

DISCUSSION DRAFT – DO NOT DISTRIBUTE – DISCUSSION DRAFT

Proposition 1A: State Finance

Board Action:

OPPOSE

Rationale:

Although the intention of the measure is to increase the General Fund reserve target, there is no increase in the annual amount transferred to the state’s “rainy day” reserve account. Furthermore, the same amount that is transferred to the BSF will be dedicated to education funding and various debt payments on an annual basis (1.5%), increasing the pressure on the General Fund. The LAO’s forecast of a weakened revenue base for the next six years may require the maximization of General Fund revenues, and this measure simply secures a large portion of those funds during a uncertain economic period that could otherwise be used to close budget gaps or be put away for future years.

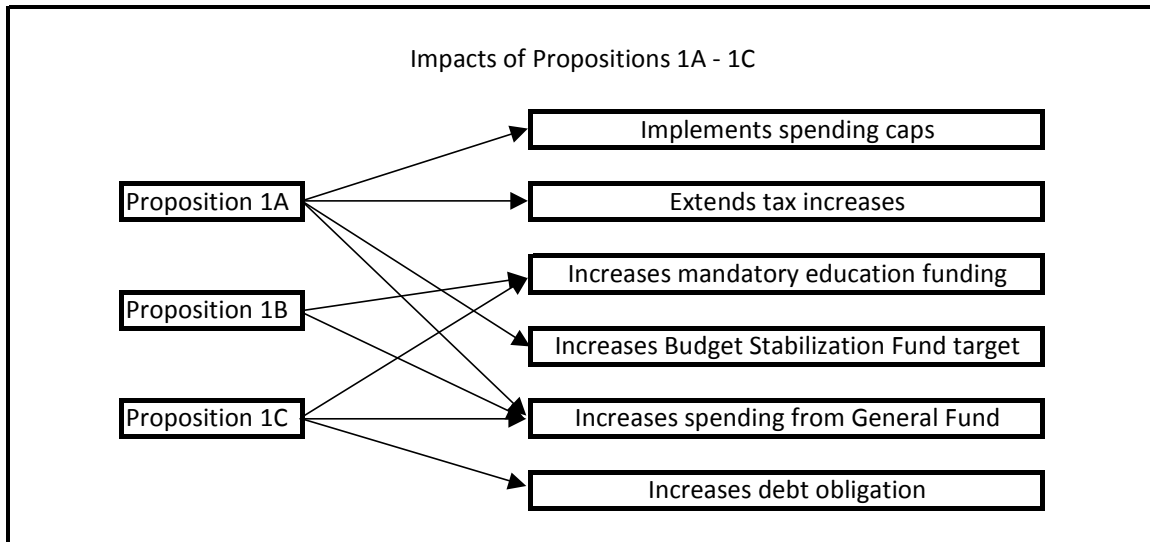
Background¹:

In January 2009, it was projected that the state would face a \$40 billion shortfall over fiscal years 2008-09 and 2009-10 if no corrective actions were taken. In February, the Governor and the Legislature agreed on a package to balance the current year and FY09-10 budget. This package is anticipated to generate \$98 billion in revenue and spend approximately \$92 billion. The remaining \$6 billion will cover the FY08-09 deficit and build up reserves.

As part of the budget package, six propositions were placed on a special election ballot to be held on May 19th. The FY09-10 budget depends on access to \$6 billion outlined within these measures. If voters approve all of the measures, it is expected that the state will still face multi-billion-dollar budget shortfalls in the coming years.

¹ Overview of the State Budget. California Legislative Analyst’s Office. February 25, 2009.

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Tax Increases

The adopted budget included a number of tax increases that are expected to remain in effect for two years. These tax increases included the following:

- **Sales & Use Tax:** Raised by one cent for every dollar of goods purchased. This raised the average tax rate in the state from 8% to 9% through 2010-11. Within San Diego County, the tax rate would increase from 7.75% to 8.75% (higher in some municipalities that recently adopted sales tax increases).
- **Vehicle License Fee (VLF):** Raised the tax rate from 0.65% to 1.15% of a vehicle's value through 2010-11
- **Personal Income Tax (PIT):** Tax rates range from 1% to 10.3% depending on a taxpayer's income. The budget raises each tax rate by a 0.25 percentage point. Also reduces the value of the dependent credit by \$210. These changes affect the 2009 and 2010 tax years.

The California Legislative Analyst's Office (LAO) has stated these tax increases will generate approximately \$12.5 billion in additional revenues.

Proposal:

The Proposition 1A ballot label will read:

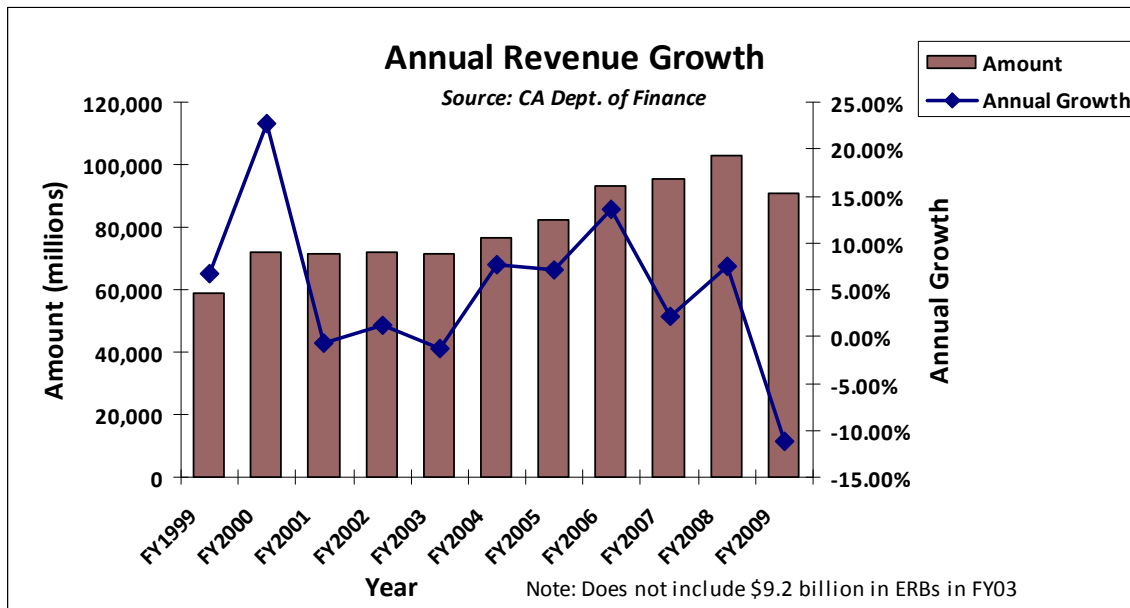
“RAINY DAY” BUDGET STABILIZATION FUND. Changes the budget process. Could limit future deficits and spending by increasing the size of the state “rainy day” fund and requiring above-average revenues to be deposited into it, for use during economic downturns and other purposes. Fiscal Impact: Higher state tax revenues of roughly \$16 billion from 2010-11 through 2012-13. Over

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time, increased amount of money in state rainy day reserve and potentially less ups and downs in state spending.

Spending Cap

For budgetary purposes, General Fund revenues for each fiscal year will be determined by the average revenue growth over the past 10 fiscal years. This forecasted amount would exclude revenues from taxes that did not last for the preceding 10 years and any bond proceeds. Since FY1999, the average annual growth in revenues has equaled 5.03%.



Above-Average Revenues

Passage of this measure will establish a process to determine which revenues are “unanticipated”. Unanticipated revenues can be defined by either those that exceed the amount expected based on average growth of revenues received over the past 10 years, or revenues above the amount needed to pay for spending equal to the prior year’s level (including growth factors).

Beginning in FY2010-11, any unanticipated revenues will be dedicated to the following purposes (in priority order):

- Meet funding obligations for K-14 education
- Transfer to the Budget Stabilization Fund to meet reserve target
- Pay off borrowing and debt

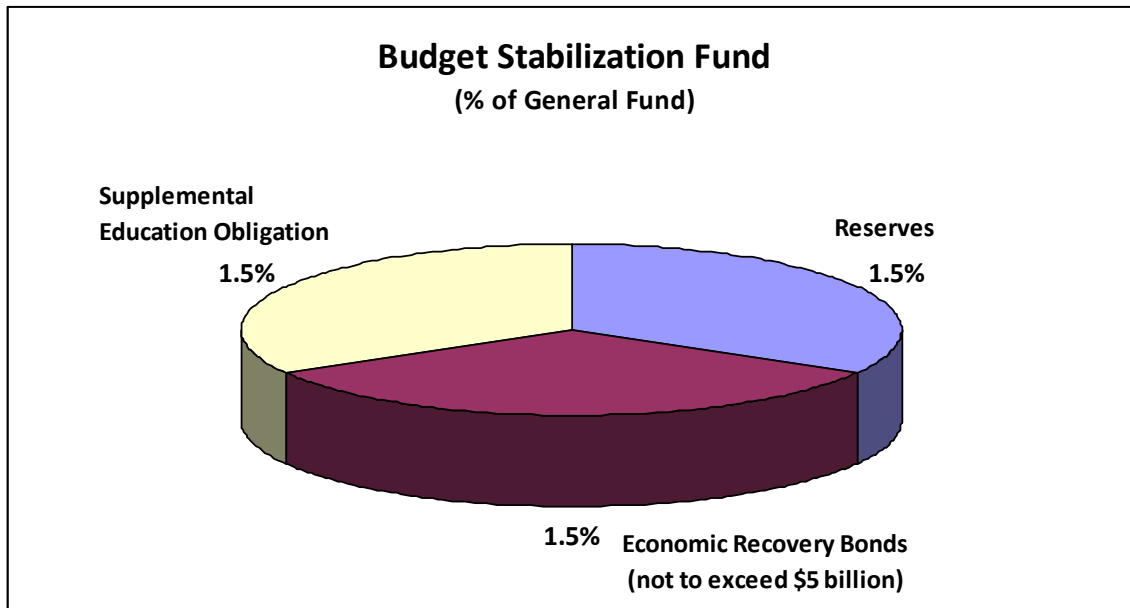
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Budget Stabilization Fund

In 2004 voters passed Proposition 58, creating the Budget Stabilization Account. Each year, 3% of estimated General Fund revenues are transferred into the Account. This transfer can be suspended though through an executive order signed by the Governor. Once this Account reaches a higher amount of either \$8 billion or 5% of revenues, transfers are suspended.

Proposition 1A would rename this Account the Budget Stabilization Fund (BSF) as well as increase the reserve target to 12.5% of state revenues, while maintaining the annual 3% transfer. Furthermore, 50% of the transfer (no more than \$5 billion of all transfers) will be dedicated to make extra Economic Recovery Bond payments. As of February 2009, approximately \$8.668 billion in ERB debt remained. Under this measure the Governor would only be allowed to suspend the annual transfer if revenues are equal to or less than spending to that of the prior year (inflation & population adjusted).

Despite the increase in the BSF target, a portion of this amount will be dedicated to education funding if Proposition 1B is passed by voters. If Propositions 1A and 1B are approved, the \$9.3 billion in education spending outlined in 1B will be paid through the BSF. Each year 1.5% of General Fund revenues will be transferred to K-14 education until the total \$9.3 billion is paid off. The LAO estimates this payback will take between 5-6 years to complete. Once these payments are complete, the 1.5% of BSF funds will then be dedicated to spending for infrastructure or state bond debt.



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Finally, this measure would limit the situations in which transfers can be made from the BSF to the following:

- Cover any costs associated with an emergency (e.g. fire, earthquake, flood)
- When revenues can not cover state spending equal to the prior year’s level of expenses (inflation adjusted)

New Governor Powers

Passage of this measure will also allow the Governor to make certain spending reductions absent legislative approval. Specifically, the Governor could reduce:

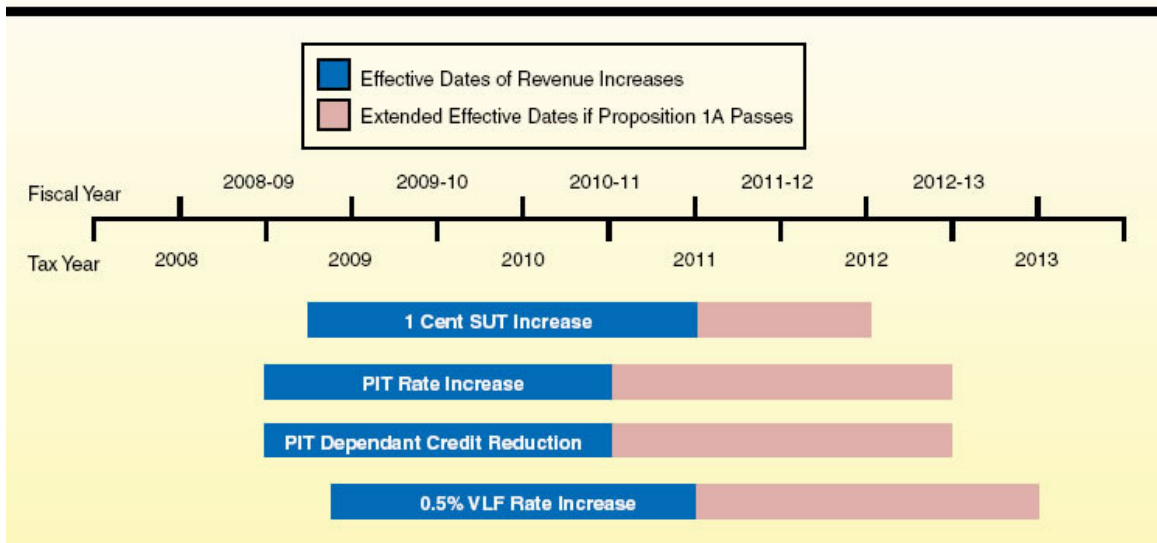
- Types of general state operations or capital outlay by up to 7%
- Cost-of-living adjustments for programs specified in the annual budget. This would not apply to increases in state employees’ salaries

Extension of Tax Increases

If voters approve Proposition 1A, the tax increases previously outlined will be extended for one or two additional years. The sales and use tax would be extended for one year (through FY2011-12); the VLF tax for two years (through FY2012-13; and PIT tax increases for two years (through 2012 tax year). The LAO anticipates these extensions will generate an additional \$16 billion in revenues.

Figure 7

Tax Increases Would Be Extended by Passage of Proposition 1A



Source: LAO Overview of the State Budget

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Fiscal Impact:

No Real Improvement to Reserves

Although this measure's intention is to build up reserves for future years, only one-third of transfers to the BSF are dedicated to reserves. The Governor or the Legislature cannot suspend the 1.5% of General Fund revenues dedicated to paying the maintenance factor for Proposition 98 funding, and 50% of the remaining transfer will be dedicated to paying for Economic Recovery Bonds. Therefore only 1.5% of revenues transferred into the BSF will actually be used as reserves.

If the economy does not recover quickly and the state maintains low revenue generation, the Governor or the Legislature will not be able to rely on reserves to balance the budget because of these required transfers. Although there may be relief of the General Fund to pay down debt payments that will now be paid by the BSF, there is question as to whether these savings will be enough to cover the growing requirements of education. The companion measure, Proposition 1B, will combine payments made by the BSF with Proposition 98 requirements as a base for the subsequent year's requirement. When combined with potential enrollment growth and/or cost of living adjustments, requirements can outpace available revenues.

If Proposition 1A fails, the transfer of funds dedicated to education as outlined by Proposition 1B will be void, even if Proposition 1B is approved by voters.

Higher Sales Taxes in San Diego

The one-cent increase in the sales tax rate will have a major effect to municipalities within San Diego County. Cities such as National City, El Cajon, La Mesa and Vista will have the highest sales tax rate in the County (9.75%, 9.75%, 9.50% and 9.25% respectively). If passed, the City of Chula Vista's proposed one-cent sales tax increase will raise the rate to 9.75%. The state's increase becomes effective April 1, 2009, and will last until July 1, 2011. Passage of this measure will maintain that increase for one additional year.

An extension of all the tax increases as outlined in this measure is estimated to generate an additional \$16 billion.

Failure of this measure will not have an impact on the recently adopted budget for FY09 and FY10, but may have an impact in later years if there is a reliance on the tax revenues that can be generated from the extension.

Impact on General Fund

While the measure would limit spending based on a 10-year average and increase transfers to the BSF, there will undoubtedly be negative impacts that will affect future General Fund spending, as passage of Proposition 1A and Proposition 1B will increase annual Proposition 98 funding requirements. This is because the annual maintenance

DISCUSSION DRAFT – DO NOT DISTRIBUTE – DISCUSSION DRAFT

factor payment from the BSF will be included within baseline for the subsequent year’s requirement. These payments, which cannot be suspended by the Governor or Legislature, will begin in FY2012 and will no longer be proportional to state revenues. This obligation is in addition to the mandated General Fund payments outlined within Proposition 1C.

Increase in Education Funding

Propositions 1A through 1C have a direct impact on state education funding. In each instance, passage of the measure will require the state to allocate more funding to K-14 education in future years. Proposition 1A will create a new account within the Budget Stabilization Fund that will direct 1.5% of General Fund revenues to K-14 education beginning in FY2012, and prohibit the suspension of these funds by the Governor and Legislature. Passage of Proposition 1B will enable these funds to be transferred each year until the \$9.3 billion outlined within the measure is reached. Finally, Proposition 1C transfers education funding responsibilities from the lottery to be placed upon the General Fund beginning in FY2010. FY2009 lottery numbers will be used as a base for the FY2010 funding requirement, and cannot be suspended by the Governor or the Legislature. This funding cannot be used to supplant Proposition 98 funding.

Proposed Education Funding

<u>FY2010</u>	<u>FY2011</u>	<u>FY2012</u>
		Proposition 1B (1.5% of General Fund Revenues COLA)
	Proposition 1C/Lottery Funds + COLA*	Proposition 1C/Lottery Funds + COLA*
Proposition 98	Proposition 98 (including enrollment growth & COLA*)	Proposition 98 (including enrollment growth & COLA*)
Proposition 1C (Based on FY09 Lottery payments plus enrollment growth & COLA*)		

*COLA is tied to gross domestic product price deflator for purchases of goods and services by state and local governments (GDPSL)