Introduction

California, like the rest of the nation, is in the midst of a severe economic downturn. The combined effect of the state's continuing structural budget deficit and the loss of revenues resulting from the economic downturn results in a budget gap of $41.6 billion – just under half of the revenues projected for 2009-10. This is the most challenging budget in the state's history. It demands quick action and calls for every type of solution possible, including major spending cuts, revenue increases, borrowing and cash management strategies. The budget proposes a balanced approach that makes use of each of these types of solutions.

The Origin of the Budget Gap

In 1998-99, the state's budget was balanced and projected to remain in balance. Figure INT-01 displays General Fund revenue and spending growth since 1998-99. As the figure shows, one year later, revenues increased by 23 percent, due to a stock market and dot-com boom that drove unprecedented increases in stock option and capital gains income. These were magnified from a state revenue perspective, because the state's income tax system relies disproportionately on the very high-end earners most likely to receive such gains.

The surge in revenues resulted in massive – and unsustainable – new spending commitments. When revenues declined, the state relied mostly on one-time measures, such as borrowing, to temporarily reduce spending without cutting back underlying program commitments. Thus, the structural deficit was born.

Revenue Volatility and Budget Reform

Recognizing that revenue volatility is at the heart of the state's chronic cyclical budget problems, the Governor has created the Commission on the 21st Century Economy to propose changes to the state's tax system that will, on a revenue-neutral basis, reduce volatility, improve the business climate and encourage job growth. In addition, the Legislature has put on the next ballot a budget reform measure proposed by the Governor that discourages the use of surges in revenues to fund increased ongoing spending programs, and at the same time start to build a rainy day fund that will ultimately grow to an amount equal to 12.5 percent of General Fund revenues. The rainy day fund will only be available for use during economic downturns.

When revenue growth again surged in 2005-06, much of the growth was used to repay loans and backfill for the loss of temporary cost-saving steps.

The budget estimates that workload revenues in the current year will drop dramatically – a year-over-year decline of $15.1 billion, or 14.7 percent – while, if unchecked, spending would increase by $1.5 billion or 1.5 percent. The budget projects continued revenue decline and spending increases in 2009-10 in the absence of any policy changes to bring the budget back into balance.

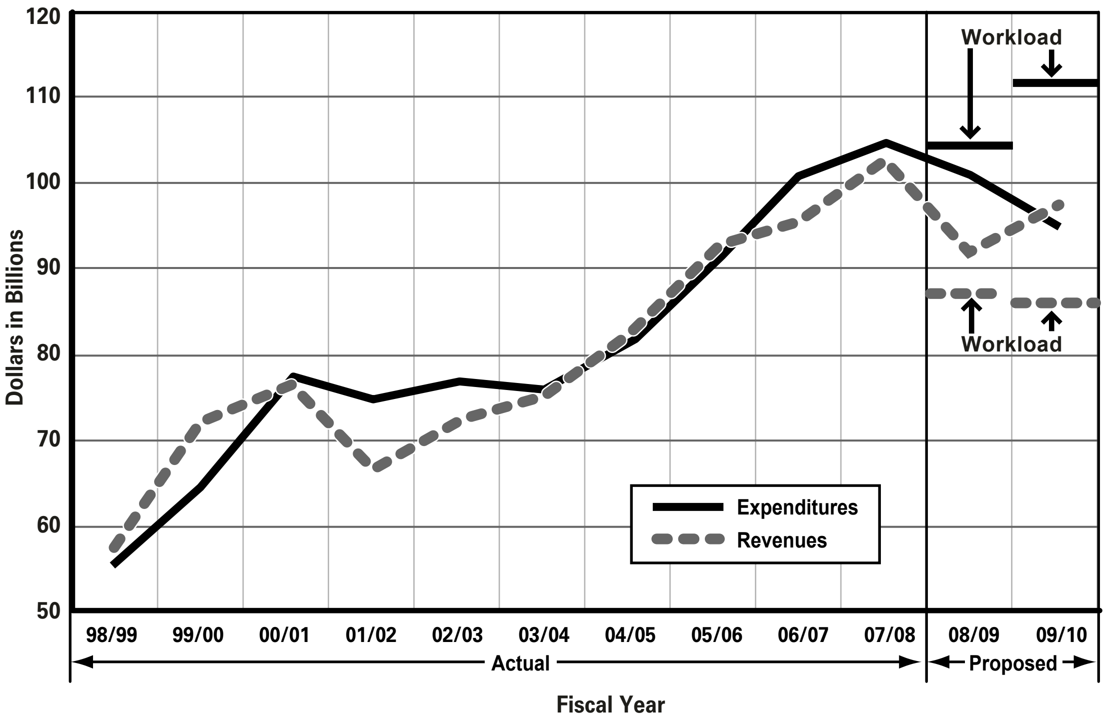
This figure tells a two-part story about the state's budget gap. First, it is partly due to the continued structural budget deficit that began ten years ago and that has never been completely eliminated. Second, a major part of the state's budget gap is due to the dramatic decline in revenues that has resulted from the current recession.

A Balanced Approach to Addressing the $41.6 Billion Budget Gap

The budget projects a deficit in the current year of $14.8 billion. If unaddressed, this deficit would grow to $41.6 billion by the end of the next fiscal year. The dual causes of the budget gap suggest both permanent and temporary solutions are necessary. Therefore, the budget proposes both.

Most budget solutions, spending cuts or revenue increases require significant time to achieve their full value. Therefore, it is imperative that solutions be enacted immediately, as opposed to waiting until the enactment of the 2009-10 Budget. That is why on November 6 and December 1, 2008, and again on December 19, 2008, the Governor

Figure INT-01
General Fund Revenue and Spending Growth



"Workload" means the projected levels of spending and revenues if the state were to make no changes to current law or practice.

When the budget reflects spending that is lower than the workload level, that means spending cuts are proposed. When the budget reflects revenues that are higher than the workload level, that means revenue increases are proposed. As the figure shows, the budget proposes both spending cuts and revenue increases in 2008-09 and 2009-10.

declared a fiscal emergency, called special sessions of the Legislature, and asked for the immediate enactment of many of the budget solutions.

Figure INT-02 displays the categories of solutions proposed and shows which are targeted for early enactment and which can be enacted next fiscal year. As the figure shows, the budget proposes a balanced approach to solving the $41.6 billion budget gap, with spending cuts being the largest category of solutions. While the magnitude of the budget shortfall requires reductions in services to the public, the budget also proposes cost savings in the way the state provides services by consolidating administrative functions and reducing the size and cost of the state's workforce. Specific solutions are described in the Revenue Chapter and in the Summary of Major Changes.

Figure INT-02

Proposed Budget Solutions

(Dollars in Billions)

	December 19 Special Session Proposals		Additional Special Session Proposals		Proposals to be Enacted By July 1*		Total	
Expenditure Reductions	$9,811	44%	$4,049	87%	$3,567	24%	$17,427	42%
Revenues	12,505	56%	236	5%	1,545	10%	14,286	34%
Lottery	0	0%	0	0%	5,001	34%	5,001	12%
Borrowing	0	0%	358	8%	0	0%	358	1%
RAWs	0	0%	0	0%	4,673	32%	4,673	11%
Total	$22,316	100%	$4,643	100%	$14,786	100%	$41,745	100%

* Includes minor policy issues of $72m ($102m in revenues and -$30m in expenditures)

Proposed Spending In Line with Population Growth and Inflation

As figure one shows, the budget proposal would bring spending and revenues back in line with historical levels. Specifically, the budget would result in spending and revenues in 2009-10 that would equate to an average annual percentage rate of growth since 1998-99 of 4.67 percent for spending and 4.75 percent for revenues. For perspective, the average annual combined increase in the state's population growth and inflation over the same period is 4.59 percent annually.

Continuing the Work of the California Performance Review

Over the past five years, the Administration has worked to eliminate outdated functions, become more efficient, eliminate redundancy and reduce costs. The state's unprecedented budget shortfall presents an opportunity for state government to increase efficiency, spend less and eliminate duplication and functions that are not absolutely critical.

The administration proposes to follow up on the work of the California Performance Review (CPR) conducted in Governor Schwarzenegger's second year in office. Many of the CPR's recommendations have already been implemented. The budget and its implementing legislation propose the following changes to promote efficiency:

- Consolidate the Postsecondary Education Commission and the Student Aid Commission for a savings of $2 million.
- Realign the California Conservation Corps, for a savings of $17 million in 2009-10, growing to $24 million in the out years.

In addition, the Administration will submit the following legislative proposals to further improve governmental efficiency:

- Streamlining and realignment of certain energy functions now performed by the Public Utilities Commission, the Energy Commission and Department of Water Resources.
- Consolidation of certain state information technology functions under the Office of the Chief Information Officer to improve coordination and efficiency and capture major efficiencies in procurement and technology implementation.
- Consolidation or realignment of recycling and cleanup, spill prevention and pollution prevention programs, including the elimination of the Integrated Waste Management Board.
- Consolidation of the Board of Geologists and Geophysicists into a related entity.
- Consolidation of the Professional Fiduciaries Bureau with the Board of Accountancy.
- Consolidation of Behavioral Sciences, Psychiatric Technicians and the Board of Psychology.
- Consolidation of the Hearing Aid Dispensers Bureau with the Speech-Language Pathology and Audiology Board.
- Consolidation of the Licensed Vocational Nurses with the Board of Registered Nurses.
- Consolidation of real estate functions within the Department of State Parks and the Wildlife Conservation Board.

The Budget Will Be Adjusted to Reflect Any Legislative Action in the Special Session.

The budget assumes that the Legislature will adopt the solutions proposed by the Governor when he called it into special session to address the fiscal emergency. To the extent that the Legislature adopts solutions other than those proposed, the budget will be adjusted to reflect the Legislature's actions.

- Elimination of the Court Reporters Board (continued oversight by the State Bar).
- Elimination of the Inspection and Maintenance Review Committee (continued by Bureau of Automotive Repair).
- Elimination of the Landscape Architects Technical Committee (licensing to continue under the Architects Board).
- Elimination of the Bureau of Naturopathic Medicine.
- Elimination of the Telephone Medical Services Bureau.
- Elimination of Permitting of Child Actors (continued through local school districts, which does all other child labor permits).

Managing the Cash Shortfall and Selling Revenue Anticipation Warrants

The budget projects that even if the Legislature enacts all of the special session solutions by February 1, 2009, the state will be unable to pay all of its bills beginning in March. This will require deferral of some payments. Absent legislative action or if the solutions adopted by the Legislature fall short of the level proposed by the Governor, it may be necessary for the state to make some payments with registered warrants, or IOUs. In spite of these challenges, there is no reason to expect any delay in paying debt service or in repaying the $5 billion in short-term Revenue Anticipation Notes (RANs) sold in October.

However, it will not be possible for the state to continue managing its cash flow into the budget year in the absence of a substantial infusion of cash. Therefore, the budget proposes selling Reimbursement Warrants (commonly known as RAWs) in July of 2009. While RANs must be repaid within the fiscal year in which they are sold, RAWs can be repaid in the subsequent fiscal year. Thus, the budget proposes repaying the RAWs no later than June 30 of 2011.

The proposed use of RAWs to manage cash flow over multiple years is consistent with past practice. This sort of cash flow management has always been a last resort in times when a sudden drop in revenues produces a deficit too large to be addressed with spending cuts and revenue increases alone. Moreover, it will be very difficult for the state to sell RAWs in the current credit environment. In order to do so, three conditions will have to be met:

- The state must have a sustainable, balanced budget, with all required statutory changes enacted prior to selling the RAWs.
- The state must have a plausible plan for repaying the RAWs in the subsequent year.
- There will have to be legislation enacted prior to the sale of the RAWs that protects the RAWs holders. Such legislation could include a trigger that automatically increases taxes or cuts programs if future events create uncertainty regarding the prompt payment of the RAWs.

Federal Economic Stimulus Proposals

It is widely believed that the incoming Congress will enact a major relief bill for states. Relying on funds from a relief bill to balance the state's budget, however, would not be prudent for several reasons. First, the state must balance its budget on its own to have any chance of re-entering the credit markets for General Obligation bonds or cash flow borrowing. Second, any bailout would be temporary, and the state needs to make permanent changes to restore balance to its budget in the longer term. Third, most of the proposals for sending federal funds to states focus on infrastructure construction as a fiscal stimulus—not on giving states unencumbered money to balance their budgets. Finally, it is far from certain that a bailout will be provided or, if so, in what amount.

The administration would, however, support using increased federal funds to repay the RAWs or to reduce the size of the RAWs, if the funds are available in time.

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