

As we have said in the past, we believe that to successfully address a budget problem of the magnitude the state now faces, it is important to cast the net broadly for solutions. This is especially so recognizing that in good budget times the state both reduced taxes and fees and increased spending commitments. In this section, we discuss proposals that look at the revenue side of the budget. In so doing, we have applied the same approach as with direct spending programs—that is, we have examined tax-related provisions referred to as tax expenditure programs (TEPs)—and recommended changes to those that are not achieving their stated purposes or are of a lower priority. These TEPs are special provisions in law—such as exemptions, deductions, and credits—that attempt to encourage certain behavior or that target relief to specific groups of people or businesses.

The Legislature could, of course, also consider raising monies by increasing the rates on any of its major taxes. For example, a 0.25 percentage rate increase in the sales tax rate would generate about $1.5 billion annually and a 1 percent increase in the corporation tax rate would also raise about $1.5 billion each year. Increasing tax rates, however, can negatively affect taxpayer work and investment decisions at the margin. We have chosen instead to focus on TEPs, which while they do increase payments for particular groups of taxpayers, do not have the same impact on work and investment decisions.

Figure 1 lists the 12 TEPs that we recommend be modified. In the sections that follow, we provide for each program: (1) background on the

Figure 1

Summary of LAO Revenue-Increasing Proposals

(In Millions)

	Revenue Gain	
	2008-09	**2009-10**
Proposals Unique to Personal Income Tax		
Reduce dependent credit	$1,330	$1,070
Eliminate senior credit	125	130
Eliminate partial exclusion of capital gains on small business stock	55	55
Subtotals	($1,510)	($1,255)
Proposals Applying to Both Personal Income and Corporation Tax		
Limit the research and development credit	$335	$290
Limit net operating loss deductions	330	410
Phase out enterprise zone programs	100	120
Eliminate exclusion for "like-kind" out-of-state property exchanges	25	50
Subtotals	($790)	($870)
Unique Sales and Use Tax Proposals		
Eliminate exemptions for industry-specific equipment	$143	$146
Eliminate certain diesel fuel exemptions	73	75
Eliminate exemption for leasing of films and tapes	65	70
Eliminate exemption for custom computer programs	53	48
Adopt one-year standard regarding use tax on out-of-state purchases	21	21
Subtotals	($355)	($360)
Totals	**$2,655**	**$2,485**

TEP, (2) our proposed change to the provision, and (3) the rationale for our proposal. We would note that there are many other TEPs that are worthy of modification that we have not included. In some cases this is because of difficult federal conformity issues—such as with the treatment of pension and health care expenditures by employers and employees. In other cases, it is because of timing issues. For example, changes to the mortgage interest deduction would likely have to be implemented over time, therefore not resulting in a significant fiscal impact until well into the future.

Following the write-ups on the individual TEPs, we also include a discussion of the Governor's proposal regarding the accrual of certain personal and corporate income tax payments.

Tax Expenditure Program Proposals

Reduce the Dependent Credit

Background. Current law provides taxpayers with a nonrefundable personal income tax (PIT) exemption credit for each dependent. In 2007, this credit, which is subject to a phase-out for high-income taxpayers, is $294. This compares to a personal exemption credit, also subject to a phase-out, of $94 for single taxpayers and $188 for couples. Before 1998, the dependent credit was the same as the personal exemption. The dependent credit exemption was increased in two steps by legislation adopted in 1997 and 1998.

Proposal. Make the dependent credit the same dollar amount as the personal exemption credit. Revenue gain of $1.3 billion 2008-09 and $1.1 billion in 2009-10.

Rationale. Exemption credits are usually justified on the grounds that people who raise children or care for others incur extra expenses and therefore have less disposable income from which to pay taxes. There is, however, no consensus as to the "right" amount of such a credit. As noted above, prior to 1998, the state's exemption credit was set at the same level as the personal credit. Our proposal would reinstate that linkage.

Currently, over 80 percent of the benefits of the credit in excess of the personal exemption amount goes to taxpayers with incomes over $50,000, and about 30 percent to those with incomes over $100,000.

Eliminate the Senior Credit

Background. California grants a special PIT exemption credit, equal to $94 in 2007, for persons aged 65 or over. The credit is in addition to the regular personal exemption credit available to seniors. The credit is not refundable.

Proposal. Eliminate the senior credit. Revenue gain of $125 million in 2008-09 and $130 million in 2009-10.

Rationale. The origin of the senior credit appears to have been related to concerns about the income level of seniors. It is not clear, however, why seniors should receive more favorable treatment than other taxpayers with the same income. California already provides special treatment to seniors by excluding social security income from its calculation of taxable income, saving seniors approximately $1.5 billion per year. Because of this treatment, combined with the state's relatively high income tax threshold, many seniors do not owe any California income tax. In fact, the senior credit provides a benefit to only about 30 percent of California's seniors. We believe that because other features of the California tax code provide relief to seniors who need it, the additional senior credit is unnecessary.

Eliminate Partial Exclusion of Capital Gains on Small Business Stock

Background. California excludes from the taxable income of personal income taxpayers 50 percent of the capital gains earned on the qualified sale of small business stock. The exclusion is generally similar to the one offered at the federal level, except that the California exclusion requires that minimum portions of the corporation's payroll and assets be located in California. The exclusion is only available for stock that was acquired upon its original issuance and has been held for at least five years. For a married couple filing jointly, the exclusion is limited to the greater of $10 million or ten times the stock's basis. For single taxpayers and married taxpayers filing separately, the limit is smaller.

Proposal. Eliminate the partial exclusion of capital gains on small business stock. Revenue gain of approximately $55 million each in 2008-09 and 2009-10.

Rationale. As described in our March 1999 report on this exclusion, *The Partial Capital Gains Exclusion for Qualifying Small Business Stock*, this program is intended to reduce the cost of financial capital for qualified small businesses. This report noted, however, that the extent to which the program actually expands the amount of financial capital available to the small business community, and how its benefits are shared, is unknown. It is also unclear why owners of small corporate enterprises should receive more favorable tax treatment than other types of small businesses.

Limit Net Operating Loss Deductions

Background. California allows businesses who experience net operating losses (NOLs) to "carry them forward" on their books and deduct them in future years when their incomes are positive, thereby reducing their tax liabilities in those years. For California purposes, NOLs may be carried forward for up to ten years, and the oldest NOLs must be used first. At the federal level, NOLs may generally be carried back 2 years and carried forward up to 20 years. Most taxpayers that incur NOLs are not able to use them in the following tax year. Since the state started allowing NOLs, only about one-fifth of those incurred have ever been deducted.

Proposal. Limit NOL deductions to 50 percent of a taxpayer's net income in a given year. Revenue gain of $330 million in 2008-09 and $410 million in 2009-10.

Rationale. The principle of permitting NOL deductions has the most obvious merit in the case of businesses that have highly cyclical profits from one year to the next. For them, NOL deductions can enable their cyclical income to essentially be spread out over a multiyear time horizon, thereby not disadvantaging them in terms of the total taxes they pay over time compared to less-cyclical enterprises. Some people have questioned NOLs, however, as potentially subsidizing economically inefficient business activities and being inconsistent with the view that an annual tax accounting period is a generally appropriate period over which to measure taxable income. The NOLs also tend to complicate budgetary management, since accurately predicting NOL usage has proved very difficult. The NOL deductions have been suspended previously during times of budgetary stress. Limiting NOL deductions to 50 percent of tax liability would provide the benefits of (1) significant fiscal relief to the state, (2) mitigating the immediate loss to taxpayers by still allowing them to receive partial tax benefits currently, and (3) still allowing taxpayers to benefit in the future from the deductions they could not now claim.

Limit the Research and Development Credit

Background. California allows taxpayers a nonrefundable income tax credit for qualified research and development (R&D) expenditures. The calculation of qualified expenditures is generally based on computations used for the federal R&D credit. The credit is available only for incremental expenditures above a baseline amount established in previous years. The credit rate is 15 percent for R&D spending undertaken by the taxpayer, and 24 percent for R&D activity paid for by corporations but undertaken by universities or charitable institutions. California also offers an election for an alternative calculation of the R&D credit based upon the Federal Alternative Incremental Credit. The state credit is generally awarded for expenditures that also qualify for the federal credit and in some cases may be larger than the federal credit. Any credits that cannot be used in a given year because a taxpayer lacks sufficient tax liabilities can be carried forward indefinitely for possible use in future years.

Proposal. Limit the amount of the credits that may be claimed in any one year to two-thirds of a taxpayer's liability. Any earned but unused credits could be carried forward for use in future years, as under current law. Revenue gain of $335 million in 2008-09 and $290 million in 2009-10.

Rationale. Economists suggest that some public subsidization of R&D spending makes sense because its level would otherwise be less than the "ideal" amount for society. This is partly because certain R&D activity has characteristics akin to a "public good" in terms of the substantial spillover benefits it can produce for society. These benefits can go well beyond those that accrue directly to the individual taxpayer actually making the expenditures. An example includes some of the electronic discoveries associated with the space program that have found applications over time in all kinds of other industries, such as medicine. However, the current program raises several concerns:

- Federal R&D incentives may already be inducing an optimal amount of R&D activity to occur without the need to provide additional state subsidies.
- The optimal state R&D credit rate, and the effects of the state credit on the total amount of R&D activity in the state, are unknown.
- In the case of those R&D projects that would have been undertaken even if the state did not offer its own credit on top of the federal credit, the state credit produces windfall benefits to select taxpayers but does contribute to the state's goal of increasing total R&D spending.
- There are now more than $10 billion in unused state R&D credits being "carried-over" to future tax years by taxpayers. Such taxpayers having large carryovers can generally eliminate their California liabilities. For many such taxpayers, however, it seems unlikely that their current and future R&D spending decisions will be influenced by their ability to stockpile even more unused R&D credits.

Limiting the use of R&D credits to two-thirds of a firm's liabilities, therefore, is likely to save substantial amounts of revenue for the state while having relatively little impact on the policy goal of supporting research activities. Our proposal would not affect the total amount of credits available to a company, as unused credits could still be carried forward to future years.

Additional analysis of the R&D credit can be found in our November 2003 report *An Overview of California's Research and Development Tax Credit*. This report noted that arguments in favor of this credit include the possibility of societal spillover benefits, the desire to boost specific types of economic activity (such as in the biotech area), and possible benefits from improvements in the perception of the California business climate. The report found, however, that state-level credits likely are not as effective as federal credits at generating spillovers and that the appropriate level of state credits is unknown. The report ended up recommending that the Legislature consider reducing the credit or phasing it out over time, especially given the substantial direct revenue losses associated with the program and the state's tight budgetary position at the time.

Phase Out Enterprise Zone Programs

Background. California offers several tax programs that provide benefits only to taxpayers affiliated with designated areas of the state. (These are typically blighted areas in need of economic redevelopment.) Tax programs for these areas include hiring credits, wage credits, credits for sales taxes paid on purchases of certain machinery, exclusions of interest earned on qualifying loans to businesses, and expensing of qualified business investments. Current law allows for the designation of 42 enterprise zones (EZs) as areas qualifying for these treatments. Zone designations are for 15 years, with some zones having received an additional five-year extension. More recently, Chapter 718, Statutes of 2006 (AB1550, Arambula), enabled roughly 20 EZs whose designations had expired to be redesignated as EZs for an additional 15 years. Thus, many EZs have now been in existence for more than 20 years.

Proposal. Cancel the recent redesignations of EZs and deny future extensions for all other EZs. Revenue gain of about $100 million in 2008-09 and $120 million in 2009-10.

Rationale. Many studies of EZs question whether they are efficient or cost-effective tools for improving the economic conditions of the targeted areas. Our December 2003 report, *An Overview of California's Enterprise Zone Hiring Credit*, concluded that EZ incentives have little, if any, impact on the creation of new economic activity or employment, but that they can be effective in shifting activity into the EZ that otherwise would have occurred elsewhere in the same geographic region. As noted above, many EZs have already been in effect for many years. It is not clear what additional benefits will be gained by extending the same incentives that have already been in place for as many as 20 years. Rather, other redevelopment policy tools could be more effective than extended use of EZ tax incentives.

Eliminate Exclusion for "Like-Kind" Out-of-State Property Exchanges

Background. California permits investors to exchange business or investment property for property of a like kind without paying any capital gains that might have accrued on the first property. A similar federal program also exists. Commonly referred to as Section 1031 exchanges, these nontaxed transactions can be repeated over time, with the tax on the accumulated capital gains from all transactions not assessed until the final property is eventually sold. These tax-free exchanges are allowed even when in-state property is exchanged for out-of-state property. Subsequent sales of out-of-state property, which ought to trigger deferred capital gains taxes, are rarely, if ever, reported to California. Such factors as the absence of a California estate tax, the stepped-up basis rule for real estate, and the ability to move assets into family trusts without property tax reassessments, also interact with these exchanges to enable many capital gains to go untaxed.

Proposal. Eliminate the income tax exclusion for capital gains on like-kind exchanges involving out-of-state commercial property. Revenue gain of approximately $25 million in 2008-09 and $50 million in 2009-10.

Rationale. Capital gains on real property transactions constitute the income earned from such activities and as such should be taxed, just like other types of income. It can be argued that these taxes should be deferred until the investment is ultimately liquidated. We see no justification, however, for allowing these gains to escape taxation completely. Given the administrative difficulty in taxing these gains once the exchange involves an out-of-state property, we recommend that existing law be amended to capture these gains.

Eliminate Exemptions for Industry-Specific Equipment

Background. California currently exempts equipment used in farming and timber harvesting (adopted in 2001), and post-production activity for television and films (adopted in 1998) from the state portion of the sales and use tax (SUT).

Proposal. Eliminate these partial SUT exemptions. Revenue gain of $143 million in 2008-09 and $146 million in 2009-10. Figure 2 (see next page) shows the breakout of these amounts by type of equipment.

Rationale. In these situations, it is clear that the owner of the equipment is the final user of the product. As such, in California, the normal practice is that a final user of an item must pay the SUT at the time it is purchased. Therefore, for consistency in the application of the SUT law, these transactions would be subject to paying the full SUT rate. The arguments that have been offered for this type of exemption vary depending on the type of equipment involved. Regarding farming equipment, one argument is that in-state sellers of equipment have a competitive disadvantage relative to out-of-state sellers, who rarely face enforcement of the state's use tax. In the case of post-production activity, the need to keep businesses from leaving California has been raised. As a general tax policy, however, we believe that all industries should be treated similarly, and it is not clear that these particular industries are more deserving of tax exemptions than a variety of other industries in the state.

Figure 2

Increased Revenue From Elimination of SUT[a] Exemptions on Industry-Specific Equipment

(In Millions)

Type of Equipment	2008-09	2009-10
Farm equipment and machinery	$120	$123
Timber harvesting equipment	3	3
Teleproduction and post-production equipment	20	20
Totals	**$143**	**$146**

[a] Sales and use tax.

Eliminate Certain Diesel Fuel Exemptions

Background. California currently exempts the excise tax portion of the price of diesel fuel from sales taxation. In addition, all diesel fuel used for farming activities is exempt from paying the SUT.

Proposal. Eliminate SUT exemption on diesel fuel excise taxes and for diesel fuel used in farming activities. Revenue gain of $73 million in 2008-09 and $75 million in 2009-10. A statutory change would be required to deposit these revenues in the General Fund. Figure 3 shows the breakout of these amounts by component.

Rationale. Both gasoline and diesel fuel are currently subject to fuel excise taxes. However, only gasoline is subject to sales tax on the excise tax portion of the price. This is because, previously, administrative complications prevented the collection of sales tax on the excise tax portion of diesel fuel. Now, however, due to the actions of past legislation changing the point where the excise tax is levied, this is no longer a valid concern. For this reason, there is no reason why diesel fuel should be treated differently than gasoline.

Figure 3

Increased Revenue From Elimination Of Diesel Fuel Exemptions

(In Millions)

Type of Exemption	2008-09	2009-10
Diesel fuel excise tax	$29	$30
Diesel fuel used in farming	44	45
Totals	**$73**	**$75**

In regards to the exemption for diesel fuel used in farming activities, one of the arguments offered in favor of this exemption is the need for California agriculture to be subsidized to help compete with interstate and international agricultural rivals, and to help farming remain economically viable in the face of increasing pressures to develop farm land for urban purposes. There are preferred options for dealing with these issues, however, including local land use policies.

Eliminate Exemption for Leasing of Films and Tapes

Background. California currently exempts from the SUT the leasing of motion picture and television films and tapes.

Proposal. Eliminate SUT exemption. Revenue gain of $65 million in 2008-09 and $70 million in 2009-10.

Rationale. Supporters of this program argue that it is needed to help maintain the profitability of the film industry in California and encourage production activities to stay in the state rather than relocate to other states and countries. We have two main concerns with the exemption. First, it is unclear why this industry is more deserving of such a subsidy than the many firms in other industries that also are mobile and can relocate elsewhere. Second, other lease transactions are generally subject to the SUT, so eliminating the exemption would make for a more consistent application of the tax.

Eliminate Exemption for Custom Computer Programs

Background. California currently exempts sales of custom computer programs from the SUT. These are programs not produced in mass but rather customized for the client to carry out specific types of applications.

Proposal. Eliminate SUT exemption and tax the sales value of custom computer programs. Revenue gain of $53 million in 2008-09 and $48 million in 2009-10 after adjusting for likely behavioral responses by taxpayers.

Rationale. The argument commonly made in favor of the exemption is that the value of such custom programs reflects largely the programming-related services provided to the purchaser. Thus, it concludes that since services are generally not subject to the SUT, neither should such custom programs. However, this argument could be applied to a wide variety of other items that *are* subject to the SUT, including "off-the-shelf" computer programs, books, musical recordings, and paintings. In fact, any physical item embodying a large amount of services might also arguably fit this criterion. Eliminating this exemption would therefore result in somewhat more consistency in the way the SUT is applied. As a general policy, special tax exemptions should not be given for specific industries or commodities.

Adopt One-Year Use Tax Standard on Selected Out-of State Purchases

Background. State law requires that a use tax be paid on goods purchased out-of-state for use in California. For purchases of vessels, vehicles, and aircraft, such items are deemed to be for use in the state if they are brought into California within 90 days of their purchase. Otherwise, no use tax is owed, even if they are permanently used here once the 90 days have passed. For a recent two-year period, California adopted a one-year standard for this purpose. In our statutorily required report *Out-of State Purchases: California's Taxation of Vessels, Vehicles, and Aircraft* (April 2006), we found that the change increased state revenues, and the associated adverse economic impact was not particularly large, and recommended that the one-year criterion be made permanent. However, that law was not extended last year when it sunset.

Proposal. Reinstate the one-year standard for determining when items purchased out-of-state are subject to the use tax. This change is also proposed in the *2008-09 Governor's Budget*. Revenue gain of $21 million annually, beginning in 2008-09.

Rationale. Using a 90-day period is too short to reliably determine where an item such as a vessel, vehicle, or aircraft will actually be used on an ongoing basis. Evidence exists of the purchasers of items, such as expensive yachts, arranging to keep them out of state until the 90 days have passed, sometimes using the large use tax savings involved to help finance recreational stays in such places as the coast of Mexico until the qualifying period is up. Based on our review, the one-year period eliminated much of this tax-avoidance behavior.

Proposal to Accrue Estimated Tax Payments

The administration is proposing to make an accrual change that would result in a "paper shift" of $2 billion in tax revenues from 2009-10 back into 2008-09 to help balance the budget. This amount represents one-third of the September 2009 estimated tax payments projected to be made under the PIT and the Corporate Tax (CT). Under current law, these revenues would be counted in 2009-10 when they are received. The administration argues, however, that this $2 billion in taxes is really attributable to economic activity that will take place in June 2009, and thus deserves to be counted in 2008-09. The proposal would affect neither the amount of taxes paid nor when they are due, but only the year in which they are scored for budgetary purposes. For future years, the same accounting change would also apply. Thus, for 2009-10 the loss of revenues shifted from September 2009 to 2008-09 would be offset by revenues shifted into 2009-10 from September 2010. The practical result would be a one-time $2 billion increase in 2008-09 revenues, which is a significant solution in the Governor's budget plan.

Does the Proposal Make Sense?

In evaluating the proposal there are two key questions to ask:

- *First*, is the proposal consistent with sound governmental accounting standards?
- *Second*, is the $2 billion accrual amount reasonable?

The Accounting Standards Issue

The Rules for Accruals. In order to determine how to allocate revenues between fiscal years, governments use what are referred to as "accrual" rules. In principle, these rules attempt to allocate revenues to the fiscal year in which the economic and financial activity giving rise to them occurs. Because it can be difficult to identify in all cases exactly what these transactions are on a month-to-month basis, simple "second best" accrual rules have been adopted for practical purposes. These rules govern the way in which tax payments are moved from the year when they are actually received to when the activity that produced them happened. Under current law, the general rule is that revenues can be accrued to a previous fiscal year if (1) the underlying activity to which they are attributable occurs prior to the end of that previous year and (2) the due date for the tax is within two months of the previous year's end. The administration would change this rule by eliminating the two-month standard and replacing it with the requirements that the amount of any accrued revenues be (1) measurable and (2) received in time to pay current year-end liabilities.

Proposal Has Inherent Problems. We agree with the administration that some of the estimated tax payments received in September of a given year are due to economic and financial activity occurring in the preceding June. The question, however, is if this activity is measurable. For example:

- In the case of the CT, the tax is imposed on a year's net taxable corporate profits, and requires a complicated calculation involving a firm's income, expenses, credits, net operating loss deductions, alternative minimum tax, and various other items over an entire 12-month period. Many of the individual elements in the computation are not even calculated or identifiable on a monthly basis, such as those relating to products produced or costs incurred.
- In the case of the PIT, the individuals making estimated payments tend to be those having income other than normal wage and salary income subject to monthly withholding. Thus, most of the estimated payments relate to such income as business income, proprietor's and partnership income, capital gains, stock options, investment income generally, and other types of income not subject to withholding. Given its nature, much of this income also can be difficult to estimate and/or keep track of on a monthly basis.

Given the above, we conclude that the "measurable" criterion may be difficult to meet.

Proposal Also Might Require Other Accounting Changes. Apart from the above problems, if the administration's proposal is adopted, its principle should arguably be applied consistently to all types of payments, not just those estimated tax payments made in September. For example, each year, many taxpayers overpay their state income tax and receive refunds in the spring of a fiscal year. This means that some of the money included in estimated payments made in the prior April and June—and counted in the prior fiscal year—was higher than necessary. To apply the administration's reasoning consistently, adjustments would also have to be made to reduce certain estimated payments, thereby lowering the amount of budgetary solution from this proposal. Various other adjustments—such as to final payments (revenues) and Medi-Cal (spending)—would have to be made in order for the proposal to be consistent in its implementation.

The Proposal's Accrual Amount Is Overstated

Even if the Legislature decided to adopt the administration's accrual proposal, we believe that assigning one-third of each September's estimated payments to the previous fiscal year would be much too high a share. As a result, the administration's estimated $2 billion revenue effect for the proposal is seriously overstated.

Few September Payments Are for June Income. There are two different ways that taxpayers may calculate estimated tax payments. Under one method, taxpayers track income on a monthly basis and make estimated payments quarterly based on the resulting liabilities. Under the other, much simpler method, taxpayers calculate an annual liability and make four, equal quarterly payments (generally in January, April, June, and September). The administration's proposal assumes that most estimated payments are of the first type. If true, it would be appropriate to accrue a portion of September estimated payments back to June as there would be measurable evidence for income actually earned in that month. Data on estimated payments suggests, however, that most taxpayers make estimated payments based on the second method. As such, most income attributable to June is already being captured in the June 15 estimated payment, not the September 15 estimated payment. As a result, we estimate that, if the budget proposal were adopted, the appropriate amount to accrue would be in the hundreds of millions of dollars—not the $2 billion estimated by the administration.

Conclusion

We agree in principle with the administration that some portion of September 2009 revenues in 2008-09 is associated with June 2009 economic activity and therefore could be accrued to the budget year. However, there are serious concerns as to whether this potential accrual amount is based on a measurable underlying activity and as to the amount of the accrual. Given these concerns, we have not included the accrual proposal in our alternative budget plan laid out in this part of the document.

Parole Realignment and the 2008-09 Budget

What Role Could Parole Realignment Play in Improving Public Safety and Addressing the State's Budget Difficulties?

Summary

A major component in the LAO's alternative budget package is a nearly $500 million realignment of responsibility for supervision of lower-level criminal offenders released from state prison.

Currently, when a state prison inmate completes his or her sentence, state staff in the community supervise the offender's parole. The supervision services the state provides parolees are very similar to the services county probation departments provide probationers.

Under our alternative, responsibility for supervising lower-level parolees would shift from the state to counties. Our plan is designed to give counties greater stake in the success of these offenders in the community, thereby reducing their likelihood of reoffending.

Under our alternative, counties would receive slightly more resources than the state currently dedicates to this purpose ($495 million instead of $483 million). Counties would have broad authority to use these resources to reduce recidivism and improve public safety.

Funding for parole realignment would come from a reallocation of: waste and water enterprise special district property taxes, city Proposition 172 sales taxes, and vehicle license fees retained by the Department of Motor Vehicles for administrative purposes.

Introduction

In a state as large and dynamic as California, it is important for the Legislature to periodically review state-local program responsibilities to clarify duties and make sure that programs are assigned to the level of government likely to achieve the best program outcomes. Over the years, the Legislature has achieved notable policy improvements by realigning responsibility for some state programs to local government and by shifting local programs to the state.

Which programs should the state control and which should local government control? While there is no single answer to this question, Figure 1 summarizes the major factors for the Legislature to weigh as it reviews the assignment of program responsibilities. In general, we find that programs are most effectively controlled and funded by local government if (1) they are closely related to other local government programs, and (2) program innovation and experimentation is desired. Programs are more appropriately assigned to state government, in contrast, if statewide uniformity is important or if the primary purpose of the program is income redistribution.

In this section of the *Perspective and Issues*, we review the state's parole program for lower-level offenders. Because exploration of new approaches to reducing recidivism is important, and because state parole and county probation programs are so similar, we recommend the Legislature realign responsibility for supervising lower-level parolees from state government to county probation departments. Our proposed approach is designed to give counties a greater stake in the success of these offenders in the community, thereby reducing the likelihood of their reoffending.

In our view, realigning parole responsibilities makes policy sense regardless of the state's fiscal condition. If the state's fiscal condition were stronger, the Legislature could implement parole realignment simply by providing counties the resources the state would have spent on parole. In light of the state's fiscal challenges, however, we reviewed various existing revenues to determine whether any would be appropriate to redirect to this purpose, thereby also creating a budgetary solution. To provide counties resources to carry out this responsibility and provide financial incentives to counties that operate programs that successfully reintegrate offenders into society, we recommend the Legislature modify three revenue allocation formulas. Specifically, we recommend the Legislature provide counties $495 million from: waste and water enterprise special district property taxes ($188 million), city Proposition 172 sales taxes ($178 million), and vehicle license fees (VLF) currently retained for administrative purposes by the Department of Motor Vehicles ($130 million).

Figure 1

Assigning Program Responsibilities Between the State and Local Governments

✓ Programs where statewide uniformity is important, where statewide benefits are the overriding concern, or where the primary purpose of the program is income redistribution—usually are more effectively controlled and funded by the state.

- Reduces inappropriate service level variation.
- Focuses state attention on programs integral to state goals.
- Allows income support programs to reflect the resources of the state—not a single county.

✓ Programs where innovation, responsiveness to community interests, and efficiency are paramount—usually are more effectively controlled by local governments.

- Facilitates citizen access to the decision-making process and encourages experimentation.
- Allows community standards and priorities to influence allocation of scarce resources.

✓ Coordination of closely linked programs is facilitated when all programs are controlled and funded by one level of government, usually local government.

- Increases attention to programmatic outcomes.
- Reduces incentives for cost shifting among programs.

✓ If state and local governments share a program's costs, the state's share should reflect its level of program control. If the costs of closely linked programs are shared, the cost-sharing arrangements should be similar across programs.

- Increases accountability to the public.
- Promotes efficiency in expenditures and discourages inappropriate cost shifting.

The discussion below is divided into three parts. In the first part, we discuss the similarities between parole and probation, and explain why increasing counties' role with regards to parole supervision makes sense. We then outline a plan for realigning lower-level parolees. In the second part, we discuss the financial components of our alternative. Part three concludes with a discussion of some important questions regarding parole realignment, including the state's ability to achieve savings in 2008-09.

Part One: Why Realigning Parole Makes Sense

What Are Parole and Probation?

Criminal courts can sentence offenders to state prison for a felony offense. After completing their prison term, inmates are released to their most recent county of legal residence where they are placed under parole supervision. State parole agents are responsible for supervising parolees in part by maintaining a certain level of contact with the parolee. The frequency of contact depends on the risk level of the parolee. Parole agents refer parolees to various programs and services—such as substance abuse treatment, employment assistance, and mental health services—to assist the offenders in making a successful transition to parole and to reduce the likelihood that they will reoffend. Some of these programs and services are operated by the state, and others are contracted for with other governmental or community organizations. Parolees must comply with their conditions of parole that include, for example, obeying all laws and submitting to drug testing. Failure to abide by these parole conditions can result in sanctions, including administrative return to prison by the Board of Parole Hearings for up to one year. Parolees can also be prosecuted in criminal courts for new crimes. As of December 31, 2007, there were about 127,000 state parolees.

Criminal courts place some offenders on county probation, instead of sending them to state prison. Like parole, probation involves supervision (by a county probation officer, in this case) of the offender in the local community, requirements to comply with specified conditions, referrals to programs and services, and sanctions—including reincarceration—for those offenders who violate those conditions. According to the Department of Justice, there were about 344,000 offenders on probation throughout the state in 2005. About three-quarters of those probationers were offenders convicted of a felony offense. Figure 2 shows the population of offenders on probation and parole, as well as in local jails and state prisons.

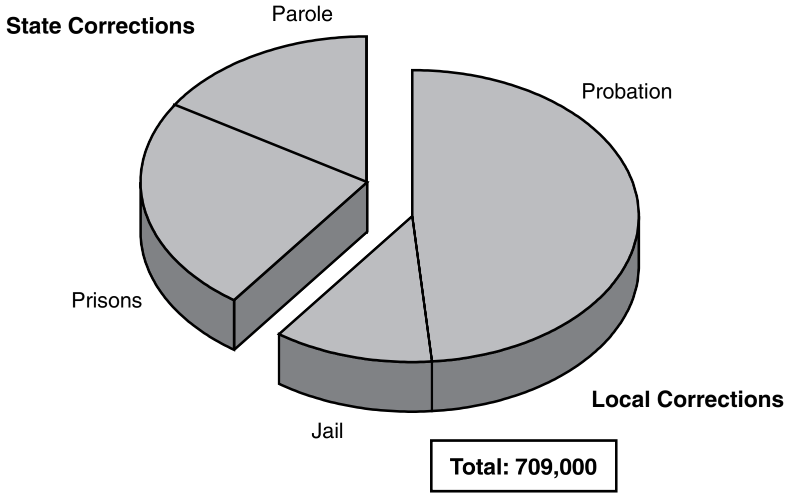
Why Parole Makes Sense for Realignment

In past years, our office has proposed state parole for realignment for several reasons. In particular, realignment could result in better public safety outcomes because the realignment of resources and responsibilities provides an incentive for local governments to have a greater stake in the outcomes of these offenders, develop innovative approaches to supervision, and reduce crime. Moreover, realignment would enable local governments to better meet their public safety priorities, as well as reduce the current duplication of effort that occurs by the state and counties supervising similar offenders in the community. We discuss the case for parole realignment in more detail below.

Figure 2

Most Offenders Under Local Supervision

2005



Better Outcomes and Innovation With Local Control. Parole realignment would change fiscal incentives in such a way as to likely improve public safety outcomes. Specifically, counties would have a greater incentive than they have now to intervene and treat these criminal offenders because they would be responsible for the costs of reincarcerating offenders who commit violations of their probation conditions. Currently, the state bears the cost of reincarcerating parolees who fail under community supervision. Our analysis indicates that giving counties a direct stake in the success of offenders living in their communities is likely to improve offender outcomes and reduce their risk of reoffending. In other words, this strategy is likely to reduce crime.

In part, the incentive for counties to intervene with these offenders will lead them to have greater access to community programs—such as mental health and drug treatment—than sometimes occurs now. For example, counties could use available Proposition 63 funds for these offenders. Proposition 63 provides funding for county mental health programs but excludes parolees from receiving services provided by these funds. However, probationers are eligible for Proposition 63 services.

Moreover, parole realignment would encourage small-scale experimentation and piloting of projects at the local level. Because local governments would be responsible for a number of different programs and offenders, they would be likely to try different models for intervention and treatment of offenders. As a result, innovative approaches to supervising offenders are more likely to be developed by local governments, and these innovations could spread throughout the state.

Better Meet Local Criminal Justice Priorities. In California, as in most states, local governments have the responsibility for most criminal justice activities, including the arrest, prosecution, legal defense, and supervision of criminal offenders. Historically, local governments have had this responsibility because it allows them to respond to activity specific to their communities and set their own priorities for public safety programs and expenditures. Realigning parole is consistent with this general approach by making the supervision of parolees a local public safety responsibility.

Duplication of Effort by State and Local Governments. As described above, local probation departments and the state's parole agency fulfill very similar functions. In particular, they supervise criminal offenders living in the community, monitor their compliance with state laws and other conditions of their supervision, as well as provide programs and services designed to reduce recidivism. Moreover, while judges generally have significant discretion to send felons to state or local corrections, parole agents and probation officers supervise very similar offender populations in many respects. As shown in Figure 3, for example, an almost identical percentage of offenders sentenced to probation and prison were convicted for a violent offense. (In many cases, the offenders sentenced to prison are those who have committed more serious violent offenses.)

These similarities in functions as well as populations served means that there exists significant duplication of effort between the state and local governments. Therefore, realigning responsibility for supervising parolees to local probation departments could achieve better economies of scale and reduce overall criminal justice costs.

LAO Recommendation: Realign Lower-Level Parolees

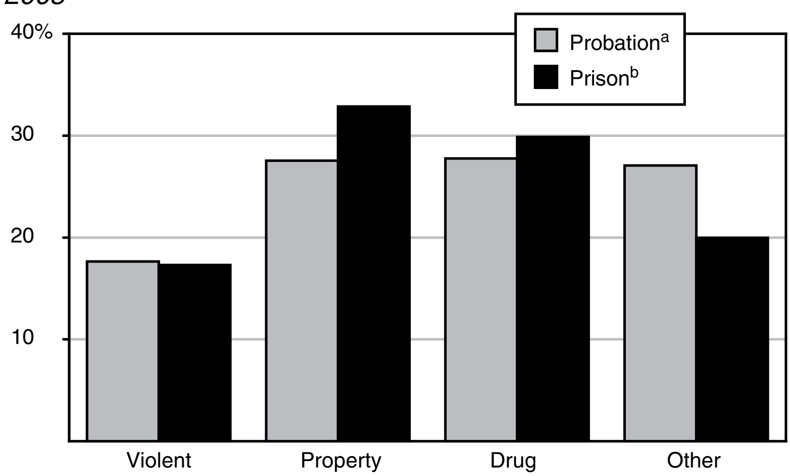
We recommend realigning some responsibility for supervising parolees to local governments. Under our proposal, certain lower-level inmates released from prison would be supervised by local probation departments rather than the state parole agency. We discuss our proposal in more detail below.

How Would Realignment Work? Under our proposal, local governments would have responsibility for supervising lower-level offenders released from prison on probation. This would include the full responsibility for supervision of these offenders in the community, provision of programs and services, and applying punishments for violations of probation conditions, such as reincarceration in county jails. Returns to prison would only occur for a new criminal court conviction, as can occur currently (though we do propose that counties be able to use some of their revenues to reimburse the state for use of state prison beds if they are experiencing significant jail overcrowding). As discussed below, counties would receive an additional $495 million for local probation programs provided from a shift of existing revenues. This funding would be for the probation-related services described above. The state would retain responsibility for supervising higher-level offenders, such as those convicted of violent crimes, first degree burglary, and drug manufacturing and sales. In the past, our office has proposed realigning all of parole to local probation. While such a proposal still has merit, in our view, we propose focusing on lower-level offenders as a first step.

Figure 3

Similar Offenders Sentenced to Prison and Probation

2005



[a] Includes sentences to probation, as well as sentences requiring jail and probation.
[b] Offenders are not sentenced directly to parole. Instead, parole is required for all offenders after they complete a prison sentence.

Who Do We Mean by Lower-Level? We do not propose to shift all parolees to local governments. Instead, we propose to shift a total of 71,000 lower-level parolees, about 56 percent of the total parole caseload. These lower-level parolees are the ones who are most likely to resemble the relatively lower-level offenders already supervised by local probation departments. Specifically, the parolees we propose to shift to probation are convicted of property and drug offenses. We exclude offenders with current convictions for violent or sex offenses, though some of the lower-level offenders may have such offenses in their criminal history. Figure 4 lists the current offenses for which offenders would be transferred to probation supervision, as well as the number of current parolees.

Figure 4

Parolees Proposed for Realignment to Local Probation

June 30, 2007

Current Offense	Number of Parolees
Property Offenses	
Second degree burglary	7,482
Vehicle theft	7,128
Petty theft with a prior theft	6,159
Receiving stolen property	4,920
Forgery/fraud	4,104
Grand theft	3,736
Other property offenses	1,146
Subtotal, Property Offenses	(34,675)
Drug Offenses	
Drug possession	19,046
Drug possession for sale	12,057
Marijuana possession for sale	1,280
Marijuana sales	538
Other marijuana crimes	179
Hashish possession	49
Subtotal, Drug Offenses	(33,149)
Driving under the influence	3,539
Total, All Offenses	**71,363**

Benefits Both State and Local Governments. Realigning these supervision responsibilities to local governments would yield benefits to both state and local governments. The state would save approximately $500 million from reduced parole caseloads, reincarceration of parole violators, and administrative costs. There would be less "churning" of lower-level offenders repeatedly coming in and out of prison for short stays related to parole violations. This would reduce prison overcrowding, particularly in expensive reception center beds. Moreover, shedding lower-level offenders from the state parole caseloads would allow the department to refocus its parole mission on supervising the higher-level offenders that would remain on parole, including, for example, sex offenders and those offenders with a recent serious or violent offense on their record.

While this realignment proposal would significantly increase local probation caseloads and costs, it would also provide significant additional revenues for local probation and public safety programs. Our proposal would result in approximately a 25 percent increase in funding for local probation departments which we estimate spend about $2 billion annually now, though this also includes funding for juvenile probation. The 71,000 offenders shifted to local probation departments would constitute about a 20 percent increase in county caseloads on a statewide basis. Therefore, under our alternative, counties would receive significant new revenues with which to manage their new offenders, as well as to bolster programs for their existing populations. The additional funding provided to counties could be used for more intensive supervision, expansion of rehabilitation programs and services, and jail costs to reincarcerate probation violators. In may also make sense to allow counties to be able to use some of their revenues to reimburse the state for the use of state prison beds if they currently face overcrowding in their jails. As we discuss above, counties would have discretion as to how they would use this funding, providing them flexibility to manage this offender population as they determine appropriate, as well as to invest some of these funds in prevention or intervention programs that might yield significant improvements to public safety in the longer term.

Below, we discuss how this shift of responsibilities from the state to the counties would be financed.

PART TWO: FINANCING REALIGNMENT

Under our alternative, each county would create a Public Safety Realignment Account (PSRA) within its existing Local Public Safety Fund (discussed in detail below). Every county would deposit into its PSRA a portion of the property tax revenues currently allocated to water and waste enterprise special districts in the county.

Our alternative also creates a State Public Safety Realignment Account (SPSRA) and directs into this account (1) 6 percent of total statewide Proposition 172 sales taxes (approximately the share received by cities) and (2) about one-third of the VLF currently retained by the Department of Motor Vehicles. Funds from SPSRA, in turn, would be allocated to county

PSRAs to the extent necessary to ensure that every county had sufficient resources to carry out its expanded supervision responsibilities. Counties could use PSRA resources for a broad range of services related to offender supervision, including rehabilitation and incarceration

We discuss the three revenue sources used in our financing plan (property taxes, Proposition 172 sales taxes, and VLF) separately below. We then describe how the LAO alternative would provide revenues to each county.

Water and Waste Disposal Enterprise Special District Property Taxes

Background

While most Californians receive water, sewer, and solid waste disposal service from a branch of their city or county government, some Californians are served by independently elected special districts. These water and waste special districts are called "enterprise" special districts because they (1) have broad authority to charge service fees and (2) account for their finances like private businesses.

Prior to Proposition 13, about one-half of these water and waste districts levied a property tax rate to offset part of their costs. Paying for water and waste services with property tax revenues was common throughout the United States at that time. (Since the 1970s, there has been greater reliance on variable-rate user fees to finance these services because the fees provide incentives to conserve and recycle.)

In 1978, Proposition 13 dramatically changed the fiscal landscape for local government. Specifically, Proposition 13 (1) reduced the average property tax rate from over 2.5 percent to 1 percent of assessed value and (2) gave the state the responsibility for determining how property taxes are allocated among local governments. To implement Proposition 13, the Legislature enacted measures, beginning with SB 154, Conference Committee (Chapter 292, Statutes of 1978) and AB 8, L. Greene (Chapter 282, Statutes of 1979). Under these laws, local governments that levied a property tax rate before Proposition 13 continue to receive a share of the property tax today. The only exceptions to this provision are if the local government dissolves or follows a statutory process to (1) shift its share of the property tax to another local government or (2) notify the county auditor that it no longer wishes to receive property tax revenues (in which case the auditor reduces the 1 percent property tax rate commensurately).

At the time the Legislature implemented Proposition 13, the Legislature recognized that the state's reduced property tax rate would not be sufficient to maintain funding for all local government services. Accordingly, in 1978 the Legislature urged enterprise special districts to shift to user fee financing. Specifically, the Legislature stated in Government Code Section 16270:

> The Legislature finds and declares that many special districts have the ability to raise revenue through user charges and fees and that their ability to raise revenue directly from the property tax for district operations has been eliminated by Article XIIIA of the California Constitution. It is the intent of the Legislature that such districts rely on user fees and charges for raising revenue due to the lack of the availability of property tax revenues after the 1978-79 fiscal year. Such districts are encouraged to begin the transition to user fees and charges during the 1978-79 fiscal year.

Notwithstanding this legislative intent, most water or waste districts that levied a property tax before Proposition 13 continue to receive property tax revenues today. To illustrate this link between modern property tax allocation and tax policies of the 1970s, the box on the next page describes a district (Los Trancos County Water District) whose ongoing need for property tax revenues has been eliminated, yet the district continues to receive property taxes. While the Los Trancos example is admittedly extreme, it illustrates the rigidity of the current property tax allocation system and its lack of connection with modern local needs and preferences.

Enterprise Special Districts Use of Property Taxes Today. In 2008-09, we estimate that waste and water districts will receive $370 million in property taxes. (This sum does not include property taxes collected in excess of the 1 percent rate and pledged to payment of bonded indebtedness.) Every county in California has some waste and water districts that receive property taxes, except San Francisco. Districts that receive property taxes (less than one-half of all waste and water districts statewide) typically rely on these revenues for less than 7 percent of their operating costs. Districts typically indicate that property taxes allow them to set lower service charges than providers that do not receive property taxes.

Proposal

Under our alternative, county boards of supervisors would hold hearings to review the property tax revenues that waste and water districts receive. Counties would determine the amount to shift from each district to its PSRA. (As described in the shaded box on page 137, this approach draws heavily from legislation enacted on a one-time basis for the County of Santa Cruz, Chapter 905, Statutes of 1993 [AB 1519, Isenberg].)

As we describe more fully below in the section "How the Financial Model Would Work," under our alternative, each county shifts to its PSRA 70 percent of countywide water and waste district property tax revenues, unless a *lower* percentage of property taxes would raise sufficient funds to support the realignment program. (This would be the case in 11 counties—Orange, El Dorado, Kern, Marin, and Placer and several small counties, where tax shifts of about 35 percent to 45 percent would raise the full amount needed.) The percentage of property taxes shifted from different districts need not be identical. For example, a county might decide to shift 5 percent of a small water district's property taxes and 90 percent of a large waste district's property taxes.

Statewide, we estimate that our alternative would shift about 50 percent of waste and water district property taxes—$188 million—to county PSRAs to support the realignment program. This property tax shift, in turn, would put pressure on districts to increase service charges.

Remaining Waste and Water Enterprise Special District Property Taxes. To minimize the near-term fiscal disruption to water and waste districts, our alternative leaves almost 50 percent, or $180 million, of property taxes with districts. Within a couple years, however, we think the Legislature should authorize county boards of supervisors to determine whether these property taxes should remain with the districts or be reallocated to other local governments to support local priorities. Because local communities have had no authority over property tax allocation in nearly 30 years, we are mindful that this process would engender concerns by special districts and significant public debate. While difficult, we believe that this result would be a sign of a healthy local democratic process, appropriately debating the allocation of local revenues.

Example: Los Trancos County Water District

In 1954, residents of a hilly, rural area in San Mateo County created an enterprise special district to provide water service and levied a property tax rate to help pay for this service. In 2005, the water district sold its entire water distribution system to a private company (a change that resulted in lower water service charges to the area's residents). Although the water district no longer provides water service, the district did not dissolve or request that its property tax revenues be redistributed or eliminated. The water district continues to receive property taxes pursuant to current law. The district uses about one-half of these revenues to provide tax rebates to its residents and the rest for activities unrelated to water delivery.

City Proposition 172 Sales Taxes

Background

By approving Proposition 172 in 1993, California voters established a statewide half-cent sales tax for support of local public safety activities. Proposition 172 was placed on the ballot by the Legislature and the Governor to partially replace $2.6 billion in property taxes permanently shifted from local agencies to school districts as part of the 1993-94 state budget agreement. (The value of this 1993-94 property tax shift has grown over time.)

Under Proposition 172, resources from the half-cent sales tax (almost $3 billion in 2008-09) are allocated to each county based on its share of statewide taxable sales. When Proposition 172 was considered initially by the Legislature, the measure did not direct counties to transfer any Proposition 172 revenues to cities. This is because Proposition 172 was considered property tax shift mitigation and cities bore a much smaller share of the 1993-94 property tax shift than counties (in fact, some cities were exempt from the 1993-94 property tax shift).

As the debate over Proposition 172 evolved, however, the Legislature determined that (1) cities which sustained a property tax shift in 1993-94 would benefit from some offsetting revenues and (2) allocating some Proposition 172 revenues to cities would broaden the measure's political support. Accordingly, the Legislature modified the Proposition 172 allocation formula to direct each county to transfer a small share (about 6 percent) of its revenues to those cities in the county that sustained a 1993-94 property tax shift.

Santa Cruz Precedent

In 1993, the Santa Cruz County Board of Supervisors held public hearings to determine the relative need for funding for all enterprise special districts and the County Library Fund. The county reported to the Legislature that in the case of about 12 percent of the revenues the "districts provided convincing reasons for retaining all or part of the allocated taxes." With regard to the remaining 88 percent of the taxes, however, the board concluded that "considerations of equity and appropriate use of tax funds" led them to conclude that depositing the property taxes into the County Library Fund was appropriate.

Controversy Regarding City Share of Proposition 172. In the years after the Legislature developed the Proposition 172 allocation formula, there has been significant controversy about the share of Proposition 172 allocated to cities. Some cities that do not receive Proposition 172 revenues (because they were not affected by the 1993-94 property tax shift) have argued that they should be included in its distribution because they provide public safety services. Cities and counties also have debated the percentage of county Proposition 172 revenues that should be transferred to cities.

Proposal

When the Legislature drafted Proposition 172, it recognized that local government public safety and financing needs change over time. Accordingly, Proposition 172 gives the Legislature broad authority to modify how its revenues are allocated to local governments for public safety purposes.

Based on our review of state-local finance and the potential benefits of parole realignment, we think a revision to the allocation formula is reasonable. Specifically, due to strong growth in property taxes over the last decade, city expansion of redevelopment activities, and the significant fiscal benefit cities have realized under the 2004 VLF-for-property tax swap, city financial conditions appear stronger than they were at the time the Legislature earmarked for them a portion of Proposition 172 funding.

Under our alternative, cities do not receive Proposition 172 sales tax revenues. Instead, 6 percent of total statewide Proposition 172 revenues—approximately the amount cities receive—are deposited to the SPSRA and then allocated to county PSRAs as described in the section "How the Financial Model Would Work." Cities' loss of Proposition 172 revenues likely would result in commensurate program reductions. As a point of reference, we note that Proposition 172 funding represents about 1 percent of city tax revenues and less than 2 percent of city spending for public safety.

VLF Revenues Retained by DMV

Background

When one government collects revenues on behalf of another, it is common for the revenue-collecting government to retain a portion of the revenues to cover its administrative costs. The DMV collects VLF on behalf of cities and counties and retains a portion of these revenues to offset its costs.

When the Governor reduced the VLF rate in 2004 from 2 percent to 0.65 percent, the administration was concerned that DMV would experience fiscal stress from a commensurate reduction in its retained VLF revenues. (The amount of VLF that DMV retains is calculated under a statutory formula that uses as a factor the total amount of VLF collected.) Accordingly, the administration proposed that DMV be allowed to calculate the amount of its retained VLF under the assumption that the VLF rate was still 2 percent. The Legislature enacted this change into law (Revenue and Taxation Code 11003 and Vehicle Code 42205).

This change to DMV's calculations was discussed with cities and counties when the VLF for property tax swap was negotiated in 2004 and its fiscal effect was incorporated into the final tax swap agreement. Cities and counties, therefore, are not "worse off" because DMV retains its pre-2004 funding from VLF. Instead, the cost to maintain DMV's pre-2004 funding from VLF is born by the state General Fund. This is because the state shifted a larger share of K-14 property taxes to cities and counties under the VLF swap than would have been the case if DMV's VLF revenues had been based on the lower rate.

In 2008-09, we estimate that DMV will retain $130 million more VLF than would be the case if DMV's funding from the VLF reflected the current 0.65 percent VLF rate. In our view, there is little reason for the state General Fund to pay indirectly part of the cost of the DMV, a department that historically has been financed by user fees.

Proposal

Our alternative would repeal the provisions of law that allow DMV to calculate its retained VLF revenues under the assumption that the VLF rate is still 2 percent. As a result, DMV would retain $209 million of VLF for administrative purposes, rather than the $339 million proposed in the Governor's budget. The $130 million of reduced VLF retained by DMV would be deposited to SPSRA for allocation to the counties.

The DMV, in turn, likely would need to increase vehicle registration fees to offset this reduction in VLF support. We estimate that this fee increase would be approximately $4 per vehicle.

How the Financial Model Would Work

Our financing approach provides counties reliable revenues to support their increased responsibilities, authority to use these resources flexibly to provide services offenders need, and incentives to improve program outcomes.

Specifically, under our model, counties receive a total of $495 million of reallocated property tax, sales tax, and VLF revenues to support the realigned program. The $495 million is $12 million more than the amount the 2008-09 state budget includes for state supervision of lower-level parolees

($483 million). Under our approach, the additional $12 million would be allocated to counties as incentive payments (discussed below).

Because the distribution of parolees per 1,000 residents is fairly uniform among counties, our model assumes that each county's parole funding level would reflect its proportionate share of the statewide population. (As an alternative, the Legislature could base parole funding on the number of people in the age group most likely to offend.)

Figure 5 illustrates how the financial approach would work. Hypothetical counties "A," "B," and "C" have identical sized populations. Thus, our model assigns them identical parole funding levels. The resources used to meet the three counties' parole funding levels differ, however, due to differences in the amount of property taxes their water and waste districts receive. As shown in Figure 5, County A's districts receive a large amount of property taxes. As a result, County A meets its parole funding level by reallocating 45 percent of these district property taxes to its county PSRA.

Figure 5

How Parole Realignment Financing Would Work

(Dollars in Millions)

	Hypothetical Counties[a]		
	A	**B**	**C**
Parole Realignment Allocation	$10.0	$10.0	$10.0
Funding Sources			
Water and waste district property taxes			
County totals	22.0	10.0	5.0
Amount allocated to PSRA[b]	10.0	7.0	3.5
Percent reallocated	45.0%	70.0%	70.0%
Support from SPSRA[c]	—	$3.0	$6.5

a Counties have same population so their funding levels are identical.

b The lesser of the amount needed for realignment funding (in this case, $10 million) or 70 percent of total property taxes is deposited to each county's Public Safety Realignment Account (PSRA).

c State Public Safety Realignment Account, which consists of certain Proposition 172 funds and reallocated Department of Motor Vehicles vehicle license fee revenues.

Water and waste districts in County B and C, in contrast, receive fewer property taxes. After County B and C reallocate the maximum percentage of property taxes (70 percent under our approach), these counties still do not have enough resources to reach their parole funding levels. Accordingly, County B and C receive support from SPSRA. The revenues in this account come from the cities' share of Proposition 172 revenues and excess VLF revenues currently retained by DMV.

County Incentive Payments. We estimate that the SPSRA would have about $12 million more in revenue than needed to bring each county to its parole funding level. For the first three years of realignment, our alternative allocates this sum to counties on a per capita basis to offset administrative costs associated with the program change. After three years, however, this funding would be allocated by the state to counties making the greatest strides towards reducing recidivism and state incarceration.

How Would the Funding Allocation Change Over Time? Every five years, these funding allocations would be updated to reflect changes in population. The amount of resources would grow over time along with the specific growth patterns of each revenue source's underlying revenue base (the property tax, VLF, and sales tax). In this way, each county's parole resources would grow commensurately with its population and the strength of three tax sources.

Part Three: Key Questions Related to Parole Realignment

Realigning supervision responsibilities for lower-level offenders from the state to counties has potential to significantly improve program outcomes. Any plan of this magnitude, however, raises practical, policy, legal, and financial questions. This is particularly true given the fiscal challenges the state is facing and the Constitution's many requirements regarding local finance. In this concluding section, we discuss several major questions related to this realignment proposal.

- What ongoing coordination between state and local governments will be required?
- How should financial incentives be arranged to ensure the best outcomes?
- How can the transition of responsibilities be best managed to mitigate the operational impact to the state and counties?

- What steps could the Legislature take to achieve state savings in 2008-09?
- Would parole realignment impose a state-reimbursable mandate?
- Would the financing plan conflict with the provisions of Proposition 1A?

What Ongoing Coordination Between State and Local Governments Would Be Required?

The transition of state inmates to county probation departments would require a level of coordination that does not currently exist between these agencies. However, for realignment to work, it would be critical to establish standard processes of communication. In particular, the California Department of Corrections and Rehabilitation (CDCR) would need to communicate to probation departments information on which state inmates are being released to probation supervision and when. This should include all relevant information about the offender that may be important for probation supervision, such as criminal history, residence, and the outcome of any assessments of the offender's risk to reoffend or needs for various programs and services.

County probation would also need to provide information to the state. For example, CDCR would need to be able to inform inmates releasing to county probation where and to whom they are required to report when they return to the community. It would also be important for counties to be able to track the outcomes of probationers formerly in state prison and provide that information to the state in order to determine how to distribute the $12 million of incentive funds proposed.

How Should Financial Incentives Be Arranged To Ensure the Best Outcomes?

As discussed above, realignment should result in better incentives for local governments to manage this population and invest in sound prevention and rehabilitation programs. However, with any change of this magnitude, it is important to ensure that the change provides sufficient incentives for the outcomes desired. In this case, that outcome is improved public safety.

One potential concern is whether counties could use the new public safety revenue to supplant existing funds used for this purpose, and divert existing public safety dollars to other county programs. This could result in a negative impact on local public safety. Therefore, it may be worth considering including a maintenance-of-effort requirement for parole realignment.

Another potential concern is whether counties would use their new revenues to sufficiently invest in prevention and rehabilitation programs designed to reduce recidivism and improve public safety. We recommend that the realigned funds be placed in a newly created PSRA in each county's Local Public Safety Fund. The Legislature will want to consider how counties would be able to use funds deposited in their PSRAs. We would suggest that these funds be designated for probation supervision, rehabilitation programs and services, incarceration of probation violators, and prevention programs.

As discussed above, we also recommend that $12 million of the SPSRA be set aside to reward those counties that show the greatest reductions in offender recidivism. This should provide additional incentive to counties to focus on this specific public safety outcome. However, the Legislature will need to determine how this outcome will be measured. For example, will the incentive be based on county crime rates or prison commitments? Will the incentive be determined by recidivism of all county probationers or just those offenders formerly in state prison?

How Can the Transition of Responsibilities Be Best Managed to Mitigate the Operational Impact to the State and Counties?

Clearly, parole realignment would have significant operational impacts for both the state and counties, particularly during the time it takes the program transition to occur. For example, counties would need to hire hundreds of additional probation officers to supervise the new offenders, and the state would likely have to reduce its total parole agent positions. The Legislature may want to explore whether there are strategies available to ease the transition of state parole agents to county probation offices for those who would want to transfer. Similarly, counties would likely need to expand rehabilitation services—such as drug treatment, mental health services, and employment assistance—for their probationers, and the state may have to reduce or alter its existing rehabilitation services to meet the programmatic needs of the remaining parolee population. Finding ways to manage this transition effectively would better ensure successful outcomes.

What Steps Could the Legislature Take To Achieve State Savings in 2008-09?

Ideally, state and local governments would have a couple years to plan the implementation of parole realignment. This would allow ample time to address personnel issues and resolve administrative matters. Given the state's fiscal challenges, however, we believe the realignment could be implemented to allow the state to realize savings in 2008-09, while giving the state and counties time to work out transition issues.

To accomplish this, the Legislature would enact urgency legislation making this parole realignment effective on July 1, 2008. That is, on that date the counties would have the fiscal responsibility for the parolees shifted to them, as well as the new revenues. The counties, however, would not have to provide the actual supervision services at the local level as of July 1, 2008. They would have up to one year to address personnel, facilities, and other administrative issues before actually providing the services locally. During that transition, the state would continue to supervise these lower-level parolees and the counties would reimburse the state for its costs. (This would be fiscally neutral for the counties, as they would have the additional revenues to pay the state for these transitional services.) These county reimbursement payments to the state would cease when the county assumed supervision responsibility.

Would Parole Realignment Impose a State-Reimbursable Mandate?

Under the California Constitution, the state generally must provide a subvention of funds to local governments if it mandates "a new program or higher level of service" which increases local governments' costs.

Would this program realignment be considered a mandate? State law is not clear. The underlying rationale for mandate law is to safeguard local governments from incurring additional costs to implement required new programs. Because our alternative provides revenues that fully offset counties' increased responsibilities, our alternative does not appear to impose a mandate. Case law is not clear, however, whether tax revenues reallocated from other local governments would count as an offset for purposes of determining whether a mandate exists.

Given the magnitude of revenues included in this realignment proposal, the Legislature should consider taking one or more of the following steps to reduce the possibility that this plan would be found to be a reimbursable mandate:

- Amend the Government Code to specify that additional tax revenues allocated to a local government shall be considered offsetting revenues in any mandate determination. (Existing law provides that *fee* revenues count for such purposes.)
- Place the proposed realignment before the state's voters on the June or November 2008 ballot. (Measures approved by voters are not considered reimbursable mandates.)
- Enact the proposed realignment only if all counties pass a resolution requesting that the Legislature approve the plan and shift parole supervision responsibilities to them. (Measures requested by local governments are not considered reimbursable mandates.)

Would the Financing Plan Conflict With the Provisions of Proposition 1A?

Proposition 1A, approved by the state's voters in 2004, amended the California Constitution to reduce the Legislature's authority over local finance. Nothing in this realignment plan, however, conflicts with the requirements of Proposition 1A. Specifically, Proposition 1A does not limit the Legislature's authority to reallocate Proposition 172 revenues or VLF retained by DMV.

In terms of property taxes, Proposition 1A specifies that laws that shift property taxes from one (noneducation) local government to another must be approved by a two-thirds vote of the Legislature. Accordingly, we would assume that the legislation granting counties the authority (and responsibility) to transfer district property taxes would be subject to the two-thirds vote requirement.

Conclusion

Successfully reintegrating criminal offenders into society requires a coordinated approach, including offender supervision, as well as the provision of mental health, substance abuse, and other types of treatment and programs. In California's current criminal justice system, counties operate most of these programs, but the state is responsible for supervising offenders released from state prison.

For many years, this office has recommended the Legislature (1) shift state parole responsibilities to counties and (2) give counties the funding and flexibility to operate these programs so that they achieve the best public safety outcomes.

In our view, realigning parole responsibilities makes policy sense regardless of the state's fiscal condition. In light of the state's fiscal challenges, we have developed an approach that would allow the Legislature to realign a significant portion of the state parole program and achieve nearly $500 million in ongoing budget solution.

Alternatives to the Governor's Budgetary Reforms

What Budgetary Reforms Does the Governor Propose? How Would the Proposed Changes Affect the Legislature's Budgetary Authority? What Alternatives Could the Legislature Consider?

Summary

The Governor proposes that a constitutional amendment be put before the state's voters related to the state's budgeting process. The Governor has identified two problems with the state's current system:

- *The state does not save enough during good economic times and is, therefore, ill–prepared for swift deteriorations in revenues.*
- *Spending formulas make it too difficult to slow spending during bad economic times.*

The administration proposes to limit the amount of revenues that the General Fund could receive in any year. In addition, the Governor proposes a system by which the administration could trigger across-the-board reductions if the state's budget situation declined.

Although the measure would help even out the state's revenues from year to year, it would also be inflexible to legislative decision making on a year-to-year basis. The proposed across-the-board reductions would fail to prioritize state spending and represent a serious diminution of the Legislature's authority. Consequently, we recommend that the Legislature reject the proposed changes. We provide, instead, some alternatives it could consider which build upon the positive aspects of the Governor's proposal.

The Governor proposes that a constitutional amendment be put before the state's voters related to the state's budgeting process. In this piece, we describe the budgetary changes that were implemented in 2004 and the Governor's proposed reforms. Then, we provide an analysis of the proposal and alternatives that the Legislature could consider.

Budgetary Reforms Under Proposition 58

Proposition 58 was approved by the voters in March of 2004. Passed in conjunction with Proposition 57, which authorized the sale of up to $15 billion in deficit-financing bonds, Proposition 58 amended the State Constitution and made a number of changes to the state's budgeting practices. These reforms were intended to help prevent the state from reaching the same level of budgetary problems that led to the issuance of the bonds. Proposition 58's key changes are described below.

Balanced Budget. The Constitution has long required the Governor to *propose* a balanced budget. Proposition 58 also requires the Legislature to *pass* a balanced budget (expenditures do not exceed estimated available revenues).

Mid-Year Adjustments. The proposition also authorizes the Governor to call a fiscal emergency and special legislative session to address such an emergency. This year, the Governor used this power on January 10 to call the Legislature into special session to address the state's budget problems. In such a case, if the Legislature fails to pass legislation to address the budget problem within 45 days, it would be prohibited from (1) acting on any other bills or (2) adjourning in joint recess until such legislation is passed.

New Reserve. Proposition 58 creates a second reserve called the Budget Stabilization Account (BSA), in addition to the state's traditional Special Fund for Economic Uncertainties (SFEU). The Constitution now requires 3 percent of annual General Fund revenues be transferred to the BSA (smaller percentages were required in earlier years). The Governor is authorized to suspend this transfer through an executive order, which the Governor proposes to do for 2008-09. The annual BSA transfer has two components:

- ***Accelerated Payoff of Deficit-Financing Bonds.*** One-half of revenues transferred into the BSA are used to provide supplementary debt payments on the state's deficit-financing bonds. These supplementary payments stop when the bonds are paid off or total BSA supplementary payments total $5 billion. Through the current year, $1.5 billion in supplementary debt payments have been made.

- ***Budgetary Reserve.*** Funds not used for supplementary debt payments stay in the BSA as a budgetary reserve. Transfers into the BSA are required until the reserve equals the greater of $8 billion or 5 percent of General Fund revenues (currently about $5 billion).

Transfers Out of the BSA. The Legislature can transfer funds out of the BSA for any purpose through statute. The *2007-08 Budget Act* (Control Section 35.60) authorizes the Department of Finance (DOF) to transfer funds out of the BSA if needed to cover state expenses. Earlier this year, DOF transferred the entire balance of the BSA—$1.5 billion—to the SFEU to help close the state's budget shortfall.

Not Much Time to Work. Under Proposition 58, transfers into the BSA began in 2006-07. With the state's worsening fiscal situation in the current year, the balance of the BSA has already been depleted. As such, the Proposition 58 changes intended to build up the state's budgetary reserve have not yet had an opportunity to fully function.

Components of the Governor's Reforms

At the time this analysis was prepared, the administration had not yet provided the actual text of its proposed measure. Instead, in preparing this analysis, we have relied on the general characterizations of the measure that the administration provided us. Many of the details of how specific provisions would work in practice, therefore, are still unknown. We describe the key components of the Governor's reforms below. The administration aims to have the measure placed on the November 2008 general election ballot, with an effective date of February 1, 2009.

Problem Definition

The Governor has identified two problems with the state's current system:

- The state does not save enough during good economic times and is, therefore, ill–prepared for swift deteriorations in revenues.
- Spending formulas make it too difficult to slow spending during bad economic times.

Limit on General Fund Revenues Forces Reserve Build-Up

Ten-Year Revenue Growth Rate. The administration proposes to limit the amount of revenues that the General Fund could receive in any year.

Specifically, the amount would be limited by the average growth rate of General Fund tax revenues over the prior ten years. For instance, the administration estimates that tax revenues have grown by 6 percent between 1998-99 and 2007-08. If the proposal was in effect for 2008-09, therefore, General Fund tax revenues available for expenditure could grow by no more than 6 percent. The limit on revenues would be adjusted to allow for any new revenues from a General Fund tax increase.

Deposits Into New Reserve. In any year in which General Fund revenues were expected to grow by more than the ten-year average (based on a DOF forecast), the "excess" revenues would be deposited into a new reserve called the Revenue Stabilization Fund (RSF). The RSF would be in addition to the state's two existing reserves, the SFEU and BSA. The administration intends to abolish the BSA once the state's deficit-financing bonds are paid off (currently expected in 2012-13).

Transfers Out of the RSF. Unlike the state's current reserves, the Legislature could not generally access the funds in the RSF, including in cases of fiscal emergencies. Instead, funds could only be transferred from the RSF to the General Fund in years in which General Fund revenues were forecasted to grow less than the ten-year average growth rate. In those years, the Legislature could transfer some or all of the RSF balance—up to the ten-year average growth rate—to the General Fund through a two-thirds vote of each house.

Building Up Reserve Balance

The aim of the Governor's proposal is to build up a substantial amount of funds in the RSF—up to 15 percent of annual General Fund revenues (about $15 billion in today's dollars). After this amount was met, the measure would require the Legislature to spend any additional funds on a variety of "one-time" purposes:

- ***K-14 Education.*** Forty percent could be spent on one-time K-14 education purposes. This spending would be outside of the Proposition 98 minimum guarantee.
- ***Other Purposes.*** The remaining 60 percent could be spent on any combination of tax relief, infrastructure, or general obligation bond debt service.

Automatic Mid-Year Budget Reductions

The measure would also establish a system by which the administration could trigger across-the-board reductions if the state's budget situation declined. The DOF would estimate the state's revenues and expenditures three times a year—in November, January, and May. If the state's current-year budget was projected to have a negative reserve, then the administration would trigger reductions. The amount of the reductions would depend upon the severity of the budget shortfall. If the negative reserve was projected to be less than 1 percent of expenditures, then the reductions would be implemented to achieve a 2 percent reduction in spending on an annualized basis. If, however, the negative reserve was more than 1 percent, then the reductions would be implemented to achieve a 5 percent reduction on an annualized basis.

Types of Reductions. If passed, the constitutional measure would give the Governor the authority to achieve the specified percentage reductions in different ways, depending on the type of program.

- ***Preauthorizations for Entitlement Reductions.*** The measure would require the Legislature to enact contingency laws for entitlement programs—where spending is driven by requirements in existing law—such as Medi-Cal and the California Work Opportunity and Responsibility to Kids (CalWORKs). These contingency laws would have to specify how reductions would be implemented to achieve 2 percent or 5 percent reductions if triggered. For any programs for which the Legislature failed to enact contingency laws but was required to do so, the Governor would be given the authority to waive any state law in order to achieve the reduction target.
- ***Other Programs, Including Proposition 98.*** For other types of programs, the measure would provide the administration the authority to reduce statutory or budget act appropriations. This would include Proposition 98 revenue limit payments to schools, local assistance grants, and prison spending. In the case of Proposition 98, the administration would have the authority to reduce appropriations but not suspend the minimum guarantee. If these reductions resulted in spending below the minimum guarantee, the state would either incur a settle-up obligation or the Legislature would have to suspend the guarantee (with the existing vote requirements).
- ***Programs Exempt From Reductions.*** Finally, some areas of the budget would be exempt from reductions—when a certain level of spending is mandated by federal law, or constitutionally or contractually protected (such as debt service). The administration would determine which programs met these criteria.

Turning Off the Reductions. Any reductions would remain in place until turned off by the passage of a new budget or other law.

Implications of the Governor's Reforms

Changes Would Help Level Out Revenues and Increase Reserves...

The administration shared with us some of its modeling of how the measure would have worked if it had been in effect in earlier years. Under the administration's projections, the state's budget problems from the recent past might have been lessened, but not eliminated, if the measure had been in effect. Since we have not reviewed the specific proposed language, we have not attempted to perform our own modeling. It is clear though—by limiting the appropriation of any revenues over the recent average growth rate—annual General Fund revenues would be leveled out under the measure. Budgetary reserves would be built up during good times and available to lessen the effect of revenue downturns.

...But With Potentially Difficult Results

Possible Pitfalls. Formulas, by their nature, cannot predict all future circumstances. As a result, they tend to limit, rather than increase, future policy makers' options to craft budgets. For instance, as the state comes out of an economic downtown, it may experience above average revenue growth. This growth, however, would be off a lowered base. In such an instance, a portion of revenues would still be transferred to the RSF—despite state spending being at a significantly lower level compared to spending before the downtown. Restoring programs to their pre-downturn service levels could be impossible under the measure (unless taxes were raised).

Measure Could Lock in Structural Imbalance. As we discuss in "Part I" of this publication, the state would continue to face a structural gap between its revenues and spending—even if the Legislature approved all of the Governor's budget proposals. If the state did not permanently bring its revenue and spending lines into alignment *prior* to the passage of the administration's measure, it is possible the measure would permanently lock in this imbalance. That is because the measure would prevent the availability of any funds from higher-than-average revenue growth years from being used to close the gap. Absent the administration's measure, such a year with healthy revenue growth could allow the state to pay off additional budgetary debt and finally gets its fiscal house in order.

Too Inflexible. For these reasons, we conclude that the proposed ten-year average formula would be too inflexible on a year-to-year basis. Without the ability to adjust to unexpected circumstances, the Legislature would be unnecessarily restricted in the tools available to balance the state budget.

Does the State Need Three Reserves?

Under the administration's proposal, the state would have three reserves—the SFEU, BSA, and RSF. As part of its proposal, the administration would eliminate the BSA once the state's deficit-financing bonds are paid off (scheduled for 2012-13). Yet, there is little reason to make the state's budgeting even more complicated by instituting three reserves—even in the short term. If the Legislature chooses to make changes regarding its budgetary reserves, we recommend modifying, rather than supplementing, the state's existing two reserves.

Across-the-Board Approach Ill-Advised and Contrary to Balance of Powers

Limited Effort to Set Priorities. Throughout this publication, we critique the administration's across-the-board reductions approach to the 2008-09 budget. The administration's budget reductions reflect little effort to prioritize and determine which state programs provide essential services or are most critical to California's future. Under the administration's constitutional measure, this across-the-board reduction approach would become the default for any future state budget problems. All state programs (except those determined to be exempt by the administration) would be subject to the 2 percent or 5 percent reductions. The Legislature could determine *how* those levels of reductions were achieved in a particular program through the passage of a contingency law. The Legislature, however, could not prioritize and determine whether some programs should be protected from any reductions or whether others should experience greater reductions.

Legislature Should Maintain Its Appropriation Authority. The proposed changes also represent a serious diminution of the Legislature's authority. Under the State Constitution, only the Legislature can appropriate funds and make mid-year reductions to those appropriations. Under the administration's proposal, however, the Governor would have the authority to determine when across–the–board reductions would occur. Moreover, if the Legislature did not pass the contingency laws envisioned by the measure, the Governor would have the authority to waive state laws affecting the state's core programs.

Existing Process for Mid-Year Reductions. The administration has not made it clear why the existing process to make mid-year reductions is not sufficient. For past mid-year budget problems, the administration has submitted specific reduction proposals to the Legislature. The Legislature is then given the opportunity to adopt the Governor's proposals or substitute other alternatives. Proposition 58 formalized this process by authorizing the Governor to declare a fiscal emergency and call the Legislature into special session, as he has done this year. This new process has the added component of the 45-day schedule described earlier to help ensure timely action. While the across-the-board mechanism envisioned by the administration could implement some reductions a few weeks earlier, it does so by denying the Legislature the opportunity to review the impacts of any proposals prior to their adoption.

Building on the Positive Aspects of the Proposal

Based upon the inherent flaws in the Governor's proposal discussed above, we recommend that the Legislature reject the administration's approach. The Legislature should not pursue budget changes which take away its appropriation authority or hamstring future budget decisions through a formula. Yet, if the Legislature wishes to pursue alternative budgetary changes, it could build upon the positive aspects of the Governor's proposal—namely, seeking to build up additional reserves during good times and avoiding formulas driving state budgeting. We discuss some alternatives to the Governor's approach for both of these areas below.

Strengthening Proposition 58's Provisions

Determining when and how much money should be transferred to a reserve always involves an inherent tension between the demands for current services and an attempt to prudently save for a rainy day. To encourage additional saving in the future, we believe the Legislature could build upon Proposition 58's framework. As noted above, due to the state's financial cycle, the measure has not yet had an opportunity to fully function. Yet, it is apparent that the measure could be strengthened to better meet its original goals.

Increase Total Amount of Reserve. Currently, the BSA has a maximum balance of $8 billion. Building up to this level will take a number of years, particularly until the state pays off its deficit-financing bonds. Even so, with the state's volatile revenue structure—where multibillion dollar swings in annual revenue forecasts are common—the Legislature should consider increasing the BSA's maximum balance. Targeting 10 percent of annual General Fund spending as a *long-term* goal for building up the reserve (currently $10 billion but growing over time) would give the state a greater cushion from economic downturns.

Harder to Access Funds. Currently, the Constitution specifies that BSA funds may be accessed through any statute. The 2007-08 budget provided the authority for DOF to access the BSA balance. In the future, if the BSA funds were more difficult to access, the state might make more conservative budgetary decisions to guard against financially overcommitting the state. For instance, requiring the passage of a separate bill (outside of the budget bill) to access the BSA would make it more difficult to count on using BSA reserve funds in a budget plan.

Mechanism to Increase Transfers in Really Good Years. We appreciate the administration's effort to transfer excess revenues to a reserve. The problem is determining what revenues are excess in any year and locking that definition into the Constitution. By driving off of the average growth rate, the administration's proposal would transfer funds to the RSF in roughly half of the years. As an alternative, the Legislature could develop a higher threshold when revenues are considered excess. The Legislature could particularly focus on those years when there is an "April surprise"—personal income tax receipts which surge well beyond the amounts predicted in the budget. When revenues are received in April (which is nearly the end of the fiscal year), we think it would be reasonable to consider them as excess and automatically transfer them to the BSA. (This is in contrast to budget-year revenue forecasts when the Legislature and Governor have the regular budget process to debate how any new funds should be used.) We would suggest limiting such transfers to those years in which the updated revenue *total* for the year exceeds the budget's forecast. (This would not require the transfer of revenues that simply catch the state up from earlier soft revenue months.)

Rethinking the State's Budgetary Formulas

The Governor also identified the large number of formulas driving state budgeting as a key problem. We agree that the state's budget has become increasingly complicated and confusing—partially as a result of the number of formulas affecting state spending. Yet, even with these formulas, the Governor's own budget proves that virtually all aspects of the state budget are controllable. Many of the formulas can be, and have been, amended or suspended by the Legislature and/or Governor when necessary.

Difficult Choices. While the Governor proposes formula changes in a couple of instances (regarding reductions to Proposition 49's after-school funding and K-12 education cost-of-living adjustments [COLAs]), the administration has not put forward a comprehensive set of proposed changes to budgetary formulas. We believe that engaging in a comprehensive review of state formulas would be a worthwhile effort for the Legislature. The Legislature could systemically review the formulas to determine if they are still needed and continue to reflect today's priorities. If it chose to "unlock" the state budget by repealing these types of formulas, it would gain a great deal of flexibility in crafting the budget on a year-to-year basis. Such changes, however, would potentially affect the funding of numerous key state program areas, as well as require asking the voters to reverse a number of previously approved propositions. We discuss below the types of propositions and statutory measures which restrict state budgeting. Figure 1 summarizes recent propositions with major General Fund effects in this regard.

Dedicated Tax Revenues. In recent years, there have been a number of approved propositions which raised tax revenues historically used for general purposes but instead dedicated them to specific purposes. As such, these measures restrict the Legislature's authority to prioritize spending among programs in any particular year.

Locked in General Fund Spending. Other ballot measures have guaranteed that a certain portion of General Fund spending be dedicated to a specific purpose. These measures restrict the Legislature's ability to alter the relative shares of General Fund spending provided to program areas in any given year.

Statutory Cost Drivers. In addition to the propositions described above, the Legislature has also enacted a variety of statutory formulas and other measures which create cost pressures or increase General Fund spending from year to year.

- The state has a variety of "entitlement" programs laid out in state law—guaranteeing benefits to any individual who is eligible for a program. These include Medi-Cal, a number of social services direct assistance programs, and a portion of the state's CalGrant financial aid program.
- The state also has a number of statutory COLAs which provide increased funding each year to compensate for the adverse effects of inflation on the purchasing power of the previous year's funding level. These include most Proposition 98 programs, trial court funding, some portions of Medi-Cal, CalWORKs, and Supplemental Security Income/State Supplementary Program.
- The state offers "defined benefit" retirement programs to its employees, both in the form of pensions and retiree health services. These programs guarantee that employees will receive specific benefits in the future, regardless of the level of state's costs necessary to provide the services.

Conclusion

The Governor's proposed budgetary reforms would make future budgeting even more complicated and represent a loss of legislative authority. In putting forward its proposal, however, the administration does raise some legitimate questions about how to better build up the state's reserves in good times and maximize budgetary flexibility.

Figure 1

Major Propositions Affecting the State General Fund

Date	Measure	Description
Dedicated Tax Revenues		
November 1988	Proposition 99	Provides a 25 cent per pack tax on cigarettes and dedicates the more than $300 million annually to tobacco education and health care services for low-income persons.
November 1993	Proposition 172	Raises the statewide sales tax rate by one-half cent and dedicates the $3 billion in annual funds to local public safety purposes.
November 1998	Proposition 10	Provides a 50 cent per pack tax on cigarettes and dedicates the roughly $600 million annually to early childhood development programs.
November 2004	Proposition 63	Enacts a state personal income tax surcharge of 1 percent that applies to taxpayers with annual taxable incomes of more than $1 million. The proceeds of the tax surcharge (about $1.6 billion annually) are earmarked to finance an expansion of community mental health programs.
Locked in State Spending		
November 1988	Proposition 98	Provides for a minimum level of total spending (General Fund and local property taxes combined) on K-14 education in any given year. The required General Fund contribution is roughly 40 percent of the state's budget.
March 2002	Proposition 42	Directs $1.5 billion in sales taxes on gasoline to transportation purposes. (Reflected as General Fund spending.)
November 2002	Proposition 49	Requires that the state spend a certain amount (currently $550 million) on after-school programs.
November 2004	Proposition 1A	Restricts the Legislature from altering local government revenues in many cases. In prior years, the state took such actions which helped the state's General Fund.
November 2006	Proposition 1A	Restricts the circumstances in which the Legislature could suspend the Proposition 42 transfer for transportation.

Expenditure Details of the LAO Alternative Budget

In the earlier sections of "Part V," we provide an overview of the LAO alternative budget approach, its revenue components, our parole realignment proposal, and budgetary reform proposals. In this section, we provide the details of the LAO alternative budget for expenditure issues. The savings shown are relative to the Governor's workload budget. (Any proposals which would raise costs above the Governor's workload budget are shown as negative amounts.) In total, these proposals would reduce state costs by $1.8 billion in 2007-08 and $9 billion in 2008-09. For each proposal, we provide either (1) a rationale for our inclusion of the item in the alternative or (2) a reference to where we provide such a rationale (typically our companion publication, the *Analysis of the 2008-09 Budget Bill*). The items are organized by major policy area and then by department (see next page).

LAO Alternative Budget: Expenditure Details[a]

(In Millions)

Department/Program—Description	2007-08	2008-09
Proposition 98		
Proposition 98—Capture unspent current-year and prior-year monies.	**$950.0**	**—**
Rationale: See the "Proposition 98 Priorities" write-up in the "Education" chapter of this year's *Analysis*.		
Proposition 98—Use Public Transportation Account (PTA) monies to fund portion of Home-to-School (HTS) transportation.	**409.0**	**—**
Rationale: A recent court ruling determined that PTA monies could not be used for prior-year debt service but could be used for HTS transportation. Given the ruling, we recommend using additional PTA monies for HTS transportation in the current year.		
Proposition 98—Fund flat year-to-year budget rather than workload budget.	**—**	**$2,769.3**
Rationale: See the "Proposition 98 Priorities" write-up in the "Education" chapter of this year's *Analysis*.		
Proposition 98—Suspend *Quality Education Investment Act*.	**—**	**450.0**
Rationale: See the "Proposition 98 Priorities" write-up in the "Education" chapter of this year's *Analysis*.		
Proposition 98—Prepay "settle-up" obligation for 2008-09 in 2007-08.	**—**	**150.0**
Rationale: See the "Proposition 98 Priorities" write-up in the "Education" chapter of this year's *Analysis*.		
Higher Education		
University of California (UC)—Reduce 5 percent base increase to 1.5 percent.	**—**	**$105.3**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
UC—Reduce enrollment growth from 2.5 percent to 1.8 percent.	**—**	**16.4**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
UC—Increase student fees by 10 percent, and use revenue as General Fund solution.	**—**	**167.5**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		

Continued

Department/Program—Description	2007-08	2008-09
UC—Increase institutional financial aid to cover increased student need resulting from LAO proposed fee increase.	—	**-32.5**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
UC—Reduce administrative support spending by 10 percent (Governor's budget-balancing reductions).	—	**32.3**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
Hastings College of the Law—Reduce administrative support spending by 10 percent (Governor's budget-balancing reductions).	—	**0.3**
Rationale: We have no issues with the administration's proposed reduction.		
California State University (CSU)—Reduce 5 percent base increase to 1.5 percent.	—	**101.2**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
CSU—Reduce enrollment growth from 2.5 percent to 1.6 percent.	—	**22.0**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
CSU—Increase student fees by 10 percent, and use revenue as General Fund solution.	—	**108.7**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
CSU—Increase institutional financial aid to cover increased student need resulting from LAO proposed fee increase.	—	**-28.5**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
CSU—Reduce administrative support spending by 10 percent (Governor's budget-balancing reductions).	—	**43.2**
Rationale: See the "LAO Alternative Budget for Higher Education" write-up in the "Education" chapter of this year's *Analysis*.		
California Community Colleges Chancellor's Office—Reduce state operations funding (non-Proposition 98).	—	**0.2**
Rationale: See the "California Community Colleges" write-up in the "Education" chapter of this year's *Analysis*.		

Continued

Department/Program—Description	2007-08	2008-09
California Student Aid Commission (CSAC)—Fund Cal Grant entitlement program assuming LAO fee recommendations (which are lower than assumption in Governor's budget). Rationale: See the "California Student Aid Commission" write-up in the "Education" chapter of this year's *Analysis*.	—	**74.3**
CSAC—Continue Cal Grant competitive program, that Governor proposed for elimination. Rationale: See the "California Student Aid Commission" write-up in the "Education" chapter of this year's *Analysis*.	—	**-58.3**
CSAC—Reduce funding for state operations. Rationale: The planned elimination of EdFund as CSAC's auxiliary affords opportunities to restructure and reduce some costs.	—	**0.6**
California Postsecondary Education Commission—Adopt Governor's budget-balancing reductions. Rationale: We have no issues with the administration's proposed reduction.	—	**0.2**
Health		
Department of Alcohol and Drug Programs (DADP)—Eliminate funding for the California Methamphetamine Initiative in the budget year. Rationale: See the "Department of Alcohol and Drug Programs" write-up in the "Health and Social Services" chapter of this year's *Analysis*.	—	**$9.6**
DADP—Redirect state and federal asset forfeiture proceeds. Rationale: See the "Department of Alcohol and Drug Programs" write-up in the "Health and Social Services" chapter of this year's *Analysis*.	—	**10.0**
DADP—Adopt Governor's budget-balancing reductions that do not impact direct drug treatment services. Rationale: We have no issues with the administration's proposed reductions that do not impact direct drug treatment services.	**$0.4**	**0.1**
DHCS/Medi-Cal—Adopt Governor's budget balancing reductions to reinstate quarterly status reporting and eliminate continuous eligibility for children. Rationale: We have no issue with this request. We have made an adjustment to the Governor's budget reduction to account for increased costs caused by beneficiaries reentering the program when services are needed.	—	**69.0**
DHCS/Medi-Cal—Adopt Governor's budget-balancing reduction to discontinue payments for Medicare Part B premiums for beneficiaries who have share of cost requirements. Rationale: We have no issues with the administration's proposed reduction.	**5.5**	**65.5**

Continued

Department/Program—Description	2007-08	2008-09
DHCS/Medi-Cal—Adopt Governor's budget-balancing reductions to reduce certain payments to hospitals.	—	**54.0**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
DHCS/Medi-Cal—Adopt Governor's budget-balancing reduction to eliminate the County Cost of Doing Business.	—	**32.3**
Rationale: We have no issues with the administration's proposed reduction. The savings amount is higher than in the Governor's budget due to a higher than anticipated growth in the California Necessities Index.		
DHCS/Family Health—Adopt Governor's budget-balancing reductions to shift federal funding from public hospitals to other state health programs to reduce General Fund spending.	—	**26.7**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
DHCS/Medi-Cal—Apply Deficit Reduction Act eligibility requirements to minor consent beneficiaries in order to obtain federal funds.	—	**18.9**
Rationale: The state chose to forego federal funding for this population in 2006-07 by not enforcing eligibility requirements.		
DHCS/ Medi-Cal—Delay implementation of SB 437 pilot program for two years.	—	**18.5**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
DHCS/Medi-Cal—Implement a rate cap for nursing homes.	—	**16.5**
Rationale: Nursing homes have received rate increases over the last few years. This proposal would limit the rate increase in 2008-09.		
DHCS/Family Health/Medi-Cal—Increase the shift of federal funds from public hospitals to certain health programs, thereby reducing Medi-Cal General Fund spending.	—	**91.1**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
DHCS/Medi-Cal—Adopt Governor's budget-balancing reductions to shift federal funds from public hospitals to offset General Fund spending for other health care programs.	—	**7.8**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		

Continued

Department/Program—Description	2007-08	2008-09
DHCS/Medi-Cal—Implement Public Assistance and Reporting Information System early.	—	**7.0**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Service's" chapter of the *2007-08 Analysis of the Budget Bill.*		
DHCS/State Operations—Adopt Governor's budget-balancing reductions to eliminate positions in state operations.	—	**6.6**
Rationale: We have no issues with the administration's proposed reduction.		
DHCS/Medi-Cal—Reduce funding for county administration of Deficit Reduction Act (DRA) requirements.	—	**6.0**
Rationale: Our review found that the counties are overbudgeted for carrying out DRA administrative activities related to verification of citizenship and identity. The counties can perform the required tasks in a lesser amount of time and will, therefore, require less funding.		
DHCS/Medi-Cal—Implement cash and counseling methodology for certain Home and Community Based Service Waiver recipients.	**1.0**	**5.0**
Rationale: Program would allow higher functioning recipients greater freedom to choose their own services in exchange for spending caps.		
DHCS/Medi-Cal—Adopt Governor's budget-balancing reductions for reductions to the Fiscal Intermediary contract.	—	**4.8**
Rationale: We have no issues with the administration's proposed reduction.		
DHCS/Medi-Cal—Allow the HIV/AIDS Pharmacy Pilot program to sunset.	—	**2.7**
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
DHCS/Medi-Cal—Shift aged, blind, and disabled into managed care.	—	—
Rationale: See 2004 report *Better Care Reduces Health Costs for Aged and Disabled Persons*. Savings of $25 million would start in 2009-10, with annual savings of $100 million thereafter.		
DHCS/Medi-Cal—Implement pay-for-performance programs for Medi-Cal managed care and Medi-Cal fee-for-service.	—	—
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*. Savings of $5 million would begin in 2009-10.		
DHCS/Medi-Cal—Centralize eligibility determinations at the state level.	—	—
Rationale: See the "Department of Health Care Services" write-up in the "Health and Social Services" chapter of the *2003-04 Analysis of the Budget Bill*. Savings of $75 million are expected to begin in 2009-10.		

Continued

Department/Program—Description	2007-08	2008-09
Managed Risk Medical Insurance Board (MRMIB)/Healthy Families Program (HFP)—Adopt Governor's budget-balancing reductions. Rationale: Pending the results of rate negotiations with the health plans, we have no issues with the administration's proposed reductions.	—	**41.9**
MRMIB/HFP—Eliminate certified application assistance (CAA) payments and caseload. Rationale: The CAA payments are provided to organizations that assist persons with the HFP application process. Elimination of these payments would not impact eligibility or benefit levels.	—	**9.6**
MRMIB/HFP—Delay implementation of SB 437. Rationale: SB 437 would simplify the annual eligibility review process for HFP beneficiaries. Delaying implementation of this change would not impact current eligibility or benefit levels.	—	**2.7**
Department of Public Health (DPH)—Adopt Governor's budget-balancing reductions that do not impact direct services. Rationale: We have no issues with the administration's proposed reductions.	—	**16.4**
DPH/Emergency Preparedness—Reduce local assistance for pandemic influenza planning. Rationale: Maintain current-year level of funding to local governments for pandemic influenza planning.	—	**6.9**
Department of Developmental Services (DDS)—Adopt Governor's budget-balancing reductions for continuing cost containment measures for regional center (RC) purchase of services. Rationale: We have no issues with continuing the RC purchase of services cost containment measures on a *temporary* basis for a few more years. However, we would not implement these measures on a permanent basis as proposed in the Governor's budget.	—	**229.0**
DDS—Adopt Governor's budget-balancing reductions for RC operations. Rationale: We have no issues with the administration's proposed budget reductions.	—	**20.5**
DDS—Adopt Governor's budget-balancing reductions for Developmental Centers (DC) with certain exceptions. Rationale: We have no issues with the administration's proposed reductions to DCs with the exception of the reduction that would delay the activation of 96 additional beds at Porterville DC.	**1.0**	**9.5**
DDS—Adopt Governor's budget-balancing reductions for reducing rates for Supported Employment Program providers. Rationale: We have no issues with the administration's proposed reductions.	—	**7.7**

Continued

Department/Program—Description	2007-08	2008-09
DDS—Adopt Governor's budget-balancing reductions for headquarters with certain exceptions.	—	2.3
Rationale: We have no issues with the administration's proposed budget-balancing reductions to DDS' headquarters with the exception of the reductions that would reduce audit functions for regional centers and vendors.		
DDS—Adopt Governor's budget-balancing reductions for the Devereux maintenance contract.	—	1.2
Rationale: We have no issues with the administration's proposed reductions.		
DDS—Adopt Governor's budget-balancing reductions for expanding the family cost participation program.	—	0.7
Rationale: We have no issues with the administration's proposed reductions.		
Department of Mental Health (DMH)—Adopt Governor's budget-balancing reductions that minimize impact to direct mental health services.	2.6	5.1
Rationale: We have no issues with the administration's proposed reductions.		
DMH/State Hospitals—Reduce Sexually Violent Predator (SVP) caseload projections.	12.6	13.8
Rationale: See the "Department of Mental Health" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
DMH/Managed Care—Reduce mental health managed care caseload projection.	—	2.5
Rationale: See the "Department of Mental Health" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
Social Services		
Supplemental Security Income/State Supplementary Program (SSI/SSP)—Delete June 2008 cost-of-living adjustment (COLA).	$23.3	$271.0
Rationale: We have no issues with the administration's proposed reduction. See the "Supplemental Security Income/State Supplementary Program" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
SSI/SSP—Delete June 2009 COLA.	—	34.6
Rationale: We have no issues with administration's proposed reduction. See the "Supplemental Security Income/State Supplementary Program" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
SSI/SSP—Reduce grants for couples to 125 percent of the federal poverty guideline.	—	89.5
Rationale: See the "Supplemental Security Income/State Supplementary Program" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		

Continued

Department/Program—Description	2007-08	2008-09
California Work Opportunity and Responsibility to Kids (CalWORKs)—Delay beginning of pay-for-performance incentive system for counties until 2008-09.	**40.0**	**—**
Rationale: A one-time delay in implementation will not significantly impact county performance.		
CalWORKs—Gradually restore Temporary Assistance for Needy Families federal fund reserve.	**—**	**47.0**
Rationale: While a reserve is desirable, there was no reserve in 2007-08. This alternative establishes a $40 million reserve ($47 million less than Governor), which could be increased in subsequent years.		
Welfare Automation—Cancel Interim Statewide Automated Welfare System Migration computer project.	**3.4**	**44.0**
Rationale: We have no issues with the administration's proposed reduction.		
Foster Care—Rescind the January 2008 5 percent rate increase and reduce rates for foster family agencies by 5 percent.	**—**	**23.6**
Rationale: See the "Foster Care" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
Foster Care—Cap specialized care increments at $1,000 per month.	**—**	**1.0**
Rationale: See the "Foster Care" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
Adoptions Assistance Program (AAP)—Prospectively reduce the maximum AAP grant, reform eligibility, and end automatic increases as adopted children age.	**—**	**2.0**
Rationale: Savings grow substantially in out-years. See page C-255 of the *Analysis of the 2004-05 Budget Bill*.		
Child Welfare Services (CWS)—Suspend the hold harmless (HH) budgeting system through 2009-10. (Under the HH system, county funding is not reduced even though the caseload declines.)	**—**	**6.0**
Rationale: See the "Child Welfare Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
CWS—Cap fully loaded social worker costs at $155,000.	**—**	**5.1**
Rationale: See the "Child Welfare Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
CWS—Do not implement disclosure of sibling contact information. Repeal Chapter 386, Statutes of 2006, (AB 2488, Leno).	**—**	**1.2**
Rationale: We have no issues with the administration's proposed reduction.		

Continued

Department/Program—Description	2007-08	2008-09
CWS—Cancel proposed new computer system and instead upgrade existing system to meet county functionality requirements and federal compliance issues.	—	—
Rationale: Results in savings of $75 million over the next six years. See the "Child Welfare Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
Aging—Reduce Senior Community Service Employment Program.	—	**1.5**
Rationale: We have no issues with the administration's proposed reduction. (Recent federal funding increase offsets this reduction resulting in no net impact on service level.)		
Aging—Delete state level support for Senior Legal Hotline.	—	**0.3**
Rationale: State General Fund was first provided to this program in 2007, the contractor has other funding sources, and local Area Agencies on Aging also provide legal services at the local level.		
Child Support Enforcement—Delay increase in pass-though of child support to custodial parents until July 2010.	—	**5.6**
Rationale: Savings increase to $11.2 million in 2009-10. See the "Department of Child Support Services" write-up in the "Health and Social Services" chapter of this year's *Analysis*.		
Department of Community Services and Development—Reduce Naturalization Services Program.	—	**1.3**
Rationale: Remaining funding of $1.7 million will maintain support for core group of contracted community based organizations which deliver these services. Some related services are available through the California Department of Education.		
Criminal Justice		
Department of Justice (DOJ), California Department of Corrections and Rehabilitation (CDCR), State Controller's Office (SCO), Office of Emergency Services (OES)—Reduce, eliminate, or shift funding for certain criminal justice local assistance programs.	**$10.0**	**$268.0**
Rationale: See the "Crosscutting Issues" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
Judicial Branch—Suspend State Appropriations Limit adjustments on a one-time basis.	—	**126.2**
Rationale: See the "Judicial Branch" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		

Continued

Department/Program—Description	2007-08	2008-09
Judicial Branch—Begin to phase in electronic court reporting.	—	**12.6**
Rationale: See the "Judicial Branch" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
Judicial Branch—Increase civil filing fees to reflect inflation in court costs.	—	**21.4**
Rationale: See the "Judicial Branch" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
Judicial Branch—Adjust the budget for likely delays in the appointment of new judges.	—	**15.2**
Rationale: See the "Judicial Branch" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
Office of the Inspector General—Reduce request for new staff by 26 positions.	—	**4.5**
Rationale: See the "Office of the Inspector General" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
DOJ—Target vacant positions for elimination.	—	**13.0**
Rationale: See the "Department of Justice" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
DOJ—Reduce budget request for Correctional Writs and Appeals unit.	—	**1.8**
Rationale: See the "Department of Justice" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
CDCR—Adopt realignment of supervision of low-level parolees to county probation departments.	—	**483.0**
Rationale: See the "Realignment of Parole" write-up in "Part V" of this publication.		
CDCR—Change crimes referred to as "wobblers" to misdemeanors to reduce inmate population.	—	**250.0**
Rationale: See the "Adult Corrections" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
CDCR—Implement "earned discharge" policy for parolees.	—	**50.0**
Rationale: See the "Adult Corrections" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.		
CDCR—Adjust budget to account for additional savings associated with our "wobblers to misdemeanor" proposal and "earned discharge" proposal.	—	**118.0**
Rationale: Reflects reduced funding need for activities related to recruitment, training, contracted bed expansions, and revocation hearings because of proposed reductions in inmate and parole populations.		

Continued

Department/Program—Description	2007-08	2008-09
CDCR—Adjust budget to reflect recent adult inmate and parole population trends. Rationale: See the "Adult Corrections" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.	**55.0**	**55.0**
CDCR—Adjust budget to reflect delays in implementing various departmental programs. Rationale: The department has experienced delays implementing various budgeted programs, resulting in current-year savings.	**28.0**	**—**
CDCR—Substitute federal Workforce Investment Act funds for General Fund support of programs for adult parolees. Rationale: See the "Adult Corrections" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.	**—**	**4.0**
CDCR—Modify Governor's proposal to reinstate inmate work crews. Rationale: See the "Adult Corrections" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.	**—**	**3.0**
CDCR—Reject proposal to relocate headquarters of dental and mental health programs. Adjust request for new headquarters staff to reflect salary savings. Rationale: See the "Adult Correctional Health Services" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.	**—**	**5.1**
CDCR—Adjust budget to reflect recent ward and parole population trends in the Division of Juvenile Facilities. Rationale: See the "Division of Juvenile Facilities" write-up in the "Judicial and Criminal Justice" chapter of this year's *Analysis*.	**4.0**	**9.0**
Resources and Environmental Protection		
Various Resources Departments/Timber Harvest Plan Review—Shift funding for timber harvest plan review and enforcement to new fee on timber operators. Rationale: See the "Funding Timber Harvest Plan Review and Enforcement" write-up in the "Resources" chapter of this year's *Analysis*.	**—**	**$23.1**
Secretary for Resources—Reduce CALFED program. Rationale: We have no issues with the administration's proposed reduction.	**$0.1**	**0.6**
Secretary for Environmental Protection—Reduce various administrative support activities. Rationale: We have no issues with the administration's proposed reductions.	**0.1**	**0.2**

Continued

Department/Program—Description	2007-08	2008-09
***California Conservation Corps*—**Reduce administration and program support and create additional General Fund savings by shifting funding to an available special fund balance. Rationale: See the "California Conservation Corps" write-up in the "Resources" chapter of this year's *Analysis*. (Reflects partial approval of administration's proposed reductions.)	**—**	**1.7**
***Department of Conservation*—**Reduce geologic hazards and mineral resources conservation program. Rationale: We have no issues with the administration's proposed reduction.	**—**	**1.0**
***Department of Forestry and Fire Protection (CalFire)*—**Shift portion of General Fund support for wildland firefighting to new fee assessed on property owners in "state responsibility areas." Rationale: See the "CalFire" write-up in the "Resources" chapter of this year's *Analysis*. (Savings amount accounts for cost of fee collection.)	**—**	**239.0**
***CalFire*—**Adjust budgeted emergency fire suppression expenditures upward. Rationale: Governor's workload budget underestimates emergency fire suppression ("E-Fund") expenditures, given historical five-year average of actual E-Fund expenditures.	**—**	**-35.7**
***CalFire*—**Fund Governor's proposal for Automatic Vehicle Locators technology from General Fund, instead of proposed insurance policy surcharge. Rationale: See the "CalFire" write-up in the "Resources" chapter of this year's *Analysis*.	**—**	**-4.2**
***CalFire*—**Reduce administration, resource management, and Office of State Fire Marshal support. Rationale: See the "CalFire" write-up in the "Resources" chapter of this year's *Analysis*. (Reflects partial approval of administration's proposed reductions.)	**—**	**5.1**
***State Lands Commission*—**Reduce various program activities. Rationale: We have no issues with the administration's proposed reductions.	**—**	**0.9**
***Department of Fish and Game (DFG)*—**Shift funding for Endangered Species Act reviews and Natural Communities Conservation Planning to fees. Rationale: See the "Department of Fish and Game" write-up in the "Resources" chapter of this year's *Analysis*.	**—**	**5.9**

Continued

Department/Program—Description	2007-08	2008-09
DFG—Shift portion of General Fund cost for law enforcement to available special fund balance. Rationale: See the "Department of Fish and Game" write-up in the "Resources" chapter of this year's *Analysis*.	—	**2.6**
DFG—Reduce hunting and fishing programs, nonregulatory biodiversity conservation programs, and administration. Rationale: See the "Department of Fish and Game" write-up in the "Resources" chapter of this year's *Analysis*. (Reflects partial approval of administration's proposed reductions.)	—	**3.3**
Wildlife Conservation Board—Replace General Fund support for Habitat Conservation Fund (Proposition 117) with special and bond funds. Rationale: See the "Wildlife Conservation Board" write-up in the "Resources" chapter of this year's *Analysis*.	—	**20.8**
California Coastal Commission—Allow commission to spend the fee and penalty revenues it collects, rather than transferring these revenues to the State Coastal Conservancy. Rationale: See the "California Coastal Commission" write-up in the "Resources" chapter of this year's *Analysis*.	—	**2.0**
Department of Parks and Recreation (DPR)—Increase state park user fees. Rationale: See the "Department of Parks and Recreation" write-up in the Resources chapter of this year's *Analysis*.	—	**13.3**
DPR—Reject budget proposal for increased fire protection. Rationale: See the "Department of Parks and Recreation" write-up in the "Resources" chapter of this year's *Analysis*.	—	**3.0**
Department of Water Resources (DWR)—Shift funding for flood management expenditures to new broad-based fee. Rationale: See the "Department of Water Resources" write-up in the "Resources" chapter of this year's *Analysis*.	—	**40.0**
DWR—Shift funding for Colorado River Quantification Settlement Agreement projects to bond funds. Rationale: See the "Department of Water Resources" write-up in the "Resources" chapter of this year's *Analysis*.	—	**13.5**
DWR—Reduce California Water Plan, flood management, Central Valley Flood Protection Board, and watermaster program activities, partially offset by bond funds. Rationale: We have no issues with the administration's proposed reductions.	**0.2**	**7.3**

Continued

Department/Program—Description	2007-08	2008-09
Air Resources Board—Reduce research contracts. Rationale: We have no issues with the administration's proposed reduction.	—	0.2
California Integrated Waste Management Board (CIWMB)—Delay budgeted special fund loan repayments. Rationale: Repayments of (1) $15 million on loan from California Tire Recycling Management Fund and (2) $2 million on loan from Integrated Waste Management Account are not statutorily required and can be delayed to a later year.	—	17.0
State Water Resources Control Board (SWRCB)—Shift funding for regulatory activities to existing regulatory fee sources by increasing fees. Rationale: See the "State Water Resources Control Board" write-up in the "Resources" chapter of this year's *Analysis*.	—	7.8
SWRCB—Shift funding for various water quality management activities to a new broad-based fee. Rationale: See the "State Water Resources Control Board" write-up in the "Resources" chapter of this year's *Analysis*.	—	22.0
SWRCB—Reduce general cleanup programs and administration. Rationale: See the "State Water Resources Control Board" write-up in the "Resources" chapter of this year's *Analysis*. (Reflects partial approval of administration's proposed reductions.)	—	0.8
Department of Toxic Substances Control—Reduce illegal drug lab cleanup, emergency response, and biomonitoring activities. Rationale: We have no issues with the administration's proposed reductions.	1.2	2.5
California Public Utilities Commission—Delay special fund loan repayment. Rationale: Repayment of $5 million on loan from California Teleconnect Fund not statutorily required and can be delayed to a later year.	—	5.0
General Government		
Arts Council—Adopt Governor's budget-balancing reduction. Rationale: We have no issues with the administration's proposed reductions.	—	$0.1
Augmentation for Employee Compensation—Reject 5 percent pay raise for correctional officers. Rationale: See February 2008 publication *Correctional Officer Pay, Benefits, and Labor Relations*	$260.4	260.4

Continued

Department/Program—Description	2007-08	2008-09
Augmentation for Employee Compensation— Delete pay differential for Human Resources Management System computer staff.	—	**0.3**
Rationale: See the "Augmentation for Employee Compensation" write-up in the "General Government" chapter of this year's *Analysis*.		
Board of Equalization (BOE)/E-Filing—Recognize efficiencies and expand e-filing.	—	**1.4**
Rationale: See the "Board of Equalization" write-up in the "General Government" chapter of this year's *Analysis*.		
BOE/Tax Gap—Adopt a modified tax gap package.	—	**-3.8**
Rationale: Amount is reduced revenues less administrative savings. See the "Board of Equalization" write-up in the "General Government" chapter of this year's *Analysis* as well as the Franchise Tax Board issue below.		
Budget Stabilization Account—Adopt Governor's proposal to suspend 2008-09 supplementary debt-service payment on deficit-financing bonds.	—	**1,551.3**
Rationale: Savings shown is different than Governor's budget due to different revenue total.		
Business, Transportation and Housing Agency— Adopt Governor's budget-balancing reductions.	—	**0.8**
Rationale: We have no issues with the administration's proposed reductions.		
California Gambling Control Commission (CGCC)/2004 Indian Compact Payments—Direct payments to the General Fund rather than for transportation purposes, on a one-time basis.	—	**101.8**
Rationale: See the "California Gambling Control Commission" write-up in the "General Government" chapter of this year's *Analysis*.		
CGCC/Revenue Sharing Trust Fund Backfill—Use Special Distribution Fund, rather than the General Fund, to provide the backfill.	—	**40.0**
Rationale: See the "California Gambling Control Commission" write-up in the "General Government" chapter of this year's *Analysis*.		
California State Teachers' Retirement System (CalSTRS)—Make full court-ordered interest payment in 2008-09, rather than deferring costs to future years.	—	**-130.8**
Rationale: See the "California State Teachers' Retirement System" write-up in the "General Government" chapter of this year's *Analysis*.		
CalSTRS/Inflation Protection—Reject administration's proposal to guarantee new benefit.	—	**-79.7**
Rationale: See the "California State Teachers' Retirement System" write-up in the "General Government" chapter of this year's *Analysis*.		

Continued

Department/Program—Description	2007-08	2008-09
Commission on State Mandates (CSM)/Animal Adoption Mandate—Repeal mandate and pay prior year claims over time. Rationale: See the "Commission on State Mandates" write-up in the "General Government" chapter of this year's *Analysis*.	**—**	**10.0**
Commission on the Status of Women—Adopt Governor's budget-balancing reduction. Rationale: We have no issues with the administration's proposed reduction.	**—**	**0.1**
Department of Industrial Relations (DIR)—Reject DIR relocation budget change proposal. Rationale: Savings increase to $1.1 million in 2009-10. See the "Department of Industrial Relations" write-up in the "General Government" chapter of this year's *Analysis*.	**—**	**0.1**
Fair Employment and Housing—Adopt Governor's budget-balancing reductions. Rationale: We have no issues with the administration's proposed reductions.	**—**	**1.8**
Food and Agriculture—Adopt Governor's budget-balancing reductions. Rationale: We have no issues with the administration's proposed reductions.	**0.5**	**8.6**
Franchise Tax Board/Tax Gap—Adopt modified tax gap proposal. Rationale: Amount is revenues less increased costs. See the "Franchise Tax Board" write-up in the "General Government" chapter of this year's *Analysis*.	**—**	**54.1**
Housing and Community Development—Adopt Governor's budget-balancing reductions. Rationale: We have no issues with the administration's proposed reductions.	**0.2**	**1.3**
Military Department/Tuition Assistance—Reject new benefit for National Guard members. Rationale: See the "Military Department" write-up in the "General Government" chapter of this year's *Analysis*.	**—**	**1.8**
Military Department—Adopt Governor's budget-balancing reductions. Rationale: We have no issues with the administration's proposed reductions.	**1.1**	**4.6**
Office of Administrative Law—Adopt Governor's budget-balancing reduction. Rationale: We have no issues with the administration's proposed reduction.	**—**	**0.3**
Office of Emergency Services (OES)/State Terrorism Threat Assessment Center—Revert unused funds. Rationale: During a January budget hearing, the administration identified that these funds will not be used in the current year.	**1.0**	**—**

Continued

Department/Program—Description	2007-08	2008-09
OES—Reduce various criminal justice grant programs.	—	—
Rationale: Savings are included in the "Restructuring Local Assistance for Public Safety" write-up in the "Criminal Justice" chapter.		
OES—Adopt Governor's current-year budget-balancing reductions other than criminal justice grants and State Terrorism Threat Assessment Center.	**3.4**	—
Rationale: We have no issues with the administration's proposed reductions in the current year.		
OES—Adopt Governor's budget-year budget-balancing reduction for victim services programs.	—	**0.4**
Rationale: We have no issues with the administration's proposed reductions.		
Office of Planning and Research (OPR)/Cesar Chavez Grants—Suspend program funding.	—	**5.0**
Rationale: See the "Office of Planning and Research" write-up in the "General Government" chapter of this year's *Analysis*.		
OPR/California Volunteer Matching Network—Do not renew funding.	—	**0.8**
Rationale: See the "Office of Planning and Research" write-up in the "General Government" chapter of this year's *Analysis*.		
Personnel Administration/Rural Health Equity Program for Annuitants—Adopt Governor's budget-balancing reductions.	—	**0.5**
Rationale: We have no issues with the administration's proposed reduction.		
Science Center—Adopt Governor's budget-balancing reductions.	—	**1.8**
Rationale: We have no issues with the administration's proposed reductions.		
Tax Relief/Williamson Act—Phase out subventions.	—	**3.9**
Rationale: See the "Tax Relief" write-up in the "General Government" chapter of this year's *Analysis*.		
Tax Relief/Senior Citizens' Homeowners Assistance Program—Roll back program to 1999-00 levels.	—	**18.5**
Rationale: See the "Tax Relief" write-up in the "General Government" chapter of this year's *Analysis*.		
Veterans Affairs—Adopt Governor's budget-balancing reductions.	**1.7**	**19.5**
Rationale: We have no issues with the administration's proposed reductions.		

[a] Scored against Governor's workload budget—budget bill as introduced excluding Control Section 4.44. Positive numbers are savings, while negative numbers are costs.