ITEM 9.F.

MOORPARK CITY COUNCIL
AGENDA REPORT

To: **Honorable City Council**

From: **John Brand, Senior Management Analyst** JB

Date: **February 14, 2007 (CC Meeting of 02/21/2007)**

Subject: **Consider Governor's Budget Proposal Regarding Transit Spillover Funding**

BACKGROUND

On January 17 the City Council directed staff to provide background information regarding how transit funding may be affected by the Governor's budget proposal for Fiscal Year 2007-2008. Of particular concern was the proposed alternative use of the so-called "spillover funds" generated by the state sales tax on gasoline.

Spillover funding was created as part of the Transportation Development Act (TDA) of 1971. Spillover revenue occurs and is transferred to the Public Transportation Account (PTA) when collections from the sales tax on gasoline increase at a faster rate than all other taxable items. The spillover amount is variable, but the formula was specifically designed to increase transit funding when gas prices are high and increasing at a faster rate than other taxable items. This is so transit agencies can cover their own higher fuel costs and meet demands for more transit from motorists priced out of their cars.

The transfer is based on a calculation required by law to be made by the Board of Equalization and Department of Finance every year. This calculation compares the revenue estimated to be generated by a state sales tax of 5% on all goods except gasoline to the revenue generated by a sales tax of 4.75% on all goods plus gasoline. (These rates come from a historical agreement between counties and the state to preserve revenue neutrality for the state General Fund.) Per the Revenue and Taxation Code section 7102(a)(1), if the amount calculated at 4.75% is greater, the difference or "Spillover" is transferred to the Public Transportation Account.

This spillover money is then split 50/50 between state transit priorities and the State Transit Assistance (STA) Program. STA funds are distributed by formula statewide, and then apportioned regionally to local public transit agencies. The STA Program is the only state program dedicated to funding transit operations. In Ventura County, STA funds have historically been used to partially fund the county's share of Metrolink commuter rail costs.

The Governor's initial 2007-2008 budget proposal would have diverted spillover revenue from the Public Transportation Account (PTA) to the General Fund. The Administration in the May Revise that was recently announced now proposes shifting these revenues to a new fund dedicated to paying part of the debt service on the new transportation bond. Based on current forecasts, the Governor estimates that over $4.1 billion in transit spillover revenues will be diverted over the next 10 years, with an initial diversion of $669 million in 2006-07, another diversion of $336 million in 2007-08, and further diversions the following years, in total $4.1 billion.

DISCUSSION

This may be a classic budget dilemma for policy makers, where conflicting public priorities of great individual merit intersect with various interest groups for the use of limited resources.

According to the Governor's office, his budget proposes total expenditures of $16.8 billion in 2007-08 for roads, highways, mass transit and intercity rail, vehicle licensing and registration, and highway law enforcement. This is an increase of $845 million from the 2006 budget. Total statewide transportation resources, which are estimated to be approximately $23.8 billion in 2007-08, will see an increase from $21.2 billion in the current year due to the transportation bond. This includes $1.4 billion for the full funding of Prop. 42.

Key concerns of critics of the Governor's proposal are claims that his shift of spillover funds is contrary to the legislative intent, and that it eliminates the only state assistance for operating expenses by using it to repay transportation bonds for capital funds. They also question using these funds for items such as school transportation that have traditionally been paid for with the state General Fund.

There are enormous sums of money involved at the state and federal levels, and the basic assumptions and projections of revenue and expenses used to prepare theses budgets can be quite variable, volatile, and open to interpretation. Staff could not identify any local government agencies or transportation planning agencies (VCTC, SCRRA, etc.) that have taken a position on the Spillover Funds. However, transit advocacy groups such as the California Transit Association (CTA) and certain legislators are actively in opposition of the Governor's proposal.

Attached for Council's reference are three documents: the Governor's budget message; an impartial analysis from the Legislative Analyst's Office; and a critique of the Governor's spillover plan from a transit advocacy group.

STAFF RECOMMENDATION

Direct staff as deemed appropriate.

Attachments

Attachment 1:	Governor's budget message press release
Attachment 2:	Legislative Analyst's Office 2007-08 Overview of Governor's Budget
Attachment 3:	"The Importance of Spillover Funding in California"

Attachment 1

Office of the Governor

ARNOLD SCHWARZENEGGER
THE PEOPLE'S GOVERNOR

PRESS RELEASE

01/10/2007 GAAS:020:07 FOR IMMEDIATE RELEASE

Gov. Schwarzenegger Proposes Budget that Eliminates Operating Deficit, Pays Off Debt Early, Creates $2 Billion Rainy Day Fund Without Raising Taxes

Gov. Schwarzenegger released a budget today that eliminates the operating deficit, fully funds education and pays down the state's debt.

"I am very happy to announce today that in this new budget, our net operating deficit has been reduced to zero," said Gov. Schwarzenegger. "It was not easy and our hard work is by no means finished. We must continue our discipline. We cannot slip back into the same old habits. As I have said many times we cannot make the same mistake of using onetime revenues for ongoing spending."

Since the Governor took office in November 2003, Gov. Schwarzenegger has focused on economic growth to increase the state's revenue. In that time, California has added more than 680,000 jobs and the state's general fund revenue has increased from $76 billion to $101.3 billion. The state also recently hit a 30 year low in the unemployment rate. In addition to spurring economic growth, Gov. Schwarzenegger has taken a disciplined approach and slowed the growth in state spending. In the proposed budget, general fund expenditures will increase by only one percent – the lowest rate of growth in general fund spending in five years.

"This budget is a responsible budget," said the Governor. "This is a prudent and realistic budget. This is a budget that lives within our means but still provides crucial services. It is a budget that moves California not right or left, but forward. I am proud of where we have come from and I am excited about where we are going."

The proposal includes $1.6 billion in pre-payments of the Economic Recovery Bonds (ERBs) and $88 million of other budgetary debt re-payments. This will bring the amount set aside to repay the ERBs to $7.4 billion in just four years since the bonds were first issued. As a result, the ERBs are on schedule to be fully retired in August 2009, 14 years ahead of schedule. The budget also creates a $2.1 billion rainy day fund.

Other important budget highlights include:

K-12 Education: This budget fully funds Prop. 98 at a record $56.8 billion. Total per pupil spending for K-12 has increased from $9,559 to $11,584 or a 21 percent increase since the Governor took office. Year over year, Prop. 98 funding increased by $1.8 billion and total per pupil spending increased by $344. Continuing the Governor's longstanding commitment vocational education, the budget provides $52 million to expand Career Technical Education course offerings and programs.

Higher Education: The Governor has continued to fund the Higher Education Compact, investing $7.5 billion of general fund money in our state colleges and universities, an increase of 6.9 percent.

Health and Human Services: General fund and other state spending for the agency is $38.1 billion, a 3.7

percent increase over the current year. That includes $8.8 million to fund 15 new positions to begin implementation of our new affordable prescription drugs program, $32 million to add 73,900 more kids to our Healthy Families Program and $217 million needed for cost-of-living adjustments for aged, blind and disabled SSI/SSP recipients.

Transportation: The Governor's budget proposes total expenditures of $16.8 billion in 2007-08 for roads, highways, mass transit and intercity rail, vehicle licensing and registration, and highway law enforcement. This is an increase of $845 million from the 2006 budget. Total statewide transportation resources, which are estimated to be approximately $23.8 billion in 2007-08, will see a major increase from $21.2 billion in the current year due to the transportation bond. This includes $1.4 billion for the full funding of Prop. 42.

Environment: The budget provides $36 million to begin implementing our new landmark Global Warming Law and $6 million for the Air Resources Board to continue development of the Hydrogen Highway. This will provide matching funds for up to eight publicly accessible hydrogen fueling stations and will prioritize funding for stations that generate hydrogen from promising renewable technologies, such as biomass, solar and wind energy.

CDCR: The budget proposes spending $10 billion for the operation of our prison system and investing $10.9 billion over the next several years via the Strategic Growth Plan to reduce overcrowding and recidivism. The budget also sets aside $150 million to upgrade our prison healthcare as required by the federal receiver. Additionally, the budget includes $193 million to implement Jessica's Law and other legislation increasing supervision of sex offenders.

The entire state budget can be found on the Web at the Department of Finance's Web site at http://govbud.dof.ca.gov/.

Attachment 2

January 12, 2007

2007-08: Overview of the Governor's Budget

The 2007-08 Governor's Budget proposes a major redirection of transportation funds, reductions in social services, and a variety of other actions to eliminate a significant shortfall in 2007-08. The plan assumes that adoption of its proposals will result in a balanced budget with an over-$2 billion reserve. However, the budget contains a significant number of downside risks and is based on a number of optimistic assumptions. Its key proposals also raise serious policy and legal issues. Adverse outcomes in just a few of these areas could easily eliminate most or all of the proposed reserve.

After a year in which the state was able to use surging revenues to significantly increase education spending and prepay budgetary debt, the situation for 2007-08 is much tougher. Reflecting these more difficult circumstances, the Governor's budget includes only a few program expansions, and instead proposes a number of budget-balancing actions, including a major redirection of transportation funds and significant reductions in social services, to eliminate a significant shortfall in the budget year.

Our Bottom Line

If the administration's assumptions were to hold, the Governor's proposal would both (1) produce a balanced budget with a healthy reserve in 2007-08 and (2) significantly reduce the state's ongoing structural shortfall. Even if all the budget's proposals were adopted, however, it is likely that the actual amount of budget savings and new revenues would fall short of the levels estimated by the administration. The Governor's key budget proposals raise a number of serious policy and legal issues, which may make their implementation problematic, and the budget's assumptions on matters ranging from the fiscal benefits of its solutions to the outcome of court cases appear to be optimistic. Adverse outcomes in just a few of these areas could easily eliminate most or all of the budget's proposed reserve.

Given the above factors, as well as the continuing existence of the structural budget shortfall facing the state, it will be important that the Legislature develop a more realistic budget which includes alternative budgetary solutions and avoids raising ongoing commitments (absent identified funding to pay for them).

How the Budget Covers the Shortfall

In November, we estimated that, under current-law revenue and expenditure policies, the state would conclude 2007-08 with a deficit of $2.4 billion. This consisted of a carryover reserve of $3.1 billion from the current year to offset an operating shortfall of $5.5 billion in 2007-08.

In contrast, the 2007-08 Governor's Budget includes a year-end reserve of $2.1 billion, an improvement of nearly $4.5 billion relative to our November baseline estimate. This difference reflects both policy actions assumed in the budget as well as its more optimistic assumptions relating to baseline revenues, expenditures, and the outcome of court cases. These factors, enumerated in Figure 1, can be separated into four major categories.

Figure 1

How the Governor's Budget Closes the 2007-08 Shortfall

(Dollars in Millions)

		Totals
LAO November Forecast		**-$2,411**
New Spending		**-$1,198**
Supplemental deficit-financing bond payment	-$595	
Other	-603	
Budget Solutions		**$3,438**
Substitute transportation special funds for General Fund expenditures	$1,111	
New tribal gambling compacts	506	
Substitute bond proceeds for General Fund expenditures	200	
CalWORKs reductions	496	
Shift some child care costs to Proposition 98	269	
Tax policy changes	200	
Other	656	
Baseline Estimates		**$1,178**
Higher revenue estimate	$641	
Lower expenditure estimate	537	
Court-Related Assumptions		**$1,078**
CalWORKs (*Guillen*)	$553	
Pension obligation bonds	525	
Budget Estimate of 2007-08 Reserve		$2,085

Spending Beyond Our November Baseline ($1.2 Billion). Relative to our baseline, the budget includes $595 million in additional spending for a supplemental payment toward retirement of outstanding deficit-financing bonds. It also includes $132 million above our baseline to University of California and California State University, and $471 million in various other state programs. In Figure 1, these factors have a negative sign, meaning that they worsen the deficit.

Budget Solutions ($3.4 Billion Savings). The single largest component is over $1.1 billion related to the redirection of monies from a transportation special fund to support certain transportation-related General Fund expenditures in the areas of

Proposition 98, general obligation bond debt service, and the Department of Developmental Services.

Other solutions include: new revenues from amended tribal gambling compacts, California Work Opportunity and Responsibility to Kids (CalWORKs) savings related to a suspension of the July 2007 cost-of-living adjustment (COLA) and time limits for children; substitution of bond fund proceeds for General Fund flood protection expenditures; elimination of General Fund support for deferred park maintenance; a shift of CalWORKs childcare to Proposition 98 (thereby reducing General Fund spending in the CalWORKs budget); and permanent elimination of the teachers' tax credit and permanent extension of recent changes involving application of the use tax to out-of-state sales of vessels, aircraft, and vehicles.

More Optimistic Baseline Estimates ($1.2 Billion). After adjusting for the impacts of policy-related changes, the budget's underlying forecast of General Fund revenues for 2005-06 through 2007-08 combined is about $641 million above our November projections. On the expenditure side, the administration's baseline estimate for the three years combined is $537 million below our November forecast. While there are a number of offsetting factors on the expenditure side, a key difference is that the administration is projecting higher local property taxes available to offset state spending on Proposition 98.

More Optimistic Assumptions About Pending Court Decisions ($1.1 Billion). Finally, the 2007-08 budget assumes that the state will prevail on its appeal in two cases where it has lost at the superior court level. One is the Guillen case, which involves retroactive application of a 2003 COLA to CalWORKs grants. The other is related to a validation case involving the sale of pension obligation bonds to cover a portion of the state contribution to its retirement fund. Our November estimates assumed that the state would incur added costs of over $500 million related to the Guillen case, and that no pension obligation bonds would be sold in the budget year or beyond.

As we note in the final section of this report, many of the assumptions regarding pending legal decisions, baseline estimates, and new revenues and/or savings from its proposed budgetary solutions are subject to considerable risk.

The Budget's Economic and Revenue Projections

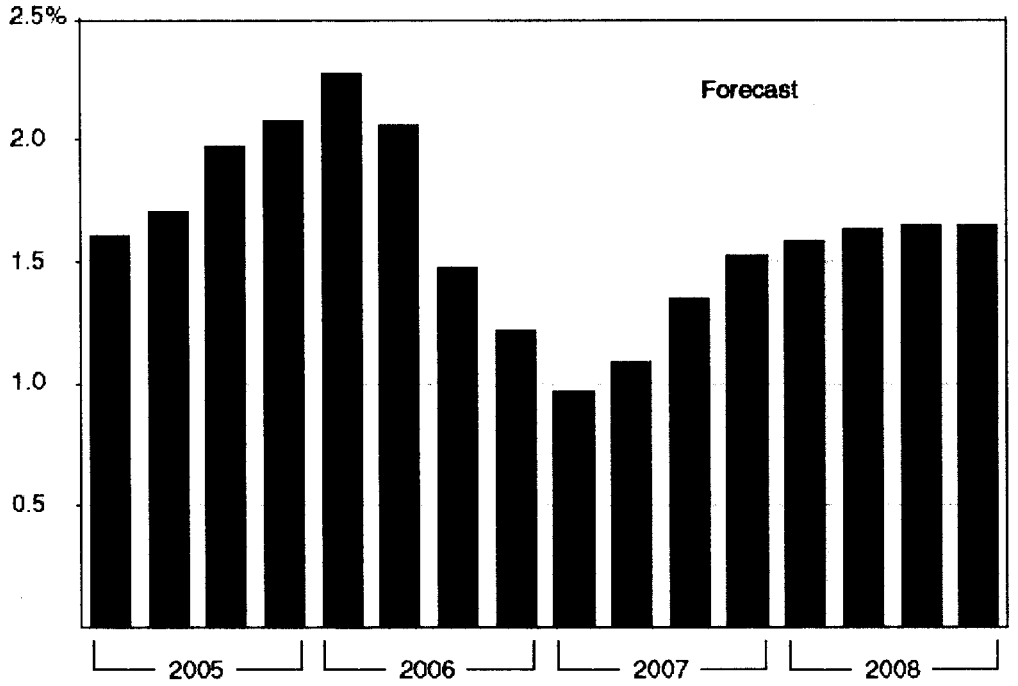
Economic Forecast- Sluggish Growth Through Mid-2007

The U.S. and California economic expansions clearly slowed over the course of 2006, reflecting high fuel prices through midyear and declines in home construction and sales of light vehicles. The budget forecast assumes that the slowdown will persist through the first half of 2007 before stabilizing real estate markets provide support for a mild upturn beginning in the second half of the year. On an annual average basis, the budget forecasts that U.S. gross domestic product growth will slow from 3.3 percent in 2006 to 2.4 percent in 2007, before partially rebounding to 2.9 percent in 2008. In California, wage and salary employment is projected to slow from 1.8 percent in 2006 to 1.2 percent in 2007, before rebounding to 1.6 percent in 2008 (see Figure 2).

Figure 2

Budget Predicts Sluggish California Job Growth Through Mid-2007

Year-to-Year Change in Nonfarm Employment, by Quarter



Modest Revenue Growth in 2006-07, Larger Increase in 2007-08

In contrast to last year, when tax-related cash receipts soared above expectations during the first half of the fiscal year, tax receipts during the first six months of this fiscal year fell slightly short of the budget act estimate, which itself assumed only modest growth in 2006-07.

The administration's forecast assumes that current trends will improve modestly in the second half of this fiscal year, but that total revenues and transfers will still increase by only 1.7 percent from the prior year-reaching $95 billion for all of 2006-07. Major taxes are projected to increase by a slightly stronger rate of 2.7 percent. In 2007-08, the budget forecast projects that revenues and transfers will be $102.3 billion, a 7.7 percent increase from the current year. The increase is boosted by the proposed expansion of tribal gambling compacts as well as one-time receipts from the assumed sale of the pension obligation bonds. Adjusting for these and other special factors, revenues are expected to increase by slightly over 6.5 percent in the budget year.

LAO Assessment. After adjusting for policy-related changes, the administration's forecast is down from our November projections by $70 million in the prior year, but up by $328 million in the current year, and $383 million in 2007-08-for a three-year total of $641 million. At this time, recent mixed developments relating to both the economy and cash receipts would not appear to support such an upward adjustment. However, cash

receipts during the next two weeks will provide us with a clearer picture of current revenue trends. During this period, the state will be receiving payments related to the fourth quarter estimated taxes from individuals, which are due on January 15. Historically, the strength in these payments has been an early indicator of the strength or weakness in final payments that are remitted in April. Early signs are not particularly positive, but we will be reviewing the upcoming collections data, along with other new economic and revenue information for purposes of making a more complete assessment of the updated revenue outlook. Our updated projections will be included in The 2007-08 Budget: Perspectives and Issues released next month.

Budget Overview

Total Budget Spending

The budget proposes total state spending in 2007-08 of $131 billion (excluding expenditures of federal funds and bond funds). General Fund spending is projected to increase from $102.1 billion to $103.1 billion (an increase of 1 percent), while special funds spending rises from $24.5 billion to $27.7 billion.

General Fund Condition

Figure 3 shows the General Fund's condition from 2005-06 through 2007-08 under the budget's assumptions and proposals. It shows that:

- The 2005-06 fiscal year concluded with a reserve of slightly under $10.1 billion. The large reserve reflects major increases in revenues in 2004-05 and 2005-06, as well as strong amnesty payments received in 2004-05. It also reflects the proceeds of the deficit-financing bonds issued in 2003-04.
- In 2006-07, expenditures (at $102.1 billion) are expected to exceed revenues (at $95 billion) by slightly over $7.1 billion, leaving $2.9 billion in the reserve.
- In 2007-08, expenditures increase slightly to $103.1 billion, while revenues are projected to reach $102.3 billion. The $800 million operating shortfall reduces the year-end reserve to $2.1 billion by the close of the budget year.

Figure 3

Governor's Budget General Fund Condition

(Dollars in Millions)

			Proposed for 2007-08	
	2005-06	2006-07	Amount	Percent Change
Prior-year fund balance	$8,981	$10,816	$3,670	
Revenues and transfers	93,427	94,991	102,300	7.7%
Total resources available	$102,408	$105,807	$105,971	
Expenditures	$91,592	$102,137	$103,141	1.0%
Ending fund balance	$10,816	$3,670	$2,830	
Encumbrances	$745	$745	$745	

Reserve	$10,071	$2,925	$2,085
Budget Stabilization Account	—	472	1,495
Reserve for Economic Uncertainties	10,071	2,453	590

Key Features of the Budget Proposal

The main programmatic and related features of the budget are shown in Figure 4. The budget provides funding to address a number of previously identified issues relating to inmate capacity and health care in the state's prison system. However, in other areas, there are relatively few major new initiatives. (The Governor's health care reform proposal is not reflected in the budget.) Funding is generally provided to cover caseload and implementation costs associated with initiatives adopted in the current year. The two areas of the budget experiencing the biggest reductions are social services and transportation.

Figure 4

Key Programmatic Features of the 2007-08 Budget Proposal

Proposition 98

- Implements current-year program expansions, but does not propose new expansions for budget year. Uses $1.9 billion funding increase to cover a 4 percent cost-of-living adjustment (COLA) in K-12 and provides additional support for CalWORKs-related child care.
- Rebenches the minimum guarantee related to transportation proposal discussed below.
- Increases community college funding to cover a 4 percent COLA, 2 percent enrollment growth, and the full-year costs associated with backfill of the student fee reduction that takes effect in the middle of 2006-07.

UC and CSU

- Provides funding to cover 4 percent base increases and 2.5 percent enrollment growth in both segments. Proposes student fee increases of 7 percent for UC and 10 percent for CSU. The increased fees would be retained by the segments.
- Eliminates state support for outreach programs.
- Proposes $70 million in lease-revenue bonds and $20 million in General Fund support to UC for a research initiative on technological innovation.

Transportation

- Uses $1.1 billion from the Public Transportation Account to replace General Fund spending in three areas: Proposition 98 funding on home-to-school transportation; transportation services provided by regional centers; and debt service on general obligations bonds issued for transportation projects.

Health and Social Services

- Suspends the July 1, 2007, COLA for CalWORKs grants, and places new time limits and sanctions on children whose parents cannot or will not comply with CalWORKs participation requirements.
- Makes relatively few significant changes in health programs. Does not reflect impacts of Governor's proposed health care reforms.

Criminal Justice

- Provides significant funding increases in the Department of Corrections and Rehabilitation to cover price increases, inmate growth, compliance with various court orders, and a new probation grant program. Includes some offsetting savings from a proposed change in parole policies and shifts juvenile

offenders to county facilities.

- • Proposes capital outlay spending of about $10 billion—mostly funded with lease-revenue bonds—that is generally consistent with the prison capacity package recently announced by the Governor.

Revenues

- • Includes $506 million resulting from amended tribal gambling compacts.
- • Proposes permanent elimination of the teachers' tax credit and permanent extension of the recent use tax law changes.
- • Assumes $78 million in new revenues from audit-related proposals to address the "tax gap."

Total General Fund Spending by Program Area

Figure 5 shows General Fund spending by major program area. As has been the case in recent years, the year-to-year changes in many programs are being affected by special factors, such as transfers of programs, funding redirections, availability from other sources, and one-time actions. For example, while part of the 34 percent decline in CalWORKs is related to significant proposed reductions in the program, a portion is also due solely to a funding shift in CalWORKs-related child care expenditures to Proposition 98.

Figure 5

General Fund Spending by Major Program Area

(Dollars in Millions)

	Actual 2005-06	Estimated 2006-07	Proposed for 2007-08 Amount	Proposed for 2007-08 Percent Change
Education Programs				
K-12 Proposition 98	$34,582	$36,658	$36,851	0.5%
CCC Proposition 98	3,670	4,040	4,224	4.6
UC/CSU	5,444	5,895	6,246	6.0
Other	3,939	4,792	5,193	8.4
Health and Social Services				
Medi-Cal	$12,358	$13,649	$14,629	7.2%
CalWORKs	1,963	2,014	1,324	-34.3
SSI/SSP	3,427	3,543	3,893	9.9
IHSS	1,355	1,444	1,471	1.9
Other	7,238	9,170	8,558	-6.7
Youth & Adult Corrections	$7,783	$9,236	$10,043	8.7%
Transportation	$1,699	$2,993	$1,558	-47.9%
All Other	$8,133	$8,704	$9,150	5.1%
Totals	**$91,592**	**$102,137**	**$103,141**	**1.0%**

Similarly, the low growth in General Fund expenditures on Proposition 98 in 2007-08 is due to two factors: (1) a transfer of $627 million in home-to-school transportation expenses to a transportation special fund; and (2) nearly 10 percent property tax growth (which offsets, dollar for dollar, General Fund obligations to Proposition 98). Finally, the large decline in transportation funding between 2006-07 and 2007-08 reflects large one-time loan repayments to transportation special funds made in the current year.

The Plan for Individual Program Areas

In this section, we provide additional discussion for Proposition 98 and certain other programs which are significantly affected by the Governor's budget's proposals.

Proposition 98

Figure 6 summarizes the Governor's Proposition 98 budget proposal for K-12 schools and community colleges. For 2007-08, it provides $56.8 billion in total K-14 Proposition 98 funding. This is an increase of $1.8 billion, or 3.3 percent, over the revised current-year estimate. (This funding level, however, reflects the "rebenching" of the Proposition 98 requirement downward by $627 million to account for the proposed shift of school transportation funding, as discussed below.) As shown in the figure, most of the increase in proposed K-14 Proposition 98 funding would be covered by growth in local property tax revenues ($1.4 billion).

Figure 6

Proposed Proposition 98 Funding

(Dollars in Millions)

	2006-07 Revised	2007-08 Proposed	Change From 2006-07 Revised	
			Amount	Percent
K-12	$49,011	$50,446[a]	$1,435	2.9%
California Community Colleges (CCC)	5,897	6,274	380	6.4
Totals[b]	**$55,022**	**$56,835**	**$1,813**	**3.3%**
General Fund	($40,812)	($41,190)	($378)	(0.9%)
Local property tax revenue	(14,210)	(15,645)	(1,435)	(10.1)
Per Pupil Spending				
K-12 average daily attendance	5,940,989	5,917,948	-23,041	-0.4%
K-12 funding per pupil	$8,250	$8,525[c]	$275	3.3
CCC full-time equivalent students (FTES)	1,153,025	1,176,086	23,061	2.0
CCC funding per FTES	$5,114	$5,335	$220	4.3

a Reflects Governor's proposal to fund the Home-to-School Transportation program ($627 million) from the Public Transportation Account and rebench the Proposition 98 guarantee down by a like amount. If the swap were not to occur, the year-to-year change for K-12 would be $2.1 billion, or 4.2 percent.

b Total Proposition 98 amounts include around $115 million in funding that goes to other state agencies

for education purposes.

- If the transportation funding swap were not to occur, K-12 per pupil funding in 2007-08 would be $8,631, reflecting a 4.6 percent increase over the current year.

K-12 Education

Year-to-year K-12 Proposition 98 comparisons are complicated by the proposed transportation funding shift. As shown in Figure 6, if the shift were to occur, total K-12 Proposition 98 funding would increase by $1.4 billion, or 2.9 percent, from 2006-07. If the $627 million shift were not to occur, total K-12 Proposition 98 funding would increase by $2.1 billion, or 4.2 percent, from 2006-07.

Similarly, comparisons of Proposition 98 per pupil funding rates also are complicated by the proposed shift. If the shift were to occur, the 2007-08 Proposition 98 per pupil funding rate would be $8,525, an increase of $275, or 3.3 percent, from the revised current-year estimate. If the $627 million shift were not to occur, the 2007-08 per pupil funding rate would be $8,631, an increase of $381, or 4.6 percent, over 2006-07.

Budget Maintains Existing Programs With Few Expansions. The 2007-08 budget proposal contains relatively few Proposition 98 program expansions. The primary funding increases go toward providing COLAs and increasing the Proposition 98 share of the state's child care program. Partial funding for these expenditures comes from savings associated with declines in K-12 attendance.

- ***Fully Funds COLAs ($1.9 Billion).*** The proposal fully funds both statutory and discretionary COLAs. Specifically, the budget provides $1.9 billion for a 4.04 percent COLA-$1.4 billion for revenue limits and $516 million for categorical programs.
- ***Increases Proposition 98 Spending for Child Care ($269 Million).*** The Governor proposes to increase Proposition 98 funding for CalWORKs child care by $269 million. This proposal would free up a comparable amount of federal Temporary Assistance for Needy Families funds for other CalWORKs purposes, thereby offsetting General Fund costs and creating savings for the state. This funding shift proposal would not affect total monies available for child care or the level of child care services.
- ***Recognizes Savings From Declining Attendance (About $90 Million).*** The budget assumes that student attendance will decline by 0.39 percent from 2006-07 to 2007-08. The Governor's budget shows roughly $90 million in associated attendance- related savings.

Proposed School Transportation Funding Shift. The budget proposes to use the Public Transportation Account (PTA) in lieu of Proposition 98 to fund the $627 million Home-to-School Transportation program. In a related action, it would "rebench" the Proposition 98 minimum funding requirement downward by a like amount, thereby freeing up $627 million in General Fund monies. As with the proposed child care funding shift, this shift would not affect total funding for school transportation or the level of school transportation services. We think the proposed funding shift and rebenching of the Proposition 98 guarantee raises serious policy and legal issues and may not achieve the proposed General Fund savings.

Additional K-12 Education Expenditures. The budget also includes the following expenditures from one-time funds:

- ***Quality Education Improvement Act ($268 Million).*** The budget includes the first installment of a $2.9 billion settlement agreement related to Proposition 98 K-14 funding requirements. The bulk of the funds are for reducing class size in grades 4-12 in about 500 low-performing schools.
- ***School Facilities ($6.9 Billion).*** The budget proposes to spend $6.9 billion in bond monies in 2006-07 and 2007-08 for school facilities. Of the $6.9 billion, $3.1 billion comes from the 2006 School Facilities Bond (authorized by Proposition 1D) and the remainder comes from the 2004 and 2002 school bonds. The Governor's Strategic Growth Plan proposes to seek an additional $6.5 billion in general obligation bonds for K-12 school facilities on the 2008 ballot and $5.1 billion on the 2010 ballot.
- ***Various One-Time Expenditures ($252 Million).*** The Governor proposes to spend $186 million from the Proposition 98 Reversion Account. The bulk of these one-time monies are designated for emergency facility repairs at low performing schools ($100 million), facility lease costs for charter schools located in low-income areas ($44 million), and child care ($26 million). In addition, the budget proposes to spend $65 million in 2006-07 attendance-related savings for various one-time purposes. The bulk is for continuing teacher block grants to low performing schools for a third year ($50 million) and establishing a new program to recruit retiring professionals into teaching ($10 million).

California Community Colleges

The Governor's budget proposes $380 million in increased Proposition 98 expenditures for community colleges in 2007-08. This reflects a 6.4 percent increase over the revised current-year estimate. Major new expenditures include:

- ***COLAs and Growth ($354 Million).*** The proposal provides funding for COLAs at the same rate (4.04 percent) as K-12's statutory rate. It also funds an assumed 2 percent growth in enrollment. This exceeds the statutory minimum guideline based on population growth, which is estimated to be 1.65 percent.
- ***Annualized Costs Related to 2006-07 Student Fee Reduction ($33.2 Million).*** Student fees were reduced-effective January 2006-from $26 per unit to $20 per unit. The state provided the community colleges $40 million in the current year to make up for the reduced fees revenues. The budget proposes an additional $33.2 million for the full-year impact in 2007-08 of the lower fee level.

Transportation

Transfer of Proposition 42 Funds to Transportation

Proposition 42, approved by voters in 2002, requires that revenue from the sales tax on gasoline that previously went to the General Fund be transferred into the Transportation Investment Fund for transportation purposes. For 2007-08, the budget proposes to transfer $1.475 billion to transportation, as required by Proposition 42. Of the amount, $602 million would be for the Traffic Congestion Relief Program, $698 million for the State Transportation Improvement Program, and $175 million would go to PTA.

Consistent with current law, none of the Proposition 42 funds in 2007-08 would be allocated to local governments for streets and road purposes.

Partial Repayment of Proposition 42 Loan

Due to the state's fiscal condition, the Proposition 42 transfer was suspended partially in 2003-04 and fully in 2004-05. By the end of 2006-07, there will be about $750 million in outstanding Proposition 42 loans that must be repaid from the General Fund. Proposition 1A, passed by voters in November 2006, requires that the amount be repaid, with interest, no later than June 30, 2016, with minimum annual repayment of one-tenth the amount owed. The budget proposes to repay from the General Fund $83 million, about one-ninth of the outstanding amount in 2007-08.

Use PTA for General Fund Expenditures

State law requires certain "spillover" gasoline sales tax revenue (the amount exceeding the amount generated from one-quarter percent sales tax on all other goods) to be deposited in the PTA. The account also receives diesel fuel sales tax revenues as well as a portion of the annual Proposition 42 funds for transportation (as noted above). Funds in the PTA are available only for transportation planning and mass transportation purposes. Current law also requires that one-half of PTA revenues be allocated to support transit operations (mainly bus and rail) under the State Transit Assistance (STA) program. The remaining revenues are used to support transportation planning, provide intercity rail services, and fund transit capital improvements.

The budget proposes several changes to the allocation of spillover funds (projected to be $617 million in 2007-08) and to the use of PTA funds. In total, these proposals would result in $1.1 billion being used in 2007-08 for expenditures that currently are funded from the General Fund.

- ***Use a Portion of Spillover for Debt Service on Transportation Bonds.*** The budget proposes to retain the first $340 million in spillover in 2007-08 to pay debt service on outstanding transportation bonds. (These include general obligation bonds issued under Propositions 108 and 116 in 1990 and Proposition 192 in 1996.) Traditionally, debt service for these bonds has been paid from the General Fund. The budget proposes a one-time shift in the fund source for these payments in 2007-08. Debt service in 2008-09 would be paid again from the General Fund.
- ***Use PTA to Offset General Fund Expenditures.*** The budget proposes about $771 million in PTA money to fund home-to-school transportation ($627 million) and regional center transportation ($144 million) in 2007-08. Currently, home-to-school transportation is paid from Proposition 98 school funding. The budget proposes the funding shift to PTA on a permanent basis and to rebench the Proposition 98 funding level. The proposal to fund regional center transportation from PTA instead of the General Fund, however, would be a one-time shift for the budget year only.
- ***No Spillover for STA.*** The budget proposes to permanently discontinue the allocation of spillover revenue to STA. For 2007-08, the proposal would free up $309 million in PTA revenue for other uses.
- ***Reduce 2007-08 STA by the Extra Amount Appropriated in 2006-07.*** The current-year budget appropriated $624 million to STA, in part based on overly high gasoline price projections. As a result, the program received about

$102 million more than it otherwise would. The budget proposes to offset this amount by reducing the 2007-08 funding level by a corresponding amount.

- ***Fund Only Staff Support for High Speed Rail Authority.*** The budget proposes to indefinitely postpone the bond measure for the development of a statewide high-speed rail system, which is scheduled for the November 2008 ballot. This would free up bonding capacity for other capital improvements proposed by the Governor. At the same time, the budget proposes $1.2 million from PTA for staff support of the authority, but no funding for any contracted services to develop the system.

The budget projects a PTA balance of $69 million at the end of the budget year. Because spillover revenue is very volatile and could fluctuate greatly depending on gasoline prices and the economy, lower than projected gasoline prices could result in significantly lower spillover revenue (as well as Proposition 42 funds) into PTA. For instance, if gasoline prices are just 5 percent lower than the budget projects (a price of $2.73 per gallon rather than $2.87 per gallon), everything else being the same, PTA would not have sufficient funds to pay for all the expenditures proposed in the budget. In that event, it is not clear what expenditures would be excluded as the administration has yet to identify its expenditure priorities for PTA funds.

Tribal Gambling Bond Revenue

Chapter 91, Statutes of 2004 (AB 687, Nuñez), provided $1.2 billion in bond funds to repay certain transportation loans made to the General Fund. The bonds would be backed by tribal gambling revenues, which have been accruing at $25 million per quarter. The current-year budget assumes that bonds would be issued in 2006-07 to repay $827 million (plus interest) in loans to the General Fund. Due to pending lawsuits, the bonds will not be issued in the current year, and most likely not in 2007-08. Absent the bonds, the budget proposes to use $100 million of tribal gambling revenue in each of the current and budget years to repay a portion of the loan.

Social Services

The budget proposes $9.4 billion from the General Fund for the state's social services programs, a reduction of about $580 million (5.8 percent) compared to 2006-07. This overall decrease is attributable to substantial reductions in CalWORKs and federal penalty relief in child support, partially offset by increased costs in the Supplemental Security Income/State Supplementary Program (SSI/SSP).

COLAs. The budget provides the statutory January 2008 SSI/SSP COLA at an estimated cost of $217 million. The budget suspends the July 2007 CalWORKs COLA resulting in savings of $140 million. The budget does not provide the discretionary Foster Care COLA or inflationary adjustments for county administration.

Increasing CalWORKs Sanctions. Currently, when an able-bodied adult does not comply with CalWORKs participation requirements, the family's grant is reduced by the adult portion, resulting in a "child-only" grant. The budget proposes a "full family sanction" whereby the reduced grant for the children is eliminated if an adult is out of compliance with participation requirements for three months. In response to this increased sanction, the budget estimates that many families will enter employment, resulting in child care and employment services costs of $28 million. In cases where

families do not comply, the budget estimates grant and administrative savings of $17 million, so the net cost of this proposal is about $11 million.

Time Limits for Aided Children. Currently, after five years of assistance, a family's grant is reduced by the adult portion, and the children continue to receive a child-only grant in the safety net program. The budget proposes to eliminate the safety net grant for children whose parents fail to comply with the federal work participation requirements (20 hours per week for families with a child under age 6 or 30 hours per week for families where all children are at least age 6). The budget also proposes to limit assistance to five years for most other child-only cases (such as those with parents who are undocumented or ineligible due to a previous felony drug conviction). These time limit policies are estimated to result in savings of about $335 million in 2007-08.

Guillen *Law Suit.* A superior court has ruled in the Guillen court case that the October 2003 COLA is required by current law. In December 2006, an appellate court heard the state's appeal and a decision is anticipated in February 2007. Unless the appellate court overturns the prior decision, the state faces one-time CalWORKs grant costs of about $435 million, plus ongoing costs of about $115 million, neither of which are included in the Governor's budget.

State Administration

Employee Compensation and Retirement

Employee Compensation. The Governor's budget proposes an appropriation of $468 million from the General Fund to cover the budget-year costs of new employee compensation costs. Specifically, the budget provides funding to pay for the costs associated with existing collective bargaining agreements, which generally provide for an inflation-based pay increase. The budget assumes that increase will equal 3.3 percent. There are no funds set aside to pay for any potential costs related to a new agreement for the only bargaining unit-correctional officers-without a current agreement. The budget, however, accounts for General Fund costs of $240 million in the current and budget years to pay for a recent arbitration decision which found that the state had miscalculated past pay raises for correctional officers.

Pension Obligation Bonds. Existing law authorizes the sale of pension obligation bonds to cover a portion of the state's retirement costs. The budget assumes the administration will sell these bonds in 2007-08 for a net General Fund benefit of $525 million. The sale of the bonds has been repeatedly delayed due to court decisions that concluded that the sale is unconstitutional without voter approval.

California State Teachers' Retirement System (CalSTRS). Current law requires funds to be annually appropriated from the General Fund to CalSTRS to ensure that retired teachers' benefits are not eroded by inflation. The program protects retirees to 80 percent of the purchasing power of their original pension, but the benefit is limited to the amount of money available. The budget proposes to reduce the statutorily required contribution to this program by $75 million on an ongoing basis. In exchange for the payment reduction, the administration will be proposing language to guarantee the inflation protection benefit for retirees. The remaining payment stream after the reduction is assumed to be sufficient to keep the program actuarially sound. In 2003-04, the state reduced funding for this program by $500 million on a one-time basis. In contrast to the current proposal, that reduction was not accompanied by a change in the

benefit guarantee, and a superior court decision (currently on appeal) requires that the state repay the funds.

Tribal Revenues

The budget assumes that General Fund revenues derived from tribal casinos grow from $33 million in 2006-07 to $539 million in 2007-08. The estimate is based on the assumption that amended gambling compacts proposed by the Governor in 2006 with tribes that operate some of Southern California's largest casinos will be approved by the Legislature. The proposed compact amendments would allow these casinos to operate 22,500 new slot machines. The tribes would make annual General Fund payments equal to a fixed amount plus a percentage of revenues derived from new slot machines. To date, the administration has provided very limited information about the reasoning behind its revenue estimates for the proposed compact amendments. A key assumption is how quickly tribes would add new slot machines. Even if the Legislature quickly approved the new compacts, we believe the level of revenues assumed for the budget year is probably still overstated by $300 million.

Statewide Savings

As in the current year, the budget proposes to capture $100 million in savings through mid-year reductions in departmental appropriations. In recent years, these savings have been concentrated in a few departments and tended to relate to items that occur "on the natural"-revised caseload estimates or other unexpected events which reduce the cost of programs.

Information Technology (IT)- New Fiscal System

In 2005-06, the Department of Finance began work on developing a new budget system for the state. The project had a budget of $138 million. The administration proposes to dramatically expand the original project's scope to include revamping most of the state's fiscal IT systems. The project, now known as the Financial Information System for California, would cost $1.3 billion over the next decade. The budget proposes $36 million and 238 positions for the project in 2007-08.

Infrastructure

In November 2006, the state's voters approved $42.7 billion in general obligation bonds for infrastructure spending on transportation, education, flood control, resources, and housing. The administration proposes commitments of roughly $14 billion by the end of the budget year. The Governor proposes additional general obligation bonds totaling $29.4 billion to be put before the voters by 2010. As shown in Figure 7, the new bonds would primarily be for education ($23.1 billion). In addition, the Governor proposes the use of lease-revenue bonds totaling $11.9 billion-primarily for corrections and local jails. In the budget year, the budget proposes $478 million in direct General Fund appropriations for capital outlay purposes, with the majority of these funds for projects in the California Department of Corrections and Rehabilitation.

Figure 7

Approved and Proposed General Obligation Bonds

2006 Through 2010 (In Billions)

	Approved 2006	Proposed 2008 and 2010	Totals
Transportation	$19.9	—	$19.9
K-12 Education	7.3	$11.6	18.9
Higher Education	3.1	11.5	14.6
Flood control	4.9	4.0	8.9
Resources	4.6	—	4.6
Housing	2.9	—	2.9
Courts and other	—	2.3	2.3
Totals	**$42.7**	**$29.4**	**$72.1**

Budget's Impact on the Structural Deficit

In our November Fiscal Outlook report, we indicated that, under current-law revenue and expenditure policies, the state faces annual operating shortfalls (that is, the difference between annual revenues and annual expenditures) averaging slightly under $5 billion over the next three years. If the Governor's budget proposals were fully adopted and all of the assumed savings were fully realized, our projected operating shortfalls would be reduced by roughly one half over this period. However, as discussed below, we believe that the fiscal benefits of many of the budget's key proposals are overstated, and that the actual decline in operating shortfalls would be significantly less.

Issues and Considerations

The Legislature will face a number of key issues as it proceeds to review the proposal and craft its own budget plan over the next several months. Clearly, the budget raises a number of key policy issues with regard to its proposals to divert public transportation funds and increase CalWORKs sanctions for families that fail to comply with its work requirements as well as impose new time limits on CalWORKs children. In addition, the proposal to issue new pension obligation bonds is at cross purposes with the administration's goal to reduce budgetary debt.

Aside from the policy considerations, however, we believe that the budget relies on optimistic assumptions in a number of areas. While any budget is subject to risks and uncertainties, we believe that the number and magnitude of these risks is unusually high in the current plan. These risks fall into three areas:

- ***Legal Issues.*** As noted in Figure 1 of this report, the budget is assuming that the state will prevail on its appeal of cases involving CalWORKs grants and the legality of pension obligation bonds. In addition, there may be legal issues with regard to the Governor's proposal to reduce the Proposition 98 guarantee to reflect the funding shift for home-to-school transportation to the PTA.

- ***Fiscal Benefits From Proposed Solutions.*** There are a number of areas where the budget's estimates of revenue increases or spending reductions resulting from its proposals are optimistic. For example, we believe that the additional revenues that would result from the Governor's proposed amendments to certain tribal gambling compacts are overstated by $300 million. Similarly, the availability of PTA funds to support added home-to-school transportation costs over time will depend in part on future gas prices. For instance, if prices fall, the amount of funds to the PTA could decline significantly, in which case the costs of providing home-to-school transportation would revert to the General Fund. Finally, the budget includes $100 million of unspecified savings in state operations. ***Baseline Assumptions.*** Our initial review suggests the current baseline estimates are on the optimistic side. Although the revenue picture could change once we receive year-end tax-related information, recent revenue developments have been somewhat mixed, and do not appear at this time to support the administration's higher revenue estimates relative to our November forecast. Also, the administration is assuming that local property taxes available to support Proposition 98 will increase by 10 percent, despite the current slowdown in the real estate market. If property tax growth proves to be less robust, any shortfall relative to the budget estimate will be offset, dollar for dollar, by an increase in state General Fund expenditures.

The downside risks in this budget could easily exceed the $2.1 billion reserve budgeted for 2007-08. It is also important to remember that the state continues to face a significant ongoing structural shortfall in its budget, as well as pressures related to unfunded retiree health care costs and potential additional costs to the state's correctional health care system. In view of these factors, it will be important that the Legislature develop a more realistic budget which includes alternative budgetary solutions and avoids raising ongoing commitments (absent identified funding to pay for them).

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Attachment 3

The Importance of Spillover Funding in California

The Governor's Spillover Proposals

The Governor's initial 2006-2007 budget proposal would have diverted so-called "Spillover" revenue from the Public Transportation Account (PTA) to the General Fund. The Administration in the May Revise now proposes shifting these revenues to a new fund dedicated to paying part of the debt service on the new transportation bond. Based on current forecasts, **the Governor estimates that over $4.1 billion in transit "spillover" revenues will be diverted over the next 10 years**, with an initial diversion of $669 million in 2006-07 and another diversion of $336 million in 2007-08.

2006-07 Proposed Cuts to the PTA		
YEAR	**$ Loss**	**Where PTA Funds Would Go**
2006-07	$544 million	Transfer "spillover" to the bond debt service
	$125 million	Transfer "spillover" to the Bay Bridge Toll Account
Total	**$669 million**	

The History of Spillover Funds

Spillover funding was created as part of the Transportation Development Act (TDA) in 1971. Spillover revenue occurs and is transferred to the Public Transportation Account when collections from the sales tax on gasoline increase at a faster rate than all other taxable items. **The spillover amount is variable, but the formula was specifically designed to increase transit funding when gas prices are high.** This is so transit agencies can cover their own higher fuel costs and meet demands for more transit from motorists priced out of their cars.

The transfer is based on a calculation required by law to be made by the Board of Equalization and Department of Finance every year. This calculation compares the revenue estimated to be generated by a state sales tax of 5% on all goods *except* gasoline to the revenue generated by a sales tax of 4.75% on all goods *plus* gasoline. (These rates come from a historical agreement between counties and the state to preserve revenue neutrality for the state General Fund.) Per Revenue and Taxation Code section 7102(a)(1), if the amount calculated at 4.75% is greater, the difference or "Spillover" is transferred to the Public Transportation Account.

This money is then split 50/50 between state transit priorities and the State Transit Assistance (STA) Program. STA funds are distributed by formula statewide, and then apportioned regionally to local public transit agencies. While these funds can be used for operations, maintenance and capital, **the State Transit Assistance Program is the *only* state program dedicated to funding transit *operations*.**

The Inefficiency and Inequity of Using Spillover Dollars for Debt Service

The Governor acknowledged that, "Over the last two decades, the bulk of the spillover funds have been redirected to the General Fund." **Yet, the Administration's new proposal would divert another projected $4.1 billion in funds away from transit – more than the $4 billion included for transit capital in the new transportation bond measure! *Thus, the bond deal actually costs transit money!*** It's also **inefficient**, wiping out funds that transit agencies would need to operate any new transit capital, buses or rail transit systems they might fund through the bond measure.

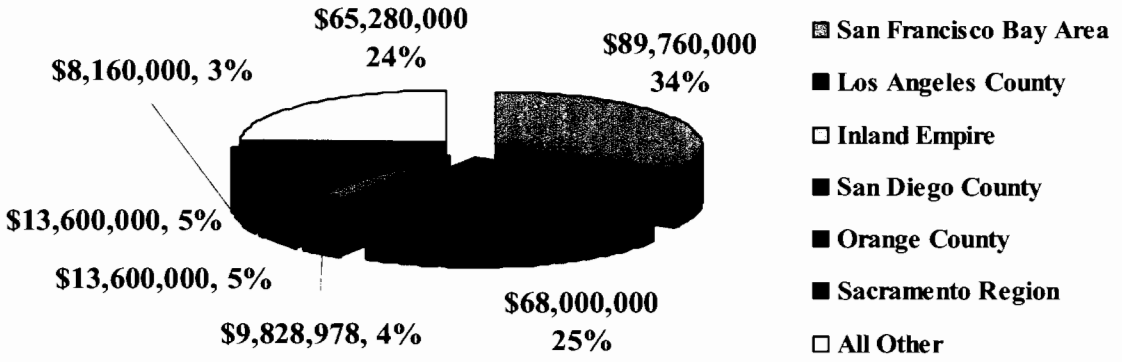
Using dedicated transit funds to pay the debt service on a General Obligation bond measure that is 75% road- and highway-oriented is also **inequitable for those who depend on transit.** Spillover funds help offset the

The Importance of Spillover Funding in California

burden of high fuel prices on residents and transit agencies at the times when Californians rely most heavily on transit services to reach work, school, medical appointments, shopping, services and more.

The chart below shows the STA funding cuts that would take place throughout the state if "spillover" dollars are not transferred to the Public Transportation Account in 2006-07.

2006-07 State Assistance Program Cuts if Spillover is Ripped Off



The Public Transportation Account has already been hit with huge cuts over the last five years:

PTA's Revenue Losses Since FY 2000-01		
	$ Loss	**Where PTA Funds Went**
2000-01	$70 million	Loan to Toll Bridge Seismic Retrofit Program
	$275 million	Loan to the Traffic Congestion Relief Fund
2002-03	$100 million	Loan to the General Fund
2003-04	$87.5 million	Transfer "spillover" to General Fund
	$93.4 million	Suspension of the PTA's share of Proposition 42
2004-05	$108 million	Divert revenue from sale of Caltrans property
	$105.8 million	Suspension of the PTA's share of Proposition 42
	$140 million	Transfer "spillover" to other programs
2005-06	$380 million	Transfer "spillover" to other programs
Total	**$1.36 billion**	

With the Governor's new proposal, the Public Transportation Account will face **another large cut of $669 million dollars this year**, resulting in:

$1.36 billion + $669 million = **$2.029 billion TOTAL CUTS**

In the face of continuing high gas prices, please support Californians' needs for public transportation services by protecting Spillover funds for transit!

Transit: Freedom • Choice • Independence • Access