
CALIFORNIA BUDGET REPORT

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LAO Trashes Governor's Budget Plan!

- **The Legislative Analyst agrees that the budget shortfall is \$22 billion for the two-year cycle, and \$15 billion for the coming budget year...**
- **LAO rejects many suggestions by the Governor in May Revision...**
- **LAO offers its own May Revision, but proposes a one-year tax increase only!**

The Legislative Analyst's Office has just released its Overview of the 2008-09 May Revision, which you can find at http://www.lao.ca.gov/2008/bud/may_revise/may_revise_051908.pdf (PDF), or at http://www.lao.ca.gov/2008/bud/may_revise/may_revise_051908.aspx (HTML).

Here are the highlights:

- ✓ The two-year budget shortfall totals \$22.3 billion, which is just about what the Governor estimated in his May Revision—less the \$2 billion for a reserve fund (page 6).
- ✓ This shortfall was reduced by about \$7 billion as a result of the actions taken by the Governor and Legislature earlier this year, although the actual savings from those actions are not as high as predicted.
- ✓ The May Revision proposes about \$8.4 billion in “new solutions,” the largest portion of which is his complicated lottery bond proposal, which would cover \$5.1 billion of the budget year problem (page 7). If the lottery proposal fails, a sales tax would be triggered. But the LAO also estimates that the actual amount that could be received during the budget year from the sales tax, should it become the revenue source, is only about \$3 billion,

because it could not be ‘triggered’ until January 1, 2009. Thus, the budget could be out of wack by \$2 billion due to this timing problem.

- ✓ Given all of that, the LAO issues its own May Revision, suggesting different ways to balance the budget.

And what does the LAO propose?

For those of our readers who don’t want to plow through the actual LAO report, here is a nice side-by-side comparison of the Governor’s budget and the May Revision (page 19):

Figure 10

Major Differences Between Governor’s Budget and LAO Alternative

Governor’s Budget	LAO Alternative
Lottery and Borrowing	
\$15 billion in proceeds from lottery securitization.	\$5.6 billion in proceeds from lottery securitization, with dramatically less risk to schools’ share of existing lottery profits.
Borrows \$564 million from state special funds to be repaid in the next few years and defers mandate reimbursements to local governments.	Rejects special fund loans and funds mandate payments.
Budget Reform	
Cap on revenues received in any year, with automatic across-the-board reductions in bad budget years.	Builds on existing Budget Stabilization Account to increase reserve deposits in good times.
Reduces budget flexibility by imposing new budget restrictions and eliminating the authority to suspend Proposition 98.	Rethinks existing budgetary formulas to ensure they reflect current state priorities.
Revenues	
\$21 million from change to use tax on out-of-state vessels and vehicles.	\$3.3 billion from 11 changes to tax credits, deductions, and exemptions.
\$1.9 billion paper shift to accrue 2009-10 revenues to earlier years.	Rejects accrual proposal.
Proposition 98	
Ongoing programmatic funding of \$56.8 billion.	Provides \$900 million more in programmatic ongoing funding (\$57.7 billion).
Health and Social Services	
Many reductions to service levels.	Generally maintains service levels at their July 1, 2007 level—rejecting many of the administration’s proposals.
Criminal Justice	
Summary parole proposal to eliminate active supervision of parolees.	Changes crimes from wobblers to misdemeanors and implements earned discharge policy for parolees.
10 percent reduction to local public safety subventions.	Eliminates or reduces subvention programs outside of the state’s core responsibility.
No major change in state-local responsibilities.	Realignment of parole responsibilities to counties, with sufficient funding to pay for shifted costs.

Resources

Generally reduces General Fund program funding by 10 percent.

Increased use of fees and bond funds to maintain program services.

General Government

Provides 5 percent pay raise for correctional officers (though not explicitly funded).

No pay raise for correctional officers, as current compensation levels are sufficient to meet labor needs at this time.

The Lottery Bond puzzle and the LAO approach

We found the LAO approach to the proposed Lottery Bonds one of the more interesting features of its critique. It was no surprise that LAO rejected the Governor's configuration of lottery bonds; that seemed inevitable. What was far more interesting was the approach they took to using some lottery funds in the Budget Year. Chart 11 (page 25) tells the story:

Figure 11

Comparing the Governor's Lottery Plan and the LAO Alternative

Issue	Governor's Plan	LAO Alternative
Improving the Lottery's Ability to Increase Sales		
Proposed measure on November 2008 ballot	Give Lottery Commission more flexibility to set prize payout percentages, design games, market their products, and manage operations.	Same as Governor's plan, plus requirements for transparency and legislative oversight of lottery sales and management.
Addressing the State Budget Problem		
Funds deposited to reserve for use by General Fund		
—2008-09	\$5.1 billion	\$2.8 billion
—2009-10	\$6.9 billion	\$2.8 billion
—2010-11	\$3 billion	—
Use of any excess lottery revenues	Directs excess revenues to the new reserve.	Legislature could direct excess revenues to any priority it chooses.
Likelihood that excess lottery funds will eventually be available for other uses	Low—due to the size of the bond issuance.	Moderate to strong due to the smaller bond issuance.
Effects on Education Lottery Funding		
Status of education payments in securitized bond structure	Subordinate to debt service payments.	Subordinate to debt service payments.
Amount available to education after debt service	Up to \$1.2 billion per year.	Up to \$1.2 billion per year. In addition, the Legislature could direct excess lottery funds to education or another public purpose.
LAO estimate of payments to education through 2020 ^a		
—Assuming that per capita lottery sales approach the national average	\$14.4 billion	\$14.4 billion, and more if Legislature designates excess funds for education.
—Assuming that per capita sales are only about 80 percent of national average	\$9.4 billion	\$14.4 billion, and more if Legislature designates excess funds for education.

Risks to Investors

Likelihood of investors receiving payments in full and on time	Strong	Virtually certain, with minimal credit risk.
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Backup Plan if Lottery Securitization Does Not Proceed

Backup plan	Temporary 1 percent sales tax in effect until end of 2010-11 or until certain reserve targets are met. Subsequent rebates to residents.	Temporary 1 percent sales tax in calendar-year 2009 only. No rebates provision.
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^a Based on administration's debt service model, adjusted for size of required borrowings. Assumes borrowing of funds for costs of issuance, required reserves, and additional reserves to increase the likelihood of making planned payments to education as lottery sales ramp up. Like the administration's forecast model, assumes linear growth pattern for lottery revenues with little volatility.

Pay particular attention to the LAO proposal for a one-year sales tax only! That comes as a big surprise, and you can be sure that Democrats will be fuming that "LAO sold us out." That's a bad rap in our view, since the estimated lottery revenues were problematic at best, and the LAO proposal gives K-14 education about \$1.2 billion more than the Governor!

And how does the LAO make the budget balance?

If the LAO is suggesting something different from the Governor's May Revision, and particularly different from his proposed Lottery Bond, how does it all balance? Well, here you should read a very long chart, but read it very carefully! On pages 29-34, the LAO lays out a lot of cuts, and some new revenue too.

Most prominent on the new revenue list is agreeing with the Governor's to move forward the payment date for Limited Liability Companies (\$360 million), and a new idea of a two-year suspension of the Net Operating Loss deduction, which generates \$664 million in 2008-09).

Appendix

LAO Alternative Budget: Additional Savings Proposals

(In Millions, Scored From Governor's Workload Budget)^a

Issue	2007-08	2008-09
K-14		
Redevelopment —Capture prior-year underreported redevelopment pass-through payments.	—	\$70.0
A State Controller's Office audit found that (1) some redevelopment agencies have not made required pass-through payments to K-14 districts and (2) some K-14 districts have not reported these sums as property taxes. We recommend (1) redevelopment agencies be required to pay overdue sums and (2) K-14 districts modify their reporting to offset the state's last five years of increased costs.		

Redevelopment —Modify redevelopment pass-through process to ensure funds are provided and reported on an ongoing basis.	—	28.0
We recommend the Legislature simplify and clarify the redevelopment pass-through process so that there are fewer future errors and increased property taxes for schools.		
Redevelopment —Increase redevelopment K–14 pass-through requirements.	—	200.0
Redevelopment increases state costs to fund K–14 districts. Requiring redevelopment agencies to pass-through an additional 5 percent of their tax increment revenues would partly offset this fiscal effect.		
Higher Education		
University of California (UC) —Reduce research funding by 10 percent, and eliminate scheduling of some research programs in order to increase flexibility.	—	\$25.0
By eliminating scheduling of research programs, UC would have flexibility to target reductions to lower-priority programs. The proposed modest reduction to research programs could be accomplished without directly affecting UC's core education mission.		
California State University (CSU) —Eliminate enrollment growth funding for the budget year.	—	48.1
The CSU estimates it will have no enrollment growth in the budget year, therefore additional funding not justified.		
Social Services		
California Work Opportunity and Responsibility to Kids (CalWORKs) —Delay beginning of pay-for-performance incentive system for counties until 2009–10.	—	\$40.0
We have no issues with the administration's proposed reduction. Further delay will not significantly impact county performance.		
CalWORKs —Reject county peer review and AB 98 budget proposals.	—	0.8
With respect to state operations, these are non-essential functions.		
CalWORKs —Modify earned income disregard to better reward work participation—\$300 and 50 percent for those meeting federal requirements, but just 50 percent for those not meeting requirements	—	15.0

This proposal provides greater incentive for recipient to work more hours. See the "CalWORKs" write-up in the "Health and Social Services" chapter of <i>The Analysis of the 2005-06 Budget Bill</i> .		
CalWORKs —Adopt (1) a community service requirement for parents who have received aid for five years and (2) a pre-assistance employment readiness system for new CalWORKs recipients.	—	13.0
See the "CalWORKs" write-up in the "Health and Social Services" chapter of <i>The Analysis of the 2008-09 Budget Bill</i> .		
Foster Care —Accept January budget-balancing reduction (BBR) for ongoing reduction to General Fund contribution to Foster Family Home Insurance Fund.	—	0.1
Fund balance can sustain the reduction without program impact.		
Foster Care —Make one-time reduction in General Fund support for Foster Family Home Insurance Fund.	—	\$2.8
Fund balance appears sufficient to sustain this adjustment without disrupting payments to families harmed by actions of foster children.		
Foster Care —Delay Implementation of AB 1453 for two years and reject corresponding budget request.	—	0.2
AB 1453 requires a non-essential rate structuring report.		
Child Welfare Services (CWS) —Reduce CWS Case Management System maintenance and operations budget.	—	1.8
Recently about \$1.8 million for making program changes has gone unspent each year.		
In-Home Supportive Services (IHSS) —Reduce state participation in share of cost (SOC) buyouts by 50 percent.	—	16.5
Governor's proposal to end state SOC buyouts for IHSS recipients with greater functional abilities does not recognize that functional ability is not correlated with income or ability to pay. While achieving less total savings, the LAO approach apportions the cut more appropriately by income rather than disability.		
IHSS —Establish graduated caps, based on functional ability, for domestic and related service hours for recipients with functional indexes between 1.01 and 3.99.	—	26.0
This proposal limits, rather than eliminates, domestic service and related service hours. The		

degree of limitation would be tied to functional ability.		
Child Care —Reduce child care reimbursements to achieve savings relative to the new regional market rate.	—	19.4
Given budget situation, state cannot afford a net increase in funding per slot.		
Rehabilitation —Accept portion of January BBR pertaining to Supported Employment Program (SEP) 10 percent rate reduction.	—	0.7
The SEP providers recently received a substantial rate increase. This is consistent with the LAO approach to SEP rates in the Department of Developmental Services (DDS).		
Department of Child Support Services (DCSS) —Accept all state operations BBRs except the reduction in state hearings.	—	4.1
The DCSS has modified their BBRs to address LAO concerns about potential adverse General Fund revenue impacts. Reject state hearings proposal, because of potential adverse impact on due process.		
Health		
DDS —Adopt Governor’s BBR for expanding the contracted–services rate freeze to all regional center negotiated rates.	—	\$26.1
We have no issues with the administration’s proposed reduction.		
DDS —Reinstate statutory language clarifying that the parents of a developmentally disabled child are responsible for bearing all costs that the parents of a child without a developmental disability would normally pay.	—	1.0
Reinstating this statute which was allowed to sunset would clarify the Lanterman Act and better define the services that regional centers are required to provide to their clients.		
Department of Mental Health (DMH) —Eliminate state subsidy for hospital beds purchased by the counties.	—	9.8
We have no issues with the Senate proposal to eliminate the state subsidy for hospital beds purchased by the counties.		
DMH —Adopt two components of the Governor’s BBR for the Early and Periodic Screening	—	13.9

Diagnosis and Treatment (EPSDT) Program.		
We have no issues with the administration's proposals to reduce cost per client through better monitoring of EPSDT claims and eliminate the cost-of-living adjustment.		
Department of Health Care Services (DHCS) —Restructure dental benefit to eliminate some restorative procedures such as root canals.	—	\$15.0
While this restructuring of dental benefits would eliminate access to some restorative dental procedures, it would still allow beneficiaries to access a wide range of dental services.		
DHCS —Expand the skilled nursing facility (SNF) quality assurance fee to include Medicare beds.	—	24.4
The quality assurance fee that is currently charged for Medi-Cal and private-pay SNF beds would be expanded to include Medicare beds.		
Criminal Justice		
Judicial Branch —Impose a \$40 fee for violators sent to traffic school.	—	\$49.0
Courts currently receive \$0 to \$15 (a court assistance program fee) from those referred to traffic violator school. Imposing a \$40 fee would create significant General Fund revenue.		
Judicial Branch —Suspend a new program for reform of conservatorships and guardianships.	—	17.0
Some courts currently are able to implement this program without additional funding. Conforms to a subcommittee action.		
Judicial Branch —Adopt a further delay for some new judgeships.	—	18.0
Delaying the appointment of judges for one month would create significant savings in 2008–09. Conforms to a subcommittee action.		
Judicial Branch —Reject various court budget requests.	—	4.0
The Administrative Office of the Courts withdrew these requests. Conforms to subcommittee actions.		
Department of Justice (DOJ) —Deny a request for additional staff to handle correctional writs and appeals.	—	4.3
Conforms to a subcommittee action. Initially, we recommended approving only one-half of the		

budget request. See the "Department of Justice" write-up in the "Judicial and Criminal Justice" chapter of <i>The Analysis of the 2008-09 Budget Bill</i> .		
DOJ—Eliminate Gang Suppression Enforcement Teams.	—	5.3
Gang enforcement is a local government responsibility. Conforms with a subcommittee action.		
DOJ—Transfer funding from the False Claims Act Fund to the General Fund.	—	8.0
The financial condition of the fund appears to be strong enough to support the one-time transfer. Revenues in the fund come from settlements of certain types of litigation.		
DOJ—Transfer the balance in the <i>Williams</i> Settlement Fund to the General Fund.	—	69.0
The DOJ received a significant amount of revenue in connection with an energy litigation settlement that the Legislature can direct to the General Fund.		
DOJ—Transfer funding from the Sexual Habitual Offender Fund to the General Fund.	—	1.0
The financial condition of the fund appears to be strong enough to support the one-time transfer. Revenues in the fund come from criminal penalties and fees.		
DOJ—Remove General Fund support for the Proposition 69 DNA program.	—	11.0
The DOJ indicates that General Fund support for this program is no longer needed.		
Victim Compensation and Government Claims Board —Transfer part of the Restitution Fund balance to the General Fund.	—	80.0
The financial condition of the fund appears to be strong enough to support the one-time transfer, especially as it has strengthened since January. Our approach rejects an administration proposal to loan some funding to another state program. See the "Victim Compensation and Government Claims" write-up in the "Judicial and Criminal Justice" chapter of this year's <i>Analysis</i> .		
California Department of Corrections and Rehabilitation (CDCR) —Reduce Receiver's request for site improvement and infrastructure funding.	—	100.0
Receiver could use part of the \$300 million available in AB 900 for infrastructure projects.		
CDCR—Reduce Receiver's request for central pharmacy operating expenses.	—	\$1.5

The start date for the central fill pharmacy has been delayed, so the anticipated operating expenses are lower than originally projected.		
CDCR—Reduce Receiver’s request for operating costs of Receivership.	—	4.0
The Receiver has reduced operating expenses by closing one of its offices and reducing staff costs and consulting fees.		
CDCR—Increase work–release credits for inmates who complete education or substance abuse programs in prison.	—	20.0
Provides incentive for inmates to complete rehabilitation programs linked to reduced risk of recidivism.		
CDCR—Early release of aging inmates.	—	30.0
Targets population reductions to older inmates who are more expensive to incarcerate because of health care costs. Option restricted to inmates with no current, prior, or serious offenses.		
Payments to Counties for the Cost of Homicide Trials—Eliminate the payments to counties for the cost of homicide trials.	—	2.5
Since the state is now responsible for the majority of trial court costs, the fund has been used less and less in recent years. Conforms to a subcommittee action.		
Peace Officer Standards and Training (POST)—Reduce funding for POST from Control Section 24.10 of the budget.	—	6.0
The General Fund receives all revenue under Control Section 24.10 that does not get transferred to other specified funds. Thus, this action to reduce POST funding increases state General Fund revenues. Conforms to a subcommittee action.		
General Government		
Transportation Funds—Shift spillover revenues from the Public Transportation Account to the General Fund and shift additional diesel sales tax revenues to the General Fund per the May Revision.	—	\$711.0
The General Fund’s condition justifies such a shift.		
Office of Planning and Research/Governor’s Mentorship Program—Delete requested funding.	—	0.1

Mentorship not a General Fund priority at this time.		
Office of Emergency Services (OES) —Reduce General Fund for satellite system.	—	1.6
Reduce General Fund request due to availability of federal funds.		
OES —Reduce communications equipment proposal.	—	2.5
Reduce General Fund request due to availability of federal funds for this project and reject \$300,000 of request for ongoing maintenance funds that were not adequately justified.		
OES —Defer capital outlay project for new Southern California facility.	—	1.7
New facility can be delayed.		
OES —Eliminate General Fund component of regional operational readiness proposal.	—	1.7
Redirect federal funds to local governments to avoid a state matching requirement.		
State Controller —Approve a portion of administration's BBR.	—	0.7
Department has identified savings at this level without programmatic harm.		
State Controller —Reduce funding for 21st Century project to match currently approved plan.	—	7.9
Spending authority should match the project's currently approved information technology documents.		
Secretary of State —Adopt Governor's budget-year BBR.	—	3.5
Department has identified a reasonable plan to generate the savings.		
Military —Reduce proposed Joint Operations Center staffing.	—	\$1.0
Reduced funding still provides 24/7 staffing for the center.		
Military —Defer capital outlay projects.	—	0.5
Multiyear upgrade plan can be deferred.		

Military —Defer computer replacement proposal.	—	0.3
Multiyear upgrade plan can be deferred.		
Military —Reject medical services staffing proposal.	—	0.2
Department has failed to provide adequate workload justification.		
California State Teachers' Retirement System (CalSTRS) —Accept administration's May Revision proposal with minor additions.	—	66.4
The proposal represents a reasonable attempt to increase benefits for older retired teachers, reduce state contributions consistent with available actuarial analyses, specify the required dates of state payments to CalSTRS to help address state cash flow issues, and address court-ordered interest payment obligations to CalSTRS. Unfunded state pension liabilities do not increase.		
Personnel Administration/Rural Health Equity Program for Annuitants —Accept administration's May Revision proposal to achieve additional General Fund savings (above the January proposal) by eliminating this program.	—	5.0
Extra contributions to health premiums for certain rural state retirees are among the few state retirement benefit costs that the Legislature may reduce as part of its budget-balancing solution. Under the proposal, the retirees' core health benefits are unaffected.		
Commission on State Mandates —Reduce funding for ongoing mandates.	—	43.0
Eliminate funding for mandates that have not yet been reported to the Legislature. Reduce funding in excess of amounts claimed.		
State Lottery —Ask voters for authority to securitize future revenues for \$5.6 billion over two years.	—	2,800.0
Funding level more prudent and could be provided with reduced risk to existing education lottery funding.		
Department of Industrial Relations —Accept all BBRs except the reductions to the Division of Occupational Safety and Health (DOSH).	—	1.1
Incorporated BBRs are in state operations and typically involve vacant positions or absorbable workload. The DOSH proposals could increase backlog of appeals and could result in delays to General Fund revenue collections.		

Employment Development Department —Accept state operations and appeals board BBRs.	—	0.3
We have no issues with the administration's proposed reduction.		
Resources		
Department of Fish and Game (DFG) —Shift funding for court-ordered suction dredge review to available special fund balance.	—	\$1.0
The Fish and Game Preservation Fund, Nondedicated Account is an eligible, alternative funding source for this activity.		
DFG —Shift funding for quagga mussel enforcement to available special fund balance.	\$5.7	5.2
The Fish and Game Preservation Fund, Nondedicated Account is an eligible, alternative funding source for this activity.		
Department of Parks and Recreation (DPR) —Shift funding for Empire Mine remediation (April Finance Letter) to bond funds.	—	5.0
Proposition 84 bond funds for state park planning and administrative purposes are an eligible, alternative funding source for this activity.		
DPR —Shift funding for Americans with Disabilities Act lawsuit settlement to bond funds.	\$11.0	\$11.0
Proposition 84 bond funds for the state park system are an eligible, alternative funding source for this activity.		
Office of Environmental Health Hazard Assessment —Shift funding for various regulatory program support to various special funds.	—	3.0
See the "Office of Environmental Health Hazard Assessment" write-up in the "Resources" chapter of <i>The 2004–05 Analysis of the Budget Bill</i> .		
Revenues		
Limited Liability Companies —Adopt May Revision proposal to move payment date forward.	—	\$360.0
We have no issues with the administration's proposal.		
Net Operating Loss (NOL) —Two-year suspension of NOL deduction.	—	664.0

State suspended deductions in both the early 1990s and early 2000s during budget crises. Revised revenue estimate reflects added revenue increase from complete suspension of NOLs in 2008 and 2009 (as compared to our February proposal).		
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^a This scoring method is consistent with our February approach. Our total solutions package totals roughly \$23 billion.

Wow! A lot to think about, although we doubt the Legislature is going to be happy with this approach. Of course, remember that the LAO's earlier Perspectives and Issues and the companion Analysis of the 2008-09 Budget Bill has other suggested tax increases ('loophole closings'), revenues and reductions that are not on this list. Just as with the May Revision, you have to read the original proposal and these May documents to understand the full recommendations.

More later.

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