CALIFORNIA Senate Republican Caucus

Updated
Highlights and Analysis of the 2010-11 Budget

November 16, 2010

SENATE REPUBLICAN FISCAL OFFICE

Table of Contents

Budget Briefs

SENATE REPUBLICAN FISCAL OFFICE

Highlights & Analysis of the Governor's Budget

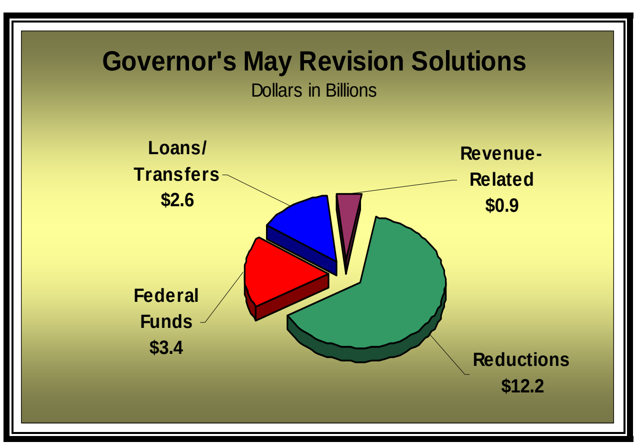
October 26, 2010

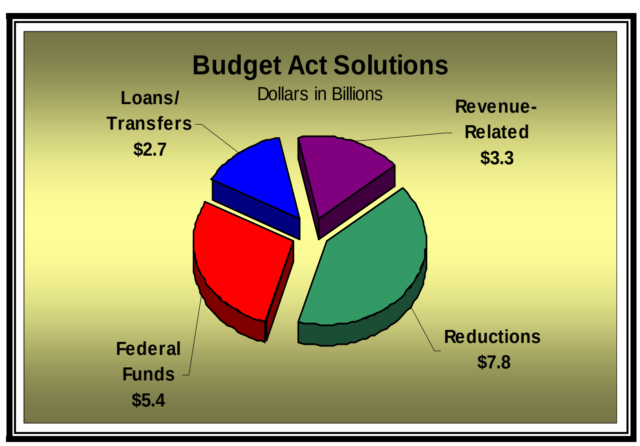
Executive Summary

The 2010-11 Budget Act appropriates $216 billion ($86.6 billion General Fund plus $31 billion Special Funds, $8 billion Bond Funds, and $91 billion Federal Funds) to support state and local programs (*see Expenditures section Page 6*). The $86.6 billion of General Fund spending is essentially flat relative to the prior (2009-10) fiscal year $86.3 billion level, although "underlying" General Fund spending, which recognizes federal fund offsets, deferrals, and fund shifts, to support General Fund programs is significantly higher (in excess of $95 billion for both the current and prior budget years).

This budget reflects $19.3 billion in budget solutions, including about $7.8 billion of expenditure reductions relative to current law spending levels, imposes no broad tax increases, and provides for a General Fund reserve of $1.3 billion. By contrast, the Democrat alternative budget included over $4.5 billion of tax increases in order to fund unsustainable state spending levels for yet another fiscal year. Overall, General Fund expenditures in this budget are about $4.2 billion less than the Democrats' Conference Committee plan.

Relative to the Governor's May Revision the solutions in this budget lean more heavily on anticipated federal funds ($2 billion higher) and additional revenues ($2.4 billion higher) from the tax policy changes and the higher Legislative Analysts' Office (LAO) revenue estimate (*see Revenues section Page 7*). Commensurately, the expenditure reductions are lower by about $4.4 billion.





Key Points:

Addressing the Long Term Problem. The budget package includes significant long-term reforms sought by Republicans, including budget reforms that reduce spending excesses, strengthen the state's "rainy day" fund, and reduce inflated state employee pensions. If approved by voters in 2012, the **Budget Reforms** (*see page 33*) will moderate the overspending that occurs when state revenues soar in good economic times and force the Legislature to act responsibly and put money into a reserve for the inevitable economic downturns that follow. The **Pension Reforms** (*see page 34*) roll back previous benefit increases for new employees and end “pension spiking.” These changes are expected to save taxpayers as much as $100 billion over the years and decades to come.

General Fund Reductions. By program area, the $7.8 billion in net expenditure reductions (i.e., *net of increased workload costs and Proposition 98 settle up payment*) are generally allocated as follows:

- $3.1 billion to Education (includes elimination of stage 3 child care)
- $1.4 billion to Employee Compensation
- $1.1 billion to Corrections
- $1.6 billion to Health and Human Services
- $215 million to Higher Education and non-Prop 98 education
- $360 million to Other Spending (mainly from defer/suspend local mandates)

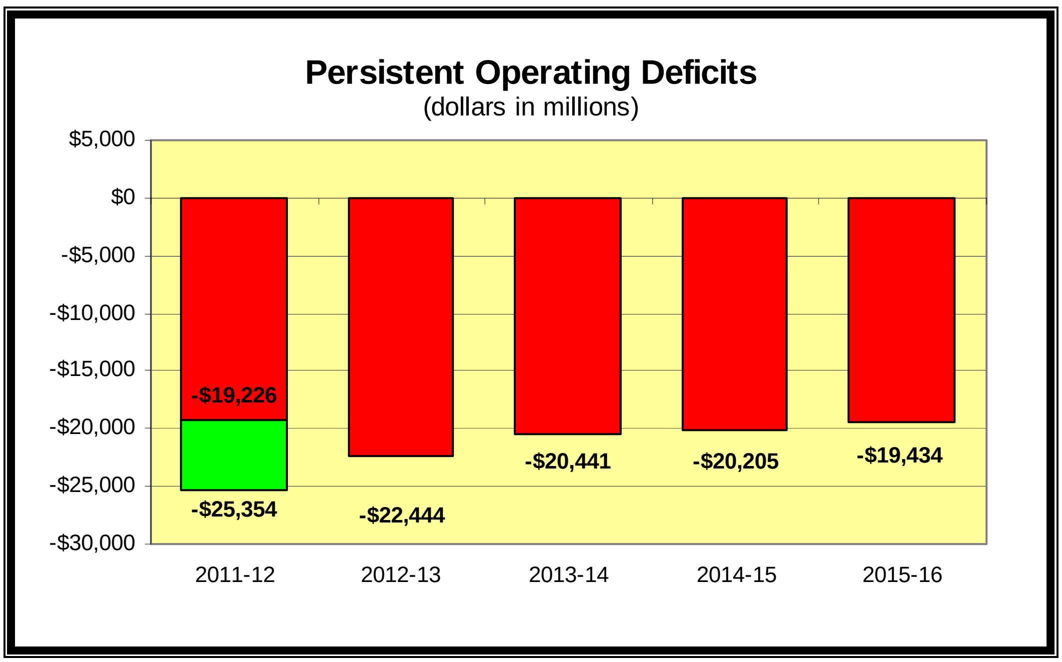
It should be noted that most of these reductions are temporary in nature, and generally do not result in major programmatic impacts. For example, the Health and Human Services reductions include a one-time accounting shift for federal TANF funds ($366 million), one-time savings from using reserves and fund shifts for Child Care ($300 million), utilizing provider fees instead of General Fund for In-Home Support Services ($190 million), and deferring payment to certain Medi-Cal managed care plans ($187 million).

Protecting California Jobs. The budget includes two significant changes to California tax policy that send an important signal that the state will be more business friendly, and that businesses will not be punished for creating jobs and opportunities if they stay or expand in the state. Specifically, creating a **“safe harbor”** for businesses that understate their tax liability by less than 20 percent will provide some modest relief from an onerous “understatement penalty” that forces honest taxpayers to overpay their taxes to avoid being penalized. Now, instead of making an interest free loan to state government, these tax-compliant businesses will be able to invest in the economy and jobs. Likewise, allowing businesses that do not elect single sales factor to use **Cost of Performance** sourcing rules for intangible sales will serve to make California more attractive to business investment within and outside the state.

Federal Funds Assumptions. The budget anticipates that $5.4 billion of federal funds will be forthcoming to offset General Fund program expenditures. However, only $1.3 billion from the extension of the enhanced Medicaid match rate has been approved by the federal government, and several hundred million more related to the state’s Medicaid 1115 Waiver (Hospital Finance) has been tentatively granted. There is still much uncertainty regarding the federal government’s intention to fund federal mandates (such as the cost of incarcerating illegal immigrants and special education) or repay monies owed for incorrect Medicare disability determinations**.** Over $3 billion of the assumed federal funds may not be realized.

Structural Deficit Remains. Despite bridging the budget gap of $17.9 billion and providing a reserve of $1.3 billion, the structural budget deficit will persist in future years. This is largely because the budget relies on one-time solutions such as federal funds, loans, transfers, fund shifts, and even most of the spending reductions are temporary in nature. No official estimate of the 2011-12 budget gap has yet been provided by the Department of Finance or the Legislative Analyst, but it is likely that it will exceed $15 billion.

Updated Operating Deficits. According to the Legislative Analyst's Office, the state will continue to face massive operating deficits (averaging $20.3 billion annually through 2015-16). Even though expenditures and revenues are roughly equal in 2009-10 and 2010-11, General Fund expenditures will continue to outpace revenues and transfers by more than $19 billion in 2011-12. This deficit plus the $6.1 billion deficit projected to be carried forward from 2010-11 results in a two-year problem (2010-11 and 2011-12) of $25.4 billion.



* Source: Legislative Analyst's Office – California's Fiscal Outlook

Conclusion: Against all odds, Republicans were able to withstand Democrat demands for billions of dollars in higher taxes and in fact were able to provide some modest tax relief (*see Protecting California Jobs on the previous page*). This budget includes some ongoing spending reductions and important pension reforms, and allows the voters an opportunity to approve critical budget reforms in 2012. However, it is clear that a substantial structural budget problem remains and **more work needs to be done** to reduce state spending to sustainable levels. Given continued Democrat resistance to necessary spending reductions and their desire for tax increases to grow state government, it appears the ground is set for yet another epic budget battle in 2011-12.

Expenditures

The 2010-11 Budget Act includes total General Fund expenditures of $86.6 billion, approximately $203 million higher than 2009-10 expenditures. As noted in the table below, expenditure levels for both 2009-10 and 2010-11 are approximately $5 billion lower than 2008-09. General Fund spending is only a part of total state spending. Including special funds, bond funds, and federal funds, total state spending for 2010-11 is projected to be approximately $216 billion, which is nearly equal to the record high of $218 billion in 2009-10. Despite the great recession and Democrats' claims of "cutting to the bone," total state spending remains at record high levels.

General Fund Expenditures By Agency

(dollars in millions)

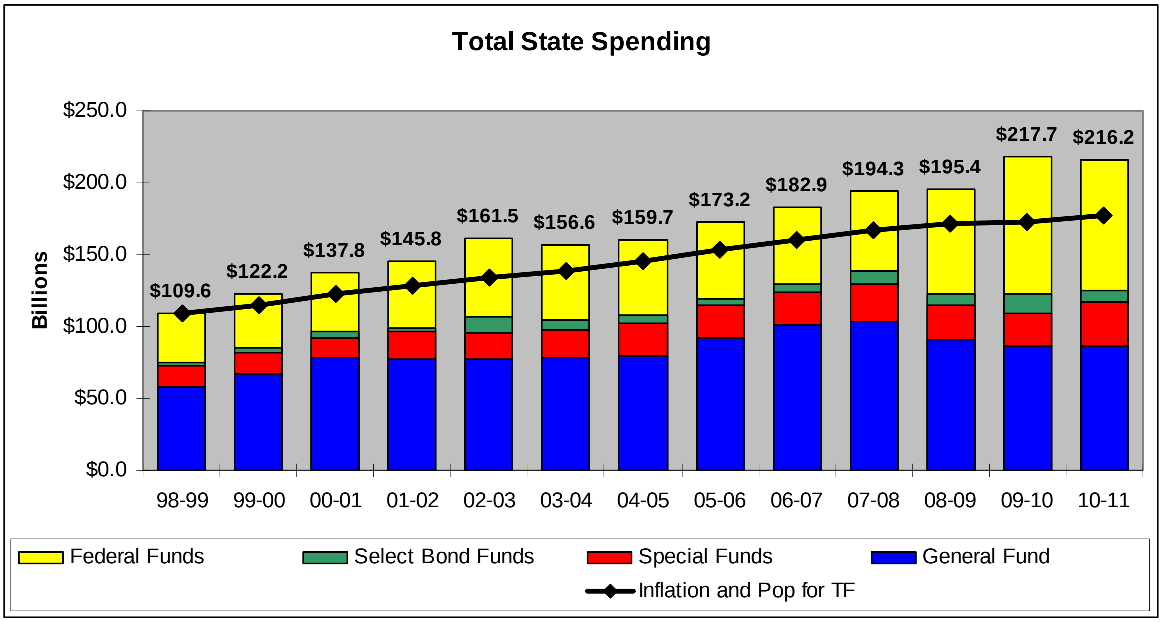
Agency	2008-09	2009-10	2010-11	Change from '08-09 to '09-10	Change from '09-10 to '10-11
Legislative, Judicial, Executive	$3,765	$1,828	$3,149	-$1,937	$1,321
State and Consumer Services	$567	$510	$598	-$57	$88
Bus, Trans, and Housing	$1,547	$2,512	$905	$965	-$1,607
Resources	$2,021	$1,873	$2,108	-$148	$235
Environmental Protection	$83	$71	$77	-$12	$6
Health and Human Services	$28,803	$24,394	$26,346	-$4,409	$1,952
Corrections and Rehabilitation	$10,008	$8,164	$8,931	-$1,844	$767
K-12 Education	$33,890	$35,732	$36,079	$1,842	$347
Higher Education	$10,181	$10,602	$11,490	$421	$888
Labor and Workforce Dev.	$102	$57	$58	-$45	$1
General Government	$1,093	$966	$1,120	-$127	$154
Statewide Expenditures/Savings	-$513	-$360	-$4,309	$153	-$3,949
Total, Underlying Expenditures	**$91,547**	**$86,349**	**$86,552**	**-$5,198**	**$203**
Percentage Change from 2008-09 to 2009-10				***-5.68%***	
Percentage Change from 2009-10 to 2010-11					***0.23%***

** The Other category expenditures includes a variety of statewide savings proposals that have not yet been allocated to specific departments or programs, including employee compensation reductions, health and dental benefits for annuitants, the PERS deferral, and assumptions for federal fund offsets related to education and health and human services programs.*

Though $86.6 billion of General Fund spending is essentially flat relative to the prior fiscal year (2009-10), true "underlying" General Fund spending, which recognizes federal fund offsets, fund shifts, and deferrals employed to support General Fund programs, is still in excess of $95 billion for both the current and prior budget years. In addition to $86.6 billion General Fund, the Budget Act counts on (1) new federal funds totaling $6.4 billion, (2) deferring $1.9 billion of education expenditures from 2010-11 to 2011-12, and (3) offsetting $350 million of trial court funding with transfers from redevelopment agencies to shore up health, human services and education spending levels that are not supportable with baseline General Fund revenues.

Total State Spending. Though General Fund spending is usually the focus of state budget conversations, it is just one component of total state spending. The 2010-11 Budget Act appropriates $216 billion ($86.6 billion General Fund plus $31 billion Special

Funds, $8 billion Bond Funds, and $91 billion Federal Funds) to support state and local programs. As the chart below demonstrates, total state spending from all fund sources has continued to increase each year over the past 12 years and the proposed 2010-11 spending level exceeds population and inflation growth by over $38 billion ($177.6 billion vs. $216.2 billion). Absent this data, most people would assume that state spending has been drastically reduced in the wake of the "great recession," but the truth is that California continues to spend significantly more than it did before the recent economic downturn.



In addition, it is important to note that, consistent with concerns noted above regarding federal fund assumptions and difficult-to-achieve reduction proposals, the LAO's 2010-11 Fiscal Outlook assumes that the mix of spending identified above will not hold. The LAO's projections assume that the state will fail to secure about $3.5 billion of federal funding and will be unable to achieve an additional $3 billion of solutions included in the 2010-11 budget.

Revenues

The 2010-11 Budget Act assumes total available General Fund revenues and transfers of approximately $94.2 billion. Baseline General Fund revenues at the 2010 May Revision were projected to be $86.5 billion for 2009-10 and $91.5 billion for 2010-11, and those estimates have held up pretty well. In fact, the LAO reports that actual revenue collections for 2009-10 appear to be approximately $400 million higher than May Revision projections. Additionally, the Budget Act assumes $1 billion of revenues above and beyond May Revision estimates for 2010-11, consistent with LAO projections.

In order to continue unsustainable spending levels, the Democrat Conference Committee budget proposed to increase taxes by $4.5 billion through increased personal income taxes, corporate taxes, oil severance taxes, and sales taxes. ***However,*** the final budget package includes no broad tax increases. It does provide a net revenue increase of $1.1 billion of revenue solutions, including:

- **Extends the Net Operating Loss (NOL) suspension**. The budget continues the suspension of the NOL corporate tax benefit for an additional two years, which results in increased revenues of about $1.2 billion in 2010-11 and $410 million in 2011-12.

  Continuing to delay the use of NOLs is unfortunate but necessary given the state's fiscal condition. However, the budget package maintains the small business exemption for taxpayers with **net** business income of less than $300,000. FTB estimates that this exemption would exclude 91 percent of corporate taxpayers and 98 percent of business taxpayers (corporations and personal income taxpayers with business income), providing tax relief to businesses and creating a friendlier environment to support job creation in California.

- **Provides Safe Harbor under the Corporate Underpayment Penalty.** The budget package provides a "safe harbor" for corporations that understate their tax liabilities by more than $1 million but less than 20 percent of their total tax liabilities, thereby decreasing General Fund revenues by $105 million in 2010-11 and $100 million in 2011-12.

  This change will provide some relief from the protective claims businesses must file under threat of the excessive, strict-liability understatement penalty.

- **Fixes the “Cost of Performance” Rule.** Allowing taxpayers that choose to retain the double-weighted sales factor apportionment formula (as opposed to the single sales factor) to use “cost of performance” rules for sourcing the sales of intangible personal property will reduce General Fund revenues by $25 million in 2010-11 and $90 million in 2011-12.

  This change, which will benefit both in-state and out-of-state businesses, is another step toward closing the gap between California's corporate tax burden and that of other states.

- **Additional Changes.** The budget package assumes additional revenues totaling $24.7 million in 2010-11 and $67.5 million in 2011-12 related to authorizing the Board of Equalization (BOE) to collect a cost recovery fee on delinquent accounts, re-establishing a voluntary line on the personal income tax return for taxpayers to report use taxes owed, providing additional audit and enforcement resources to the BOE, and interactions between the NOL suspension, the “cost of performance” change, and the understatement penalty safe harbor.

Sale of 11 State Office Buildings. The 2010 Budget Act also assumes additional one-time revenues of $1.2 billion (net) to reflect the sale of 11 state office buildings. The state would leaseback these properties for a period of 20 years with first right of refusal if the properties are put up for sale. The purchaser will be fully responsible for the maintenance and management of all facilities, with the exception of the CalEMA facility. In addition, the state will continue to pay for utilities. This “revenue” is the result of legislation enacted in July 2009 (ABX4 22/Evans) that authorized the Department of General Services to enter into a sale and long-term lease (sale/leaseback), including options for the state to repurchase that property or building, or both, for 11 state office buildings.

Successful Negotiations

Republicans successfully <u>eliminated</u> a number of tax proposals that were included in the Democrat Conference Committee budget proposal. ***The following proposals were removed, and are not included in the final budget package:***

- 2-year delayed implementation of the elective single sales factor apportionment formula, which would have increased revenues by $200 million in 2010-11 and $480 million in 2011-12.
- 2-year delayed authorization for businesses to share credits within unitary business groups, which would have increased revenues by $315 million in 2010-11 and $260 million in 2011-12.
- New Oil Severance Tax, which would have increased revenues by $842 million in 2010-11 and $1.2 billion in 2011-12.
- The Democrats’ “tax reform” proposal, which included increases to the personal income tax ($8.7 billion increase) and vehicle license fee/tax ($1.5 billion increase).
- Authorization for the Franchise Tax Board (FTB) to implement the Financial Institutions Records Match ($32 million revenue increase).
- Authorization for FTB to suspend the professional licenses of taxpayers that do not pay income taxes ($19 million revenue increase).
- Revised and expanded language regarding abusive tax shelters and abusive tax avoidance transactions ($5.7 million revenue decrease in 2010-11, offset by $2.8 million increase in 2011-12).
- Proposal, modeled after New York statutes, to establish “nexus” between out-of-state internet retailers and California using online affiliate marketers (estimated by Democrats to generate $100 million of revenues).

Emergency Response Initiative. The budget does **not** include the Governor's controversial Emergency Response Initiative (ERI), which would have created a new 4.8 percent tax on all residential and commercial multi-peril property insurance premiums (*See Statewide Issues Page 32*).

K-14 Education (Proposition 98)

Proposition 98 funding roughly flat, with exception of child care. In response to a two-year budget shortfall of about $17.9 billion, the 2010-11 budget approved by the Legislature suspended the Proposition 98 minimum guarantee of funding for K-14 education by about $4.1 billion. The Governor then vetoed another $256 million in Proposition 98 child care funding, which reduces it slightly from the 2009-10 level. However, as the chart below shows, K-12 per-pupil "programmatic funding" rises from $7,894 in 2009-10 to $7,953 in 2010-11.

- **2009-10.** The revised estimate of 2009-10 Proposition 98 spending is about $49.5 billion. This spending level is about $1.8 billion below the 2009-10 minimum guarantee, so the state will eventually have to provide that same amount ($1.8 billion) in one-time "settle-up" funding to schools (the first $300 million of which will be paid in 2010-11 to satisfy education mandate claims, as discussed below).
- **2010-11.** The 2010-11 budget passed by the Legislature provided almost $49.7 billion in Proposition 98 funding, suspending the Constitutional guarantee by about $4.1 billion. The Governor's Stage 3 child care veto then lowered Proposition 98 funding to about $49.4 billion and increased the state's "settle-up" obligation by the same $256 million. However, because the veto applied only to child care funding, it has no effect on classroom spending.

The following chart summarizes budgeted Proposition 98 funding:

Proposition 98 Funding
Source: Legislative Analyst's Office
($ in millions)

					09-10 to 10-11	
	2007-08	2008-09	2009-10	2010-11	$ change	% change
K-12 education						
General Fund	$37,752	$30,075	$31,662	$31,993	$332	1.0%
Local property tax revenue	$12,592	$12,969	$12,105	$11,529	-$576	-4.8%
K-12 subtotal	$50,344	$43,044	$43,767	$43,522	-$245	-0.6%
California Community Colleges						
General Fund	$4,142	$3,918	$3,722	$3,885	$163	4.4%
Local property tax revenue	$1,971	$2,029	$1,962	$1,907	-$55	-2.8%
CCC subtotal	$6,112	$5,947	$5,683	$5,792	$108	1.9%
Other Agencies	$121	$105	$93	$89	-$4	-4.5%
Total Proposition 98 1/	$56,577	$49,096	$49,543	$49,402	-$141	-0.3%
General Fund	$42,015	$34,098	$35,477	$36,223	$746	2.1%
Local property tax revenue	$14,563	$14,997	$14,066	$13,435	-$631	-4.5%
Prop 98 per-pupil funding (K-12)	$8,464	$7,226	$7,391	$7,342	-$49	-0.7%
K-12 per-pupil $, excluding child care	$8,175	$6,944	$7,083	$7,131	$48	0.7%
Programmatic funding 2/	$8,364	$8,423	$7,894	$7,953	$59	0.7%

1/ reflects vetoes made on October 8, 2010

2/ Programmatic funding includes P98 ongoing $, deferrals, settle-up, one-time & reserve funding, and federal stimulus & education jobs funds funding.

Programmatic changes. After determining a spending level for Proposition 98, policymakers must then determine *how* to program the funds, through specific reductions or augmentations. In this respect, the 2010-11 education budget differs from the prior year's budget in two significant ways: 1) it defers about $1.9 billion in state payments for 2010-11 activities until 2011-12 so as to avoid an outright cut in 2010-11, and 2) through a Governor's veto, it eliminates funding for Stage 3 child care, as discussed further below.

Deferrals could result in future cuts. The budget avoids an outright reduction of $1.9 billion in 2010-11 Proposition 98 funding by deferring state payments that would normally be made in 2010-11 until the following year (that is, in 2011-12, $1.9 billion in Proposition 98 funding will be provided to reimburse schools for 2010-11 costs). On the up-side, these deferrals will enable districts with unused borrowing capacity to run a higher level of program in 2010-11 than would an outright cut. On the down-side, they will exacerbate an already bad district cash situation by forcing schools to borrow in the interim, and will effectively authorize districts to run a higher level of program than the state can afford to support over the long-term, so that *a $1.9 billion increase in state funding will be necessary in 2011-12 just to maintain existing programs.* Absent that increase, the state will likely have to reduce support for existing Proposition 98 programs within the guarantee by $1.9 billion in 2011-12 just to "make room" for the deferred payments.

No COLA. The 2010-11 cost-of-living adjustment for K-12 programs, estimated at -0.39 percent, was not applied. Instead, existing statutory revenue limit "deficit factors" for school districts and county offices of education were adjusted by an equivalent amount.[1] In other words, revenue limit funding was not reduced by the amount of the negative COLA, but the state's implied future obligation to fully fund revenue limits was reduced as though the negative COLA had been applied.

Child care reforms rejected; funding reduced. As noted above, the Governor vetoed $256 million from the child care budget, reducing that line item's funding by about 17 percent, from $1.509 billion to $1.253 billion (General Fund support falls by about 27 percent, from $955 million to $699 million). Taxpayer-funded "Stage 3" child care for an estimated 55,000 children in families who formerly received cash aid through the CalWORKS program will be eliminated as of November 1, 2010. This reduction might have been avoided if the Legislature had accepted the various cost-savings options proposed in recent years by the Administration (e.g., reductions in licensed provider reimbursement rate ceilings, reductions in family income eligibility ceilings, increases in family fees, etc) and had acted more aggressively to reduce child care fraud and overpayments. A recent report by the California Senate Office of Oversight and Outcomes confirms that the state's administration of child care is fragmented and illogical, and recommends that more be done to detect and reduce fraud.

Modest mandate reforms begin. The budget denies the Governor's proposal to suspend virtually all education mandates, but does make some progress toward mandate reform: it suspends a few mandates, and amends statute to reduce the cost of, or permanently eliminate, others. It provides $300 million in 2010-11 "settle-up" funding to pay education mandate claims, which should be sufficient to fully satisfy the anticipated cost of all

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[1] Statutory establishment of deficit factors signals Legislative intent to eventually restore K-12 revenue limit funding to 100% of the amount that would have been provided had all annual COLAs been fully funded.

2010-11 claims, as well as some past-year claims.

Other reforms rejected. The Governor's proposals to loosen seniority rules to allow school districts more latitude in assigning, transferring, and re-hiring teachers, and to extend the March 15 deadline by which districts must provide teachers with preliminary layoff notifications, were not approved. Local efforts to convince the Legislature to suspend substitute teacher pay requirements were similarly unsuccessful, as were efforts to enable local savings by allowing schools to "contract out" for non-teaching services rather than hiring permanent full-time employees with full benefits packages, and to strengthen oversight of child care programs to reduce fraud and overpayments.

California Community Colleges (CCCs). The most notable adjustments to the CCCs' budget include:

- a $126 million augmentation for 2.2 percent enrollment growth
- a $60 million augmentation to CCC categorical programs
- a $20 million augmentation in one-time funds for career technical education, to maintain three-year average annual funding of $58 million, the same amount provided in 2008-09

These augmentations will be mostly offset by a $189 million deferral of state payments for 2010-11 activities until 2011-12 (the remaining $1.7 billion of the $1.9 billion deferral applies to K-12 programs). In other words, the colleges will need to borrow $189 million if they are to operate in 2010-11 at the full budgeted amount.

CCC categorical flexibility. The 2010-11 budget clarifies that Career Technical Education is not included in the group of categorical programs between which funds may be shifted locally. This is consistent with Republican assertions that the 2009 budget agreement was to have kept these programs out of the flex, and with the way the CCC Chancellor's Office actually administered the funds in 2009-10. All other CCC programs that enjoyed categorical program funding flexibility in 2009-10 will continue to enjoy that flexibility.

CCC student fees. The budget makes no change to CCC student fees, which remain at $26 per credit unit, still the lowest in the nation by far. An increase to $40 per unit, as the Legislative Analyst has suggested, would have generated roughly $150 million in additional fee revenue to support community college operations.

UC, CSU, & Student Financial Aid

Unlike most other areas of the budget, General Fund support for UC and CSU actually *rises* by $584 million in 2010-11, compared with 2009-10, and total funding grows by over $1.4 billion. The following chart summarizes UC and CSU funding:

UC & CSU Funding
(Selected core funds, in millions)

	Fund	2007-08	2008-09	2009-10	2010-11	09-10 to 10-11 $ change	09-10 to 10-11 % change
UC	**General Fund**	**$3,257**	**$2,418**	**$2,596**	**$2,913**	**$317**	**12.2%**
	Fees [1/]	**$1,593**	**$1,677**	**$2,001**	**$2,566**	**$565**	**28.2%**
	ARRA [2/]	**$0**	**$717**	**$0**	**$107**	**$107**	**n/a**
	Lottery	**$25**	**$25**	**$28**	**$27**	**-$1**	**-5.0%**
	Total UC	**$4,876**	**$4,837**	**$4,625**	**$5,612**	**$986**	**21.3%**
CSU	**General Fund**	**$2,971**	**$2,155**	**$2,350**	**$2,617**	**$267**	**11.4%**
	Fees [1/]	**$1,176**	**$1,406**	**$1,593**	**$1,670**	**$77**	**4.8%**
	ARRA [2/]	**$0**	**$717**	**$0**	**$107**	**$107**	**n/a**
	Lottery	**$58**	**$42**	**$46**	**$44**	**-$3**	**-6.1%**
	Total CSU	**$4,205**	**$4,320**	**$3,990**	**$4,438**	**$448**	**11.2%**
	Total	**$9,081**	**$9,156**	**$8,615**	**$10,050**	**$1,435**	**16.7%**

[1/] Includes amounts diverted to financial aid controlled by UC and CSU
[2/] Federal American Recovery and Reinvestment Act ('stimulus') funding for 2008-09 was received in the 2009 calendar year

Source: Legislative Analyst's Office

The most notable budget adjustments for UC and CSU include:

- $398 million augmentation to partially restore one-time reductions made in 2009-10 (a $255 million veto and a $50 million "trigger cut" to each segment). The remainder of the 2009-10 reductions are effectively restored with $212 million ($106 million at each segment) in newly-identified federal 'stimulus' funding.
- $111.9 million augmentation for enrollment preservation funding at UC ($51.3 million) and CSU ($60.6 million).
- a $10 million earmark of existing funds to support the UC Riverside Medical School, with a directive to UC to instead use new federal funds for this purpose, should they become available
- $5 million in continued "start-up" funding for UC Merced, previously scheduled to expire after 2009-10, reflecting a longer start-up period resulting from lower-than-projected enrollments.

In addition, each segment is expected to receive $106 million in federal "stimulus" funding.

UC and CSU student fees. The Governor's January and May budget proposals assumed that student fee increases approved by the UC Regents and pending before the CSU Trustees would go forward. Specifically, it anticipated that UC system-wide undergraduate fees would rise to $10,302 in 2010-11, and that CSU fees would rise to $4,429. However, the CSU Trustees increased fees to only $4,230, thus foregoing about $76 million in revenue associated with the higher fee level.[2] It is unclear whether the Trustees will act to increase fees to the higher level for the spring 2011 term.

Institutional aid. Consistent with past practice, one-third of all new fee revenue will be set aside for student financial aid controlled by UC and CSU. This set-aside will bring UC-controlled financial aid to over $800 million annually, and CSU-controlled aid to over $450 million per year (including direct General Fund support of over $52 million and $34 million respectively).[3] These amounts are in addition to state-funded financial aid discussed below.

State financial aid. The budget fully funds the CalGrant entitlement program (financial aid for needy students) at over $1 billion. One-time General Fund savings of $100 million are created through a substitution of Student Loan Operating Fund revenues for General Fund in 2010-11.

[2] As discussed in "institutional aid", one-third of this additional revenue would likely have been diverted to financial aid.
[3] This practice appears to conflict with Education Code Section 66021, which states Legislative intent that funds for increased student financial aid be provided from sources other than student fees.

Health

The 2010-11 budget package includes General Fund savings actions totaling about $2.6 billion for health-related programs. In addition to these various savings items, the budget enacts a number of other policies that are not associated with savings in 2010-11, including revising skilled nursing facility "fees" and reimbursements and implementing a plan to close Lanterman Developmental Center. Significant budget actions for each department are discussed below.

Department of Health Care Services (DHCS)

Savings Actions. The budget package enacts General Fund savings of $2.3 billion in 2010-11 for Medi-Cal and other health programs and includes the following significant items:

- **New Federal Funds Assumed.** The budget assumes savings of $1.3 billion by backfilling GF with new federal funds resulting from the temporary increase in the federal share of Medi-Cal payments. Although this increased sharing rate was originally set to expire December 31, 2010, Congress and the President extended the sunset by six months, albeit at a somewhat lower level than the previous enhanced rate. In addition to this $1.3 billion, the overall budget assumes an additional $4.1 billion in unspecified savings from new federal funds that have not yet been approved at the federal level (for a total of $5.4 billion). A significant portion of this additional amount could be for health programs. For example, the state may receive up to $500 million annually in new federal funds through a comprehensive Medicaid "waiver" that DHCS is currently negotiating. (The Legislature authorized this waiver through SB 208 (Steinberg) concurrent with the budget, although the waiver legislation is not considered budget trailer bill.)
- **Shift to Hospital "Fee" Proceeds.** Savings of $560 million by shifting Medi-Cal General Fund costs to the proceeds of the hospital quality assurance fee enacted by AB 1383 (Jones, 2009), which authorized the state to use $80 million per quarter in fee proceeds to backfill General Fund spending for children's health coverage. The state would obtain savings in 2010-11 for a total of seven quarters dating back to April 2009.
- **Managed Care Expansion.** Savings of $187 million by expanding the enrollment of seniors and persons with disabilities into Medi-Cal managed care plans. The expansion is scheduled to commence June 1, 2011. The immediate savings in 2010-11 will result from a temporary delay in paying certain managed care plans. In the long run, this expansion is expected to both enhance the quality of care provided to this population and help to hold down Medi-Cal spending.
- **Medi-Cal Hospital Payment Change and Rate Freeze.** Implements a process to shift Medi-Cal hospital rate payments from the current per diem rates to a method based on diagnosis-related groups (DRGs), in which hospitals would be paid according to the diagnosis of the patient receiving care rather than by the number of days the patient stays in the hospital. The federal Medicare Program currently uses a DRG-based reimbursement system. The budget requires DHCS to evaluate alternative DRG approaches, submit milestone reports to the Legislature, and finalize a methodology by June 30, 2012. In order to facilitate this transition, the

budget also freezes hospital inpatient rates at their January 1, 2010, levels for savings of $84.5 million General Fund in 2010-11.

- **Proposition 99 Fund Shifts.** Savings of $47.2 million by replacing General Fund spending for Medi-Cal services with Prop 99 tobacco tax proceeds. The savings amount consists of $36 million in available Prop 99 fund balances and $11.2 million made available by shifting funds from the Expanded Access for Primary Care Program for clinics.
- **County Administration Reduction.** A reduction of $43.9 million General Fund to the amounts that Medi-Cal pays to county welfare departments to administer the eligibility and enrollment process. This reduction is associated with revising the estimating methodology to ensure that certain cost factors are not double-counted. The savings amount includes a Governor's veto of $22 million General Fund, which increases the savings for this item to the level proposed by the Governor in January 2010.
- **Reduction to Radiology Rates.** Savings of $13.6 million by reducing Medi-Cal radiology rates to no more than 80 percent of the comparable Medicare payment rate. In some cases, Medi-Cal pays higher than Medicare for the same radiology service.
- **Increased Anti-Fraud Efforts.** Savings of $26 million General Fund through greater anti-fraud efforts, net of additional staff positions necessary to achieve the savings.
- **Clinic Funding Veto.** A veto of $10 million for grants to health clinics that the Legislature added back during the budget process. The Governor also vetoed these funds from the 2009-10 budget. The veto message notes that federal health reform is expected to provide $1.4 billion to clinics over five years in addition to increased clinic funding made available through the federal American Recovery and Reinvestment Act.
- **Physician-Administered Drugs.** Generates savings of $6 million General Fund by changing the physician-administered drug reimbursement methodology to the lower of the Medi-Cal pharmacy reimbursement rate, which is the Average Wholesale Price minus 17 percent, or the Medicare rate, which is the Average Sales Price plus six percent. This policy change conforms to a recent federal lawsuit settlement.
- **Medi-Cal Coverage of Over-the-Counter Drugs.** Savings of $3.1 million General Fund by eliminating certain nonprescription acetaminophen products as Medi-Cal benefits, with the exception of children's Tylenol. Other exceptions may be selected by DHCS. Over-the-counter drugs are a federal option for state Medicaid programs.

Skilled Nursing Facilities (SNFs). In addition to the savings actions, the budget makes various changes to increase revenues from SNFs by $61 million General Fund, raise payment rates by 3.9 percent, and establish a program to promote quality of care, as well as other changes. There would be no net effect on the General Fund because all new revenues would be spent on increased payments to nursing facilities. Key specific changes includes the following:

- Removing the current "fee" exemption for multi-level retirement communities for General Fund revenue of $18 million.
- Using updated cost data trends rather than three-year-old actual data when calculating cost-based rates, which increases "fee" revenue by $39 million.

- Lowering the state license fee paid by SNFs, which creates more room under the rate cap to increase payments and raises $4 million in new revenue.

Department of Public Health (DPH)

The budget package includes net General Fund savings of $8 million in 2010-11 for DPH as a result of various reductions and fund shifts, including the following:

- **HIV/AIDS Funding.** The Governor vetoed legislative augmentations totaling $59.6 million for various HIV/AIDS programs, consisting of $52 million for Office of AIDS programs and $7.6 million that the Legislature added to bolster the reserve for the AIDS Drug Assistance Program. Despite these vetoes, total funding for Office of AIDS programs is budgeted to increase by 5 percent in 2010-11 to a total of $503 million.
- **Immunization Assistance.** A reduction of $18 million General Fund for the Immunization Assistance Program, which potentially could be replaced with increased federal funds or local First 5 funds.
- **Every Woman Counts Program.** The budget provides a funding increase of $20.1 million for the Every Woman Counts Program, and generates savings of $13.7 million by eliminating the fees paid for follow-up care when screens show no evidence of cancer. These changes are estimated to allow the program to once again enroll women ages 40 through 49. The program previously raised the eligibility age from 40 to 50 due to funding shortages and program mismanagement.

Managed Risk Medical Insurance Board (MRMIB)

The budget authorizes an additional shift of nearly $60 million General Fund from the Healthy Families Program to the proceeds of the managed care tax first enacted in September 2009 by AB 1422 (Bass). The budget generates the additional savings by delaying the sunset of this tax by six months to June 30, 2011. The Healthy Families Program is fully funded, and no new eligibility or benefit restrictions were adopted.

Department of Developmental Services (DDS)

Savings Actions. The budget includes new General Fund savings of $118 million in 2010-11, including the following significant actions:

- **Additional Rate Reductions.** $25 million in General Fund savings by reducing payments to regional centers and developmental service providers by 1.25 percent in 2010-11, in addition to the 3 percent reduction already in place for these services. Of the total $25 million reduction, $4.6 million would reduce amounts paid to regional centers operations, and $20.7 million would reduce rates paid to service providers.
- **State Plan Amendment for Increased Federal Funds.** A shift of $14.5 million from the General Fund to federal funds by obtaining additional federal reimbursement for day programs and transportation services for clients residing in intermediate care facilities for the developmentally disabled. This action also allows for savings of $39 million General Fund for past claims dating back to 2007-08.

Closure of Lanterman Developmental Center. Trailer bill language enacted as part of the budget package facilitates the Administration's plan to close Lanterman Developmental Center in Pomona, which houses developmentally disabled residents. Some residents likely would transfer to a nearby developmental center, while others would transfer to community residential settings. The recent closure of Agnews Developmental Center showed that many residents thrive in less institutional surroundings provided by community-based services. In addition, community-based care generally is far less expensive than care provided in Lanterman and other developmental centers. The 2010-11 budget does not assume any savings associated with the closure, which may take several years to complete. The budget package makes various changes to implement the planned closure, including (1) authorizing state Lanterman staff to work as contract employees in the community while retaining state compensation and benefits for up to two years after the last Lanterman consumer leaves, (2) expanding the adult residential facility pilot program (including the "SB 962" homes) for use by consumers transferring out of Lanterman, and (3) establishing cost reimbursement for Lanterman consumers who enroll in Medi-Cal managed care plans.

The closure plan unfortunately repeats some mistakes seen in the Agnews closure. For example, allowing state developmental center staff to remain on the state payroll with the same compensation packages even after transferring to private community service providers is costly and unwarranted. State compensation packages far exceed market rates for private community providers, meaning that in many cases the state employees will be working alongside other employees who do the same work for significantly lower compensation. However, Republicans were able to secure a two-year sunset on the practice in Lanterman’s case. In the long run, closing Lanterman could result in improved outcomes for the consumers at lower cost to the state if the Administration does not surrender to the demands of Democrats and advocates to spend more on state staff and needlessly expensive community housing options.

Department of Mental Health (DMH)

The budget enacts $84 million in savings for DMH, including the following:

- **Special Education Mandate.** The budget defers $52 million in funding for county mandate claims for expenses related to providing mental health services to special education students (also known as the AB 3632 mandate). In addition, the Governor vetoed a legislative augmentation of $133 million for past AB 3632 mandate claims and declared the mandate to be suspended. In the absence of the state mandate, schools (rather than county mental health programs) are subject to a federal mandate to ensure that students with mental health conditions receive appropriate educational assistance.
- **State Hospital Savings.** Savings of $10 million General Fund for state mental hospital operations. Of this amount, $2.5 million will be generated by limiting the rates that mental hospitals must pay for outside medical services, such as ambulance or physician services. Currently, state hospitals negotiate their own rates with local health providers. This action would mirror recent changes to statute for state prisons, which ties reimbursement rates to Medicare/Medicaid. The remaining reduction would be unallocated.

Human Services

The 2010 budget includes total General Fund spending reductions of $1.2 billion within the state's human services programs, including $470.3 million of line item vetoes by the Governor. The vetoes included $365.9 million for a one-time federal fund advance within CalWORKs, $80 million within child welfare services consistent with the 2009 Budget Act funding level, $18 million with the elimination of the Substance Abuse Offender Treatment Program, and $6.4 million for Community Based Services programs, also consistent with 2009 Budget Act funding levels. Additionally, within the education program, the Governor vetoed $256 million to reflect the elimination of remaining funding for CalWORKs Stage 3 child care effective November 1, 2010 (*see Education, page 11)*.

Though there are some real program reductions within the IHSS program, the budget does not include any spending reductions within CalWORKs or the SSI/SSP program. The Governor had proposed to eliminate CalWORKs, as well as eliminate the state's child care program entirely, but neither of these proposals was adopted by the Legislature. By not including substantial permanent reductions in this budget, the state will continue to struggle to achieve balance in the years to come.

The reductions include the following policy changes:

- $300 million General Fund savings within the IHSS program, including $190 million from implementing a new provider tax that will bring additional federal funds to the state, $35 million from a 3.6 percent reduction in authorized IHSS hours, and $75 million from anticipated caseload savings.
- $284.1 million in one-time General Fund savings within the state's child care programs as a result of utilizing and shifting child care reserve funding. Another $31.3 million in General Fund savings would be achieved as a result of reducing license-exempt child care reimbursement rates from the current level of 90 percent to 80 percent of regional market rates, and $17.1 million General Fund savings achieved through reducing administrative and support services allowance for child care from 19 percent to 17.5 percent.
- $70 million in one-time savings from eliminating state funding for the Seriously Emotionally Disturbed portion of the Foster Care Program. The budget suspends the AB 3632 mandate and although these expenditures have not been part of any mandate claims to date (the funding was provided for in the Department of Social Services' budget for reimbursement to the Local Education Agencies [LEA's]), the budget eliminates the state funding in 2010-11, potentially allowing LEA'S to begin submitting mandate claims in 2011-12. Schools would still be required to provide these services as it is a federal mandate and it is the LEA's responsibility to either provide or contract for mental health services.

Judicial Branch

The 2010 budget includes many elements that were proposed by the Governor in January and May, such as a one-time $350 million Redevelopment Agency (RDA) fund shift and the continued suspension of the Guardianship and Conservatorship Reform Act. Some notable changes since January include the elimination of the Governor's Automated Speed Enforcement proposal and the rejection of his plan to require the courts to phase in the use of electronic court reporting.

RDA Fund Shift. The budget achieves $350 million in 2010-11 General Fund savings by using a one-time payment from RDAs to offset trial court expenditures.

Court User Fee Increases and Study. The budget includes another $102 million in temporary court user fee increases on top of the nearly $60 million of fee increases that were adopted last year. While the 2009-10 fee increases were permanent, this year's increases sunset after three years. The fee increases will provide an alternate source of funding for the trial courts so that General Fund reductions made in prior years can be made permanent. The new revenues are intended to eliminate the need for periodic court closure days that might otherwise be necessary for courts to operate within their respective budgets.

While court closures are undesirable, continuously increasing fees also results in barriers to access for those seeking justice. With the increase in civil filing fees included in this budget package, it now costs $395 to file a typical civil case. This is up from $320 in December 2008 – a 23.4 percent increase in less than two years. While families and businesses are being forced to cut back on spending to survive the economic downturn, those seeking justice are forced to pay increasingly more to sustain the judicial system. Therefore, it is important that courts find ways to keep their doors open while reducing costs through efficiency improvements. To that end, the budget also includes a requirement for the Judicial Council and the Legislative Analyst's Office to study the "default prove up" process and the existing court user fee structure. The study will look for ways to streamline key processes, eliminate bottlenecks, improve court efficiency, and ensure that the filing fees paid by court users have a nexus to the level of court resources consumed.

Use of Trial Court Reserves. The budget includes a $55 million unallocated General Fund reduction to the trial courts, offset by Trial Court Trust Fund reserves that are expected to be higher than initially projected.

Suspension of Guardianship and Conservatorship Reform Act. As proposed by the Governor in January, the enacted budget suspends implementation of the Guardianship and Conservatorship Reform Act for one more year, saving $17.4 million General Fund in 2010-11.

Public Safety

Department of Corrections and Rehabilitation

The budget includes a total of $1.1 billion in General Fund reductions within the Department of Corrections and Rehabilitation (CDCR). Notably, the enacted budget does **not** include either of the Governor's previous proposals to shift "low-risk" felons to local jails to serve their sentences. Instead, the $1.1 billion savings figure is almost entirely attributable to unallocated reductions for both CDCR and the federal court-appointed receiver (Receiver), as discussed below. In the past, CDCR has had difficulty achieving the level of savings anticipated from unallocated reductions.

Unallocated Reduction for Receiver. The budget reduces funding for prison medical care by $820 million, bringing California's costs in line with those of New York. The Receiver has indicated that he will endeavor to comply with the unallocated reduction. In order to do so, he will adopt cost-saving measures that include implementation of a system-wide utilization management program, expansion of the use of telemedicine, operation of a centralized pharmacy distribution facility, use of a provider network to drive down the cost of specialist referrals, use of a third party administrator to process medical claims, and implementation of medical parole pursuant to Chapter 405, Statutes of 2010 (SB 1399, Leno).

While the Receiver's public expression of his willingness to cooperate in achieving prison health care savings is laudable, history suggests that realizing the full $820 million in savings is unlikely. The Receiver's annual deficiency request has become somewhat of a given. Most recently, the Receiver overspent his 2009-10 budget by more than $500 million, most of which was due to contract medical expenses.

Federal Funding Assumptions. The budget assumes $5.4 billion in General Fund savings from additional federal support. One element in the Administration's plan to realize those savings is to seek federal reimbursement for the full costs of incarcerating undocumented criminal aliens – approximately $970 million. The United States Department of Justice's State Criminal Alien Assistance Program (SCAAP) has historically reimbursed roughly 10 percent of the state's costs to house these offenders. The most recent estimate of California's SCAAP payment for 2010-11 is $90.6 million. Unless California is able to convince the federal government to provide an additional $880 million, this assumption could leave a hole in the budget.

Population Changes. The budget assumes $200 million in General Fund savings due to "population changes." However, the actual changes in offender populations that will presumably yield the assumed savings have not been identified. Therefore, it is perhaps more appropriate to view these savings as an unallocated reduction. Given the magnitude of recent reductions to CDCR's budget, it is not clear whether the Department will be able to achieve these savings.

Local Reimbursement Shift. The budget includes one-time General Fund savings of $46.3 million related to a shift in the timing of reimbursement payments to local agencies for the costs of incarcerating parole violators. Instead of making estimated payments in advance based on historical data and settling up once claims are filed, CDCR will now reimburse local governments in arrears, once actual population data is available and claims have been submitted.

Juvenile Parole Realignment. The budget includes a $4.6 million reduction for the Division of Juvenile Justice to reflect savings associated with a plan to abolish the state's juvenile parole function. The plan would realign the responsibility for post-confinement supervision of juvenile offenders to local probation departments under the supervision of the courts. The budget package also authorizes an additional $200 million in lease revenue bonds to address local facilities needs through the construction of youthful offender rehabilitative facilities.

Transportation

Lost Opportunity for State Revenues. The Assembly passed SB 854 (Committee on Budget) of 2010, but the Senate failed to approve the Transportation Trailer Bill due to language that Senate Democrats tried to add, in violation of the negotiated budget deal. This language would have restricted the ability of law enforcement, cities, and counties to tow and impoundment vehicles driven by persons that do not have a valid California driver's license, in particular illegal aliens. This language would have made our roads more dangerous because individuals driving without licenses are statistically more likely to be involved in accidents and are often uninsured. Unfortunately, this measure also contained important language that would have enacted the Transportation Revenue Partnership Act that authorized the Department of Transportation to enter agreements with a private entity for an experimental project to develop and operate a network of changeable message signs within the rights-of-way of the state highway system. The revenues derived from this project would have been allocated between the department and the private entity with whom the department entered into the agreement. It is estimated that the state could have received between $50 -$100 million annually.

Capital Outlay Support Staffing. The *Governor vetoed* a $20.3 million legislative augmentation sought by Democrats, including 510 positions, for engineering, design, environmental studies, and other work for the Capitol Outlay Support program. With the veto, the program funding is more consistent with the Governor's May Revision proposal to decrease the capital outlay support program and workload while increasing the use of contract staff. The Administration indicates that the new funding levels reflect greater efficiencies in project delivery that the department has achieved over the last several years. Consistent with the provisions of Proposition 35 approved by the voters in 2000, the Governor's May Revision had proposed increasing the use of contract staff if only from 10 percent to 11 percent. Instead, the Budget Bill reflected the historical 10 percent for contractual services. The Governor indicated in the veto message that an appropriate balance between state staff and contract staff will enable the state to improve its highways, roads, bridges, and railroad crossings immediately. Republicans have long supported an increased use of contract staff.

Public Private Partnership Project. The Budget Act provides $1.1 billion in Federal Trust Fund and State Highway Account for the Presidio Parkway Public-Private Partnership project. This project is located in San Francisco and is intended to replace the existing 73 year old south access to the Golden Gate Bridge.

Project Initiation Documents. The Governor vetoed $7.4 million and 67 positions that would have been used to develop project initiation documents for locally-funded projects that are not on the state highway corridor or do not have funding identified to fund the project. These costs will have to be funded by local agencies.

State Highway Account. The Budget includes a loan of $80 million from the State Highway Account to the General Fund. The loan will be repaid by June 30, 2014.

Highway Users Tax Account. The Budget includes a loan of $762 million from the Highway Users Tax Account (HUTA) to the General Fund. The loan will be repaid by June 30, 2013.

The Governor vetoed budget bill language that distributes the loan repayment funds to local streets and roads, State Transportation Improvement Program (STIP), and to State Highway Operation and Protection Program (SHOPP). In the Governor's veto message, he directs the entire $762 million in loan repayment to SHOPP due to the critical highway maintenance and safety projects given the extraordinary backlog. It should be noted that with the passage of the "Gas Tax Swap" measures, local streets and roads and the STIP were held harmless while providing a small increase to these programs overtime. The measure also set aside $650 million to be appropriated by the Legislature for transportation related purposes. These funds along with an additional $112 million from HUTA would now be subject to a future appropriation by the Legislature for SHOPP when the funds are repaid in 2013. Historically, Republicans have preferred highway funding go toward road improvement and expansion projects instead of operation and maintenance costs.

Public Transportation Account. The Budget includes a loan of $29 million from the Public Transportation Account to the General Fund. The loan will be repaid by June 30, 2014.

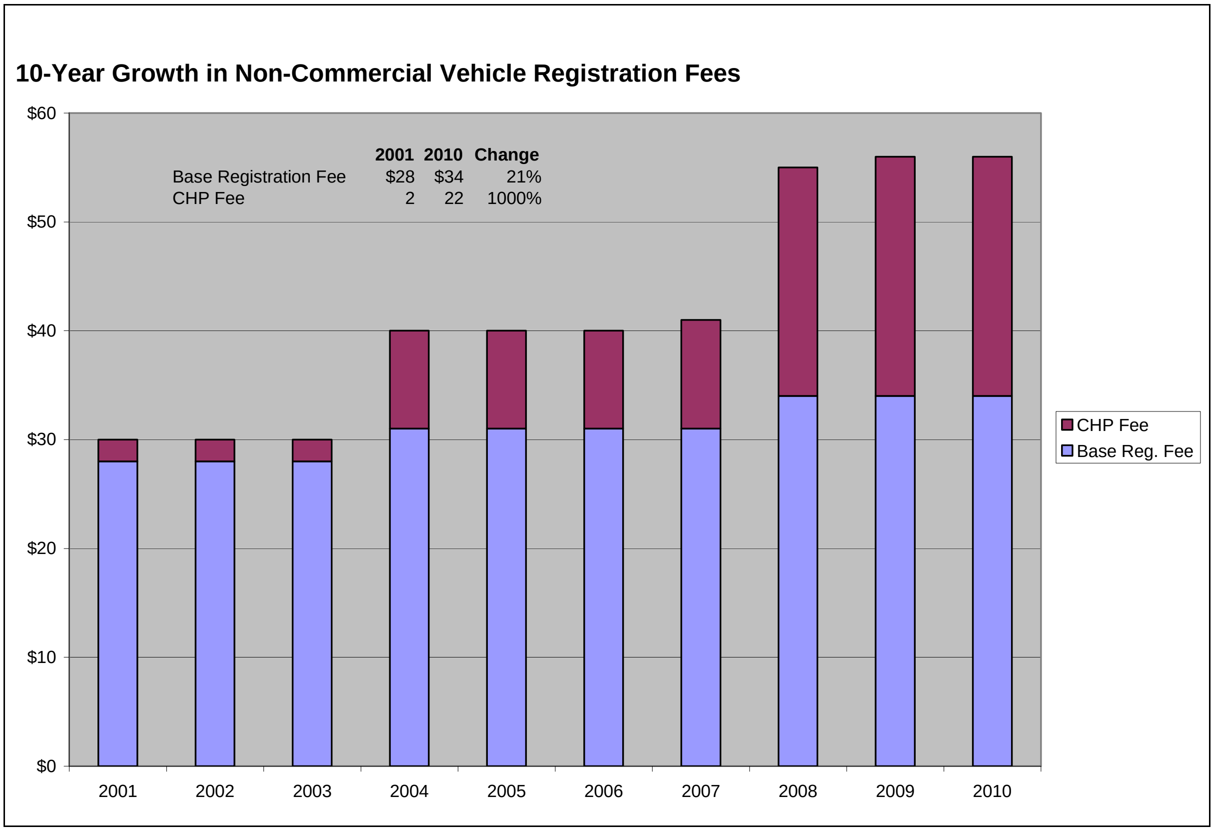
Loan Extensions. The Budget Act extends the repayment of $231 million in loans made to the General Fund from the State Highway Account and other transportation funds in the 2008 Budget Act by an additional year, until June 30, 2012.

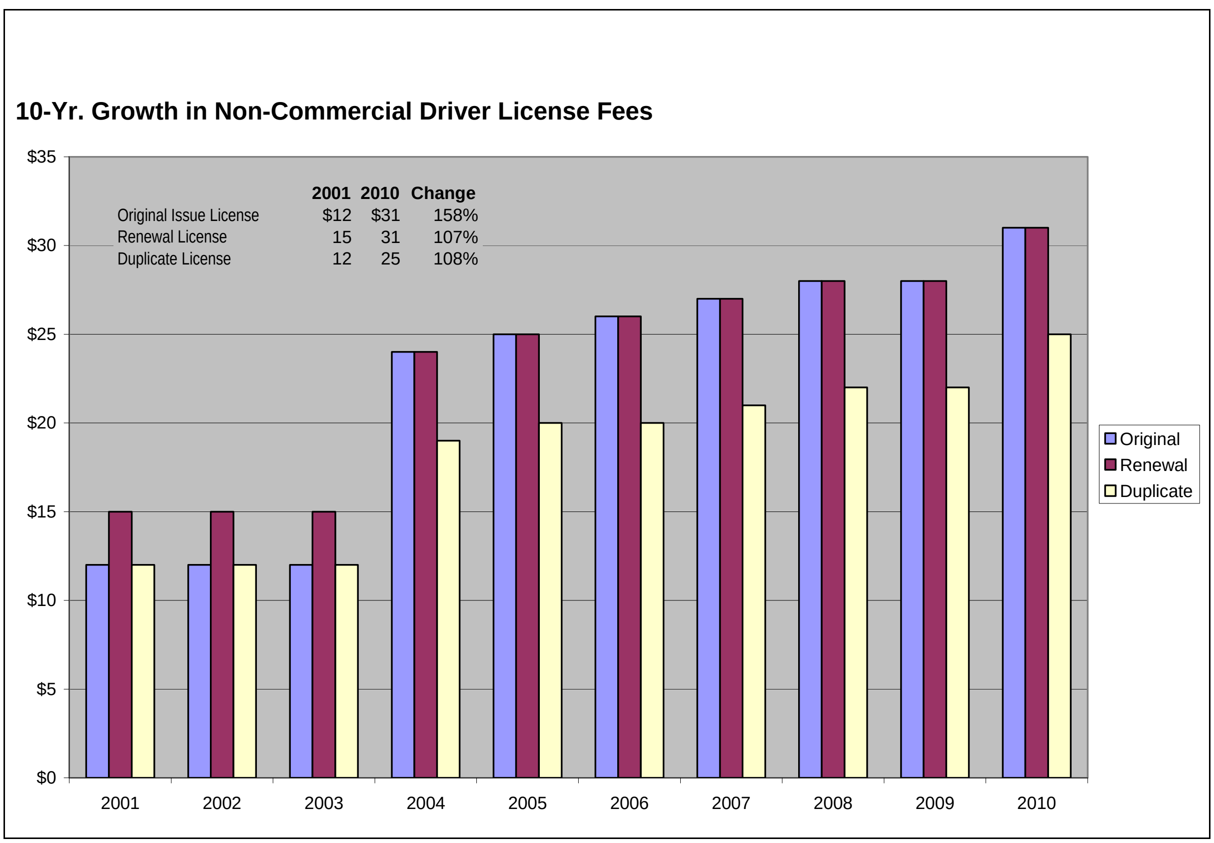
Motor Vehicle Account Loan and Transfer. The budget includes two separate, one-time solutions involving the Motor Vehicle Account (MVA), as follows:

- ***Transfer of Non-Article XIX Revenues from the MVA to the General Fund.*** The budget transfers $72.2 million from the MVA to the General Fund from revenues not covered by Article XIX of the California Constitution. Article XIX restricts the use of revenues from fees and taxes on motor vehicles to the enforcement of motor vehicle laws, including environmental regulations relating to the operation of motor vehicles, and to transportation infrastructure planning, improvements, construction, and maintenance. The $72.2 million figure represents revenues to the MVA from sources other than motor vehicle fees and taxes, such as funds received from the sale of documents and various other services to the public.

- ***Loan from the MVA to the General Fund.*** The budget also authorizes a loan of up to $180 million from the MVA to the General Fund. According to the Administration, these funds are available as a result of recent furloughs and savings from the California Highway Patrol (CHP) Enhanced Radio System project.

Over the past ten years, fees imposed on California motorists have risen sharply. For example, although the base vehicle registration fee has remained relatively stagnant, growing just 21 percent (20 percent less than inflation), the component of non-commercial vehicle registration fees that is dedicated to the CHP has risen by 1,000 percent (38 times inflation). During the same period, fees for non-commercial driver licenses, including originals, renewals, and duplicates, have more than doubled, outpacing inflation by nearly six times for original issue licenses. The charts on the following page summarize these changes.


10-Year Growth in Non-Commercial Vehicle Registration Fees
2001 2010 Change
Base Registration Fee $28 $34 21%
CHP Fee 2 22 1000%
$60
$50
$40
$30
$20
$10
$0
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
CHP Fee
Base Reg. Fee


10-Yr. Growth in Non-Commercial Driver License Fees
2001 2010 Change
Original Issue License $12 $31 158%
Renewal License 15 31 107%
Duplicate License 12 25 108%
$35
$30
$25
$20
$15
$10
$5
$0
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Original
Renewal
Duplicate

As the people of California become increasingly burdened by the size of government and the costs to support it, California's economy continues to suffer. These two short-term remedies maintain the pattern of shifting General Fund costs to special funds in lieu of making necessary reductions. These are one-time "solutions" that do nothing to address the ongoing structural imbalance between General Fund revenues and spending. In fact, the MVA loan proposal actually compounds the problem in the out years because the borrowed funds will have to be repaid.

Resources & Environmental Protection

Emergency Response Initiative Tax. The Budget Act does not include the Administration's proposal to enact the Emergency Response Initiative (ERI). The Governor's May Revise reflected $76 million of General Fund savings from the department's baseline fire protection services associated with a July 1, 2010 ERI enactment date. The ERI would have imposed a 4.8 percent statewide "surcharge" on all residential and commercial property insurance to fund state and local fire protection and emergency response activities. Legislative Counsel, in a written opinion dated March 17th, 2010, concluded that the ERI surcharge was a "tax." (*See Statewide Issues on Page 32*)

Environmental Fees. The Budget continues to provide $13 million General Fund for water quality and water rights programs avoiding additional fees on water users, landowners, and businesses. Specifically these fees affect the following programs: National Pollutant Discharge Elimination System, Irrigated Lands, Water Rights, and Basin Planning.

Landfill Operators, Solid Waste: Disposal and Discharge Fee Increases. The Budget would authorize the State Water Resources Control Board (SWRCB) to charge the operator of an open solid waste disposal facility a waste discharge permit fee in addition to the solid waste disposal fee (tipping fee) for the same solid waste, if the tipping fee revenues are insufficient for the administration and implementation of the SWRCB's water quality program. In 2010-11, there will be a $2 million shift from the tipping fees to waste discharge permit fees. Although the shift would be revenue neutral in 2010-11, fees could increase by $2 million in the out years.

Sacramento-San Joaquin Delta, Zero-Base Budgeting. The Budget Act requires the Governor to submit a zero-based budget and workload analysis for all water and ecosystem restoration activities in the Sacramento-San Joaquin Delta on April 1, 2011, as part of the 2011-12 proposed budget. The zero-based budget shall justify all expenditures proposed to support these activities. Since the Delta Stewardship Council will be proposing a long-term financing plan as part of the Delta Plan, future fee payers should be able to see the justification for these costs and a correlation to any future fee requirements.

AB 32, Zero-Base Budget. The Budget requires the Governor to submit on April 1, 2011, as part of the 2011-12 proposed budget, a zero-based budget and workload analysis for the AB 32 program implementation across all state agencies. This information shall justify all expenditures proposed to support AB 32 implementation and enforcement. Since the AB 32 fee requirements will begin in the Spring of 2011, it seems that this language is too little too late.

Department of Fish and Game Funding. The Budget contains an $8.5 million General Fund reduction for conservation and restoration programs, and reductions to the hunting and fishing programs. These reductions do not impact funding for game wardens.

In addition, **the Governor vetoed** another $1.5 million for the department's timber harvest plan review while sustaining funding of $1.5 million for Marine Life Protection Act projects.

Department of Parks and Recreation. The Budget Act reduces General Fund by $7 million to the state park system. These reductions will not require the closure of any state parks and services will remain at the 2009-10 levels.

Department of Resources Recycling and Recovery. The Budget includes a loan of $80 million from the Electronic Waste Recovery and Recycling Account to the General Fund. The loan will be repaid by July 1, 2012.

California Energy Commission. There will be a deferral of $35 million in General Fund loan repayments to the Renewable Resources Energy Trust Fund, with an additional loan of $25 million to the General Fund. The loans will be repaid by June 30, 2012, and June 30, 2013 respectively.

Public Utilities Commission. The Budget contains a deferral of $150 million in loan repayments from the General Fund to various Public Utilities Commission special funds. The loans were authorized in the 2008 Budget Act and will be repaid by June 30, 2012.

Employee Compensation

The 2010 budget includes significant policy changes and savings within the state's employee compensation arena. Fifteen bargaining units, including CHP, firefighters and SEIU, have ratified agreements for new contracts, conceding pension changes and increased retirement contributions, and paving the way for additional agreements with the remaining six units that could result in very major General Fund savings in years to come. The budget includes the following policy changes:

- The budget reduces spending for state employees by about $1.5 billion ($896 million General Fund) consistent with collective bargaining agreements that have already been reached or are in negotiations. If negotiations fail to provide an agreement, the Administration has the authority to take action (such as through furloughs or other administrative adjustments) in order to achieve these savings.

- Savings of $547.7 million General Fund would be achieved as a result of implementing a cap on payroll costs in 2010-11 and delaying OPEB pre-payments. An additional decrease of $130 million General Fund may result from overall reduction in OE&E, although the level of savings may fall short depending on actual savings departments are able to achieve.

- $43.6 million General Fund savings from implementing CalPERS Health Reinsurance program.

General Government

Assistance to Small Business. The budget package transfers $32.3 million from the General Fund to continuously appropriated special funds for the purpose of economic development:

- $20 million to the California Small Business Expansion Fund for the Small Business Loan Guarantee Program.
- $6 million to the California Capital Access Fund for the California Capital Access Program.
- $6 million to the California Economic Development Fund for the Small Business Development Center program.
- $350,000 to the California Economic Development Fund for the Federal Technology Center program.

Approximately $6.4 million of this funding will be matched on a dollar-by-dollar basis by the federal government to support the Small Business Development Center program and the Federal Technology Center program.

Reimbursable State Mandates. The Budget includes one-time General Fund savings of $365 million related to suspending most mandates not related to elections, law enforcement, and property taxes, including approximately $133 million that was vetoed by the Governor. This veto effectively suspended the "Handicapped and Disabled Student I and II, and seriously Emotionally Disturbed Pupils: Out of State Mental Health Services" mandate.

Local Mandate Securitization. The budget package includes a bill that allows cities, counties, and special districts to receive up-front payments of up to approximately $956 million for outstanding state mandate reimbursement claims that had accumulated prior to June 30, 2004. Specifically, this bill authorizes a joint powers authority to issue ten-year "local mandate claim receivables" (backed by the state's repayment obligation) and use the proceeds to pay local agencies for their outstanding mandate claims. Under the plan, the state would pay interest on "sold" receivables at a rate of 2 percent per year, while receivables "not sold" to a JPA would continue to earn interest at the Pooled Money Investment Account rate. Local agencies would pay any additional interest or debt-issuance costs. ***This bill was passed by the Legislature, but has yet been signed by the Governor.***

California Department of Veterans Affairs. The budget package makes the following key provisions for veterans' programs:

- Provides an increase of $4.5 million ($4.2 million General Fund) in grant funds for county veterans services organization (CVSOs), bringing the total CVSO funding to nearly $8.5 million. The CVSOs assist veterans in obtaining federal benefits available to them, among other services. The budget mandates that $5 million General Fund of this amount be used for Operation Welcome Home, the Governor's initiative to assist California's veterans in returning to civilian life.

- Provides $800,000 in redirected General Fund savings for the Pathway Home Program, an innovative program focused on assisting young veterans returning from

Iraq and Afghanistan with mental health challenges. This program is operated by an independent non-profit organization on the premises of the Yountville Veterans Home. The budget also authorizes the Department of Finance to provide an additional $500,000 to Pathway Home in the event the program is unable to obtain additional private funding by March 2011.

Statewide Issues

Rejection of the Governor's Emergency Response Initiative. The budget does **not** include the Governor's controversial ERI, which would have created a new 4.8 percent tax on all residential and commercial multi-peril property insurance premiums. The Administration projected the ERI would have raised approximately $480 million annually in new revenues that would have been used to offset a reduction in General Fund support for the Department of Forestry and Fire Protection's (CAL FIRE) Emergency Fund. In addition, revenues would have been used to improve the state's emergency response capabilities, including enhancements for CAL FIRE, the California Emergency Management Agency, the Military Department, and additional support for the state's mutual aid system. Notwithstanding the potential merits of these actions, the increases would have increased the burden on taxpayers even as tens of thousands of Californians are failing in the struggle to keep the doors of their businesses open and to avoid losing their homes to foreclosure.

Cash Management. During the unprecedented three-month budget impasse, the state has not been able to issue Revenue Anticipation Notes (RANs – the state's regular annual cash-flow borrowing mechanism), and has not paid several billion dollars in bills due to a lack of budget appropriations. Without the proceeds of RANs now, the state may not be able to pay all October and November payments, as well as the backlog in bills from July through September, without resorting to registered warrants (also known as IOUs). To reduce the potential need for IOUs over the next couple of weeks, the budget includes legislation that authorizes the Controller to delay specified school and community college payments, as well as other payments, in October by several days. The State Treasurer plans to market the RANs in November.

Budget Reform

The budget package includes a constitutional amendment (ACA 4/Gatto and Niello) to strengthen the state's "rainy day" fund and to establish a General Fund spending limit based on a twenty-year revenue trend. The amendment would be placed before the voters at the March 2012 presidential primary election and, if approved, would take effect beginning in the 2013-14 fiscal year. Savings resulting from the new budget controls could reach the billions of dollars in high revenue growth years, and the larger rainy day fund could provide billions of dollars to partially offset the effects of budget shortfalls. The net effect in the long run would likely be a reduction in the volatility of state General Fund spending, with a commensurate reduction in the pressure for spending reductions and/or new taxes.

Specifically, the budget stabilization amendment includes the following key provisions:

- Requires two transfers to a revised Budget Stabilization Fund (BSF) each year. First, three percent of General Fund revenues would be transferred to the BSF early in each fiscal year. Next, any revenues that exceed a twenty-year revenue trend (i.e., "unanticipated revenues") also would be transferred to the BSF near the end of each year.
- Transfers to the BSF would not be made once the BSF balance reaches more than 10 percent of total General Fund revenues for that year. This would be an increase from the current reserve fund ceiling, which is set at five percent of General Fund revenues or $8 billion.
- Permits funds in the BSF to be withdrawn over a minimum of three years to help address budget shortfalls. The amounts that could be withdrawn from the BSF in the first or second year of a budget shortfall could not exceed 50 percent of the fund balance or the amount of the shortfall, whichever is less. In a third consecutive year of shortfall, the withdrawal amount could be as much as the shortfall amount.
- Establishes a Supplemental Budget Stabilization Account that could be used only for capital outlay or infrastructure projects or to retire debt. Half of the three percent amount transferred to the BSF each year would be deposited into this supplemental account.
- Allows transfers to be made in or out of the BSF during the year if needed to meet the state's education funding obligations under Proposition 98, as estimates of this obligation amount are updated.
- Permits use of BSF funds for declared emergencies and for cash flow borrowing.

This measure's approach is likely to be more effective than a spending cap based strictly on population and inflation because it would reflect the state of the economy. State spending would change as revenues increase or decrease, whereas a cap based on population and inflation would tend to allow state spending to increase regardless of how the economy and state revenues perform. Department of Finance modeling suggests that if this bill had been in place beginning in 1998-99, there would have been $10 billion in the BSF by the end of 2007-08. These funds would have been available to cushion the $16 billion drop in revenues that occurred in 2008-09.

Pension Reform

As part of the overall budget package, SBX6 22 implements long-term pension reform for new state employees hired on or after January 15, 2011. These changes would impact state employees in bargaining units that do not currently have a Memorandum of Understanding (MOU) with the state, as well as employees of the California State University, the judicial branch of government, and the Legislature. **These changes do not apply to current employees**.

- **Rolls Back SB 400 Pension Benefits.** New state employees' retirement benefits would generally be returned to the pension benefit levels that existed prior to the adoption of SB 400 (Chapter 555, Statutes of 1999) as detailed in the chart below:

Retirement Category	Current Retirement Formulas	Proposed Formulas
Miscellaneous (including classified school employees)	2% at Age 55 (up to 2.5% at 63)	2% at Age 60 (up to 2.418% at 63)
Industrial	2% at Age 55 (up to 2.5% at age 63)	2% at Age 60 (up to 2.418% at age 63)
State Safety	2.5% at Age 55	2% at Age 55
Peace Officer and Firefighters, with the State, CSU, Legislature and Judicial branch	3% at Age 50	2.5% at Age 55

- **Ends Pension "Spiking."** Requires three-year final compensation method of calculating benefit levels for new state employees who are not already under this calculation method.

- **Transparency**. Requires additional analysis and oversight of CalPERS' actuarial assumptions. This will improve the transparency of the state's pension liabilities and costs of servicing those liabilities.

- **Increased Pension Contributions**. Although not included in SBX6 22, for all employees, new and existing, the budget assumes savings as a result of currently bargained and yet-to-be bargained permanent increases in employee pension contributions, ranging from two to five percent.

- **Doesn't Roll Back SB 183**. The bill does not roll back SB 183, a measure that expanded the state safety classification to include milk and meat inspectors, pest control specialists, etc. As a result of increasing the number of employees eligible for a state safety level retirement, the bill resulted in increased pension benefit costs for the state, which would continue.

- **California School Employee Association Not Included**. The bill does not include local school employees as part of the pension roll back.

Governor's Vetoes

(Dollars in Thousands)

VETO-PROGRAM/ISSUE	Amount
Aging--Community Based Services Programs	$6,400
Community Clinics	$10,000
Child Welfare Services	$79,956
Office of AIDS - Public Health Programs	$52,133
Maternal, Child, and Adolescent Health	$5,000
Habitat Conservation and Restoration Program	$1,500
Substance Abuse Offender Treatment Program	$18,000
Women and Children's Residential Treatment Services	$663
Medi-Cal County Administration Funding	$21,974
AIDS Drug Assistance Program – Augmentation for Rebate Fund Reserve	$7,600
Prostate Cancer Treatment Program	$1,000
Child Care Stage 3	$256,000
Curriculum Development History/Social Science	$1
"Fund Your Future" Financial Aid Publication	$280
Augmentation for IT Position, Equipment, and Surveillance System for CSAC/EdFund Detangling	$195
AB 3632 Mandate Suspension - Mental Health Services for Special Education Students	$132,941
Local Recreational Areas Background Screenings Mandate	$2,995
Other	
CalWORKs	$365,900
Total General Fund Vetoes	**$962,538**

NOTABLE SPECIAL FUND VETOES	Amount
Capital Outlay Support Program	$20,307
Project Initiation Documents	$7,438
High Speed Rail -Local Transit	$107,626
High Speed Rail - Positive Train Control Technology	$25,812
Acquisition of Agricultural Easements	$5,000
Total Special Fund Vetoes	**$166,183**

2010-11 Budget & Trailer Bill List

Subject	Vote	Bills	SEN VOTE	ASM VOTE
2010-11 STATE BUDGET -The main budget bill.	27	SB 870	27-9	57-13
Budget Reform -Implements a new budget reform measure. Not effective unless approved by the votes in November 2012 election.	27	ACA 4	29-7	65-8
CalPERS Transparency Part of Pension reform	21	SB 867	35-0	67-5
Cash Management -Authorizes a short-term cash-flow solution to ensure adequate cash flow through November 2010.	27	AB 1624	34-1	64-11
Department of Developmental Services Bay Area Housing -Provides for alternative financing of the Agnews/Bay Area Housing Plan.	27	AB 1629	34-2	73-0
Education -Makes amendments related to education and higher education necessary to implement the budget.	27	AB 1610	28-6	56-14
Education: P98 Suspension -Suspends the Proposition 98 guarantee and locks in Maintenance Factor.	27	SB 851	27-8	54-19
Elections (Budget Reform) -Specifies that the budget reform measure (ACA 4/SCA 10) will be on the November 2012 ballot.	27	AB 1619	28-4	67-7
FI$CAL -Makes various changes to implement FI$CAL information technology program.	27	AB 1621	32-3	57-18
General Government -Makes various changes in general government programs necessary to implement the budget.	27	SB 856	31-2	61-8
Health -Makes amendments related to health services programs necessary to implement the budget.	27	SB 853	27-7	58-15
Human Services -Makes amendments related to human services programs necessary to implement the budget.	27	AB 1612	27-8	54-17
JPA Mandate Securitization - Allows locals to securitize a new revenue stream based on $956 million of mandate obligations. No ASM version & may not come out the the House.	27	SB 866	29-4	43-25
Judicial -Makes various changes in court and judicial programs necessary to implement the budget.	27	SB 857	27-9	56-18
Local Government -Williamson Act	27	SB 863	28-5	58-8
MOU SEIU	27	AB 1625	32-0	66-5
Public Safety -Makes various changes in public safety and corrections programs necessary to implement the budget.	27	AB 1628	32-3	71-3
Public Works Board -Makes various changes relative to the State Public Works Board.	27	AB 1620	33-3	56-18
Resources -Makes amendments related to resources and environmental protection programs necessary to implement the budget.	27	SB 855	27-4	54-21
Revenues -Delays Net Operating Losses for two years and makes various other revenue changes necessary to implement the budget.	27	SB 858	27-7	60-13
Secretary of Volunteering -Creates a new Secretary of Volunteering within the California office of Planning and Research	21	ABx6 10	23-10	43-25
Small Business Bill -Implements various small business programs and loan guarantees.	27	AB 1632	36-0	68-5
State Employee Benefits -Retirement	21	SBx6 22	22-10	47-10
Transportation -Makes amendments related to transportation programs necessary to implement the budget.	27	SB 854	12-18 FAIL	63-10
Transportation Funds -Sales tax on gasoline to be transferred from GF to TIF for allocation	27	SB 524	28-2	65-4
1115 Waiver -Makes various changes necessary to implement the CEED Program portion of the 1115 Waiver related to health care.	27	AB 342	29-1	66-3
1115 Waiver -Makes various changes necessary to implement the 1115 Waiver related to health care without the CEED Program.	27	SB 208	35-0	71-0

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