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October 2008

TO: Democratic Lawmakers and Staff

FROM: David Kersten, Budget Analyst

RE: Hidden Consequences of the 2008-09 State Budget Agreement

On September 23 Governor Arnold Schwarzenegger signed the 2008-09 Budget into law, ending a 88-day budget standoff—the longest in the state’s history. It has been well noted that the plan included deep cuts to state spending and relied on a series of budget shifts, transfers and overly optimistic revenue assumptions to close the \$17 billion budget gap—on paper at least.

But the potentially long-lasting consequences of the 2008-09 budget deal have been talked about far less in the media and public circles, which is likely due to their complex nature. The budget agreement includes:

Sweeping Midyear Cut Authority for the Executive Branch. The Legislature approved a series of budget process changes that will give the Governor and the Director of Finance sweeping authority to unilaterally reduce state spending by up to seven percent without legislative approval.

A New State Spending Cap that Will Significantly Restrict Future State Spending on Education, Health Care, Public Safety, Transportation and Other Vital State Programs and Services. The budget deal included the passage of two constitutional amendments (which require voter approval) that were billed as an expansion of the state’s rainy day fund. However, a closer look reveals that the proposal is really a new spending cap that will significantly restrict future state spending for education, health care, public safety, transportation, and other vital state programs services. The proposal requires that the excess revenues be transferred to a rainy day fund and provides very limited opportunities for withdrawal.

Massive New Corporate Tax Breaks That Will Cost The State More Than \$1 Billion A Year. The business community was given tax breaks, on the order of more than \$1 billion a year beginning in the 2010-11 budget year, in exchange for a temporary 2-year limitation on the use of corporate tax credits and net operating losses.

The purpose of this paper is to analyze the three aforementioned consequences of the 2008-09 budget agreement and highlight their negative aspects.

Background

These proposals were carefully crafted by their proponents but were jammed through the Legislature at the last minute without receiving proper scrutiny and review. Democratic leaders have vehemently opposed similar proposals in the past but surrendered on all three in one fell swoop.

The good news is that the new midyear cut authority and spending cap require voter approval. The bad news is that they were crafted in such a way to make them tough to beat at the ballot box. The Governor has yet to call a special election but the conventional wisdom is that these changes are likely to appear on a special election ballot in June of 2009.

The corporate tax breaks have been passed into law and can only be reversed by a 2/3 vote of the Legislature or through initiative. These corporate tax giveaways contain provisions that the business community could never dream of getting through the Legislature during the normal course of business.

The budget process changes contain provisions that the Governor and many Republicans have wanted for years and have proposed in various forms. Both proposals build on Proposition 58, which was a constitutional amendment placed on the ballot by the California Legislature at the request of Governor Schwarzenegger in March of 2004.

For example, in November 2003, the Governor proposed a restrictive spending cap that would limit General Fund spending to 2004-05 levels, adjusted for population growth and inflation (cost-of-living increase), and require the excess revenues to be transferred to a newly created "Budget Stabilization Fund."

This proposal, ACAX5 4 (Keene), contains provisions that would give the Governor sweeping powers to unilaterally make midyear cuts and law changes to major state programs. The proposal allows Governor to declare a fiscal emergency and by proclamation call the Legislature into special session. When issuing the proclamation, the Governor would be required to submit a recovery plan to the Legislature in the form of one or more bills to reduce General Fund spending or make other changes to law, to eliminate the deficit or reduce estimated expenditures.

This plan would take effect immediately within 30 calendar days after its transmittal to the Legislature, unless, prior to that date, the Legislature votes by a two-thirds vote to approve its own plan to eliminate the deficit.

ACAX5 4 went nowhere in the Legislature and the Governor was forced to settle for a far narrower compromise proposal, as contained in Propositions 57 and 58, which were both approved by voters in March 2004.

Proposition 57 approved the sale of the so-called “economic recovery bonds” to help close a portion of the 2004-05 deficit and Proposition 58 included budget process changes and the establishment of a rainy day budget reserve fund.

Prop. 58 Process for Mid-Year Adjustments. Prop. 58 set up a process for making midyear budget adjustments to deal with a projected budget deficit. Under the measure, the Governor may declare a fiscal emergency if he determines that the state is facing substantial revenue shortfalls or spending deficiencies. The Governor would then be required to propose legislation to address the problem, and call the Legislature into special session to consider legislation.

If the Legislature fails to pass and send the Governor legislation to address the budget problem within 45 days, it would be prohibited from acting on any other bills or recessing until such legislation is passed. In February 2008, the Legislature passed and the Governor approved a package of legislation which was projected to reduce the 2008-09 budget deficit by \$3.7 billion.

Prop. 58 Rainy Day Budget Reserve. Prop. 58 also required that a special budget reserve—called the Budget Stabilization Account (BSA)—be established in the state’s General Fund. The measure required that a portion of General Fund revenues would be transferred by the State Controller into the account no later than September 30 of each fiscal year.

The transfers were required to be 1% of general fund expenditures (about \$850 million) in 2006-07, 2% of general fund expenditures (about \$1.8 billion in 2007-08, and 3% of general fund expenditures (about \$2.9 billion) in 2008-09 and thereafter, according to the ballot analysis by the Legislative Analyst’s Office. The transfers would continue until the balance in the account reaches \$8 billion or 5% of General Fund revenues, whichever is greater. The annual transfer requirement would be required in every year in which the fund is less than fully funded.

Each year, 50% of the annual transfers to the BSA would be allocated to a subaccount that is dedicated to the repayment of the deficit-recovery bonds authorized by Proposition 57 (until \$5 billion is reached). The remaining funds in the BSA would be available for transfer to the General Fund by a majority vote of the Legislature (2/3 vote for budget spending) and approval of the Governor.

Prop. 58 does allow for the Governor, by executive order, to reduce or suspend transfers to the BSA for a given fiscal year. For example, in January 2008 the Governor proposed to suspend transfers for a budget savings of \$1.5 billion in 2008-09.

The new midyear cut authority and spending cap proposals build on Prop. 58 but contain a number of elements that the Democratic-controlled Legislature has rejected in the past for good reason.

Let us take a closer look at each proposal to assess its impact and examine any flaws.

I. Sweeping New Midyear Cut Authority for the Executive Branch

As a condition for agreeing to sign the 2008-09 budget, Governor Schwarzenegger required the budget agreement to include sweeping new midyear cut authority for the executive branch. These statutory changes were included in AB 1389 but do not take effect unless voters approve the Governor's spending cap and expanded rainy day fund proposals.

Buried in AB 1389, the general government budget trailer bill, were a series of changes that essentially give the Director of Finance the power to make unilateral seven percent reductions to a broad range of state programs and services.

Beginning with the 2008-09 fiscal year, the Director of Finance would be allowed to make these reductions if he or she determines that available General Fund resources for the fiscal year will decline "substantially" below the estimate of resources available upon which the budget act was based, or that General Fund expenditures will increase substantially above the estimate of General Fund resources available.

It is left totally up to the discretion of the Director of Finance to determine what is a "substantial" decline in revenues, increase in expenditures, or combination thereof that would trigger budget reductions. A small number of programs and expenditures are excluded, such as the Legislature, constitutional officers, debt service and emergency spending.

But a broad range of major state programs and State Departments would be eligible for cuts including the Department of Health Care Services, Department of Public Health, Department of Transportation, California State University, University of California, and a variety of state and local law enforcement programs.

The legislation also allows the Director of Finance to unilaterally suspend cost-of-living adjustments (COLAs) and rate increases that will affect the poor, the disabled, foster children and seniors. If the Governor issues a proclamation declaring a fiscal emergency, no COLAs or rate increase funded in the annual Budget Act would take effect unless the Legislature passes and sends to the Governor legislation to address the emergency.

The legislation excludes COLAs and revenue limits related to public school appropriations. AB 1389 requires the annual budget act to include a list of COLAs and rate increases that could be suspended beginning with the 2009-10 budget year.

Summary of Negative Aspects:

Power to make significant, unilateral cuts to vital state departments and programs is transferred from the legislative to the executive branch of government.

The Director of Finance would be given the sole discretion to determine the meaning of the word “substantially”—the trigger for the authority to make significant reductions to state programs and services. The Director of Finance would have the sole authority to choose what programs to cut and by how much.

The non-Prop. 98 component of the budget would be disproportionately impacted which means deeper cuts to health, human services, higher education, public safety and transportation programs and services.

A perpetual conflict would develop between interest groups lobbying to have their COLA or rate cut maintained or restored. This would be likely to disproportionately impact citizens with the least resources, namely the poor and disabled.

II. Restrictive New State Spending Cap Disguised As An Expansion Of The State’s Rainy Day Fund

As mentioned previously, the Governor and Republican lawmakers have repeatedly fought for a hard cap on state spending in recent years. While this proposal is different from past spending cap proposals, it would have the same effect—significantly curtailing state spending on vital state programs by requiring that a large portion of the revenue growth be transferred into a rainy day fund.

The proposed constitutional changes, which are contained in SCA 13 and SCA 30, were demanded by Governor Schwarzenegger as a condition of for signing the budget.

These proposals would:

Limit State Spending by Siphoning Off Revenue Growth. The proposal requires the state to transfer 3% of General Fund revenues for a given fiscal year into a Budget Stabilization Fund (BSF). The transfers would be required in every fiscal year until the balance in the BSF reaches 12.5% of General Fund spending for a given fiscal year (the current rainy day fund reserve is 5% of General Fund spending). According to the California Budget Project, this provision would have forced more than \$2 billion in additional spending cuts in 2008-09 if it was in effect this year, even if the fund contained sufficient revenues to avert the need for such reductions.

Severely Limit the Ability to Suspend Transfers to the Budget Stabilization Fund. Beginning in 2010-11 transfers would be required every year unless General Fund revenues are less than the prior year’s General Fund expenditures, adjusted for population growth and per capita personal income growth. Qualifying for this exemption would be a

very rare occurrence and would have not even happened this year even though the state faced a \$17 billion budget deficit.

Place Strict Controls on the Expenditure of Funds in the Budget Stabilization Fund. Funds in the budget stabilization fund could only be used to fund the difference between the budget year's expected revenues and the prior year's expenditures, adjusted for population growth and per capita personal income growth.

Restrict the Use of "April Surprise" Revenues. By the end of May of each year the Director of Finance would be required to report to the Legislature and the Governor the estimated amount of General Fund revenues available for the current fiscal year from the prior fiscal year. Unanticipated revenues that exceed 105% of the budget act estimate would be required to be dedicated to the payment of specified Proposition 98 obligations. The remaining amount would be required to be transferred to the BSF.

Restrict the Use of BSF Spending Once the Fund Reaches 12.5% of General Fund Spending. Once the balance in the BSF reaches 12.5% of General Fund revenues for a given year, the excess could only be used for specified one-time purposes including Prop. 98 "settle up" payments and maintenance factor obligations, bonded indebtedness, one-time infrastructure spending, unfunded retiree health benefits for state workers, and one-time tax refunds.

Summary of Negative Aspects:

Sets an arbitrary cap on state expenditures. This cap would not account for changing economic circumstances, caseload growth, health obligations for the baby-boom generation, other demographic factors, and unforeseen circumstances. Population and per capita income growth is not a reliable benchmark to determine what state spending should be. To illustrate, caring for the aging baby boom generation will put increasing strains on the state budget. Also, state spending obligations go up during times of economic down turn but limiting state spending growth to inflation and per capita personal income would further restrict state spending during these tough economic times—thereby placing greater burdens on working California families, the poor, seniors and the disabled when they can least afford it.

Requires transfers to the BSA even in years when significant budget cuts are required to balance the budget. To illustrate, the 2008-09 budget included \$10.3 billion in spending reductions and is already projected to be out of balance by \$3 to \$5 billion. As mentioned above, this measure would have forced more than \$2 billion in additional spending cuts in 2008-09 if it was in effect this year, even if the fund contained sufficient revenues to avert the need for such reductions.

Locks in spending at a historically low levels. Revenues and expenditures were down this year due to the economy. This measure would prevent the Legislature from

restoring cuts to important state programs such as education, health care, and public safety when revenues improve along with the economy.

Would not prevent future budget crises. This measure ties yet more knots in a budget process that is already overly restrictive and it would further limit the ability of the Legislature and the Governor to address state budget deficits.

III. Massive New Corporate Tax Breaks that Will Cost the State More than \$1 Billion A Year

The expression, “when you are in a hole, the first thing you should do is quit digging” comes to mind when examining these budget provisions.

One of the reasons why the budget standoff lasted so long is that Democratic leaders and constituencies were insistent that any potential solution include new revenues, tax revenues, as a way to permanently close the budget gap. Governor Schwarzenegger also advocated for a temporary increase in the state sales tax to help close the budget gap for the next three years.

But in the end, the budget agreement included a temporary suspension of corporate tax credits for the next two budget years, followed by a permanent expansion of two of the state’s largest corporate tax breaks. Businesses with less than \$500,000 in annual income are excluded from the tax changes.

The budget suspends the ability of a business to claim net operating loss (NOL) deductions in 2008 and 2009 to increase revenues by \$1.1 billion in 2008-09 and \$600 million in 2009-10 but then extends the carry forward period from 10 years to 20 years and allows a business to “carry back” losses, which were earned in 2008 and 2009, for both years beginning in 2011. Providing businesses with the two year carry back period will allow businesses and large corporations to get a full refund for the extra taxes paid in 2008 and 2009.

Generally speaking, as a matter of tax policy, net operating loss deductions make sense because they allow businesses to carry forward losses from one year to the next—acknowledging that the tax year is a somewhat arbitrary way to plan business expenses over the long term. For example, a biomedical startup company may incur several years of losses for tax profits during its product development stage which could then be carried forward and used to reduce future tax liability when the product reaches the market.

On the other hand, critics have argued that the state should not be handing out permanent tax breaks to the business community during a time when the state faces a structural budget deficit for many years to come.

The NOL provisions included in the budget agreement are essentially a short term loan from businesses followed by an enormous tax break in 2011 and beyond. The expansion

of NOL deductions is estimated to result in revenue losses of \$320 million in 2010-11, \$600 million in 2011-12, \$485 million in 2012-13 and similar amounts thereafter. This is a bad deal for low and middle income taxpayers who will be forced to shoulder a greater share of the tax burden in the years to come.

The budget limits the use of business tax credits (i.e. research and development, enterprise zones) in 2008 and 2009 for a revenue increase of approximately \$900 million in 2009-10 and a \$415 million in 2009-10. Specifically, the limitation would only allow taxpayers to use tax credits to reduce up to 50% of their tax liability during these two tax years. Many businesses have such a large store of tax credits that they are able to use tax credits to reduce their entire tax liability.

Beginning in 2010 the budget agreement allows corporations that are part of a “unitary group”—affiliated companies—to share tax credits. There is no tax policy justification for this—it is a pure tax giveaway to big business which makes absolutely no sense from a public policy perspective.

For example, a biomedical research and development firm that has incurred losses for the past 10 years—creating a store of more tax credits than it will ever be able to use on its own—could now share those with an affiliate company that has no tax credits at its disposal.

This is a change that the business community has never proposed in the Legislature because they know it is difficult, if not impossible, to justify from a tax policy perspective. To date, the state has always insisted that the credits be taken by the corporation that engaged in the activity which is eligible for the credit.

The true revenue impact of these provisions will not be known for years and will increase over time as companies alter their behavior to exploit these new tax loopholes.

This sharing of tax credits is estimated to cost from \$300 million to more than \$1 billion beginning in 2010-11. It would take a 2/3 vote of the Legislature to close this loophole once it has been opened.

Summary of Negative Aspects:

Increases the state’s structural budget deficit by about \$1 billion a year. The state faces a long-term structural deficit and should not pass law changes that further exacerbate this problem. The revenue the state will get from temporarily suspending the ability of large businesses to claim net operating loss deductions and business tax credits will be given back many times over in future tax breaks.

These tax policy violate principles of fair and equitable tax policy as discussed above.

Provides tax breaks to those who can most afford it, which will in turn shift the tax burden to working families and middle class taxpayers. Big business won, the ordinary taxpayer lost.

These tax changes are, for all practical purposes, permanent because of the state's 2/3 vote requirement to increase taxes.

Conclusion

The 2008-09 budget deal included three proposals which have not been adequately scrutinized by the public and the press. The midyear cut authority and spending cap ballot measure to which it is tied will hopefully be given a full public debate in the months leading up to the special election, whenever it may be.

On the contrary, the complex and convoluted nature of the budget process proposals will make it hard for the general public to accurately assess their true impact.

The business tax breaks are permanent, unless opponents collect the necessary signatures to put a measure on the ballot to overturn them.

The mainstream press has only picked up on the tip of the iceberg in terms of the impact that these proposals will have on the future of the California budget process. I urge you to take a close look at them and ask yourself whether they should be a permanent fixture in state government finance?

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