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## Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Betsy Shotwell  
Roxanne Miller

**SUBJECT:** UPDATE ON STATE BUDGET  
AND 4X SPECIAL SESSION

**DATE:** November 26, 2008

Approved

*Christine J. Shipp*

Date

*11-26-08*

### INFORMATION

With the Legislature scheduled to adjourn the 2008-09 Legislative Session and extraordinary sessions *sine die* on November 30, Floor Session was convened in both Houses on November 25, but failed to pass the Democrats' \$17.1 billion package to deal with the State's budget shortfall that has now grown to more than \$28 billion over the next 18 months. The following summarizes actions taken by the Governor and State Legislature since the Governor declared another fiscal emergency and called for a new extraordinary session on November 6.

Governor Schwarzenegger called the Fourth Extraordinary Session of the 2007-08 Legislative Session to deal with a staggering current year budget shortfall of \$11.2 billion and budget-related matters, including legislation to stimulate the economy, create and retain jobs; and address the housing foreclosure crisis and solvency of the unemployment insurance fund. On November 6, the Governor released his Special Session Budget Proposal to deal with the deterioration in General Fund revenues since signing the 2008-09 State Budget just weeks earlier on September 23. The Governor has described the current crisis as a "revenue problem" requiring extraordinary solutions precipitated by the meltdown in financial markets, the ongoing housing slump, mortgage foreclosures, and unemployment.

**In summary, the Governor's Special Session Budget Proposal includes a wide range of budget cuts and new revenues to address the current mid-year "revenue" shortfall of \$11.2 billion. For San José and cities, the proposal does not "borrow" from either Proposition 1A local property tax revenues or from Proposition 42 sales tax revenues. The Governor's plan does not propose to expand the one year, \$350 million ERAF shift of local redevelopment tax increment funds that was part of the adopted FY 2008-09 State Budget. The Legislative Analyst (LAO), however, has included in his options a proposal to increase the current year's redevelopment ERAF shift to \$400 million and make the pass-through permanent. The Governor's plan also proposes a reduction in General Fund dollars for local law enforcement programs, while alternatively providing vehicle license fee funding.**

11/26/08

**Subject: Update on State Budget and Special Session**

Page 2 of 6

In addition to the current mid-year \$11.2 billion shortfall, the Department of Finance (DOF) is projecting a \$13 billion shortfall in 2009-10 for a total revenue shortfall of \$24.2 billion over the next 19 months. The LAO has projected the State will need \$27.8 billion in budget solutions over that time period. The LAO has concurred with DOF's assessment but has differences with the administration in the magnitude of benefit that some of its solutions will generate. "On net, however, we project that the Governor's special session proposal would provide a similar level of benefit. Combined with the first \$5 billion in securitized revenues from lottery profits (pending voter approval and successful marketing of the bonds), the Governor's approach would essentially close the projected \$28 billion gap — leaving a minimal \$169 million reserve in 2009-10."

While Democrats and Republicans have yet to reach agreement on policy or ways to increase revenue or cut spending, both DOF and LAO agree that solutions to solve the budget revenue shortfall should be a balance of cuts and taxes. The magnitude of the State's fiscal situation is dire with the ongoing rapid deterioration of State revenues. According to DOF, the State's ongoing revenue shortfall and "extremely low" cash balance require immediate action to meet the State's cash flow requirements. If not addressed now, the State could be out of funds by February 2009. The LAO's revenue projections and long-term outlook are even bleaker with the LAO projecting annual budget shortfalls in the range of \$22 billion through 2013-14, unless the Governor and Legislature take early and aggressive action to adopt a balance of long-lasting solutions. Both revenue increases and spending reductions will be required to meet both the immediate 2008-09 shortfall and projected revenue shortfalls through 2009-10 and to realize permanent improvements to the State's fiscal outlook.

The Governor's Special Session Budget solutions to address the \$11.2 billion, mid-year "revenue" shortfall propose significant changes in State taxes, including proposals to increase the sales and use tax, broaden the sales tax to include some specified services, and impose an oil severance tax on oil production. The solution includes closing a \$9.2 billion revenue "gap" in the General Fund with a balanced approach, including a combination of \$4.5 billion in spending cuts and \$4.7 billion in revenue increases and ongoing revenue sources. The \$4.5 billion in spending reductions includes \$2.5 billion in cuts to K-12 schools and community colleges, and more than \$800 million in additional cuts to health and human services.

The Governor's proposals to generate \$4.7 billion in new revenues are dependent upon securing a 2/3 vote of the Legislature to approve the tax increases. New revenue proposals include:

- A temporary 1.5 percent increase in the sales and use tax use rate, effective January 1, 2009, for three years and reverting back to 5 percent at the end of the third year. This change would boost the current base rate from 7.25 percent to 8.75 percent. The State average rate with local add-ons would be 9.5 percent. The sales tax increase is estimated by DOF to generate \$3.5 billion in 2008-09, and \$7.319 billion in 2009-10.
- Broadening of the sales tax to apply to appliance and furniture repair, vehicle repair, golf, and veterinary services effective February 1, and then to amusement parks and sports events as of March 1, 2009. This change is estimated to generate \$357 million in 2008-09, and \$1.156 billion in 2009-10. This proposal is intended to also apply to local share of the sales tax. DOF estimates this change will increase local sales and use tax revenues

11/26/08

Subject: Update on State Budget and Special Session

Page 3 of 6

by \$151 million in 2008-09, including \$27 million for public safety under Proposition 172, and \$487 million in 2009-10, including \$89 million for public safety.

- Impose a 9.9 percent Oil Severance Tax on the gross value of oil produced in the State, effective January 1, 2009, estimated to generate \$530 million in 2008-09, and \$1.195 billion in 2009-10.
- Increase existing alcohol excise tax adding five cents per drink, estimated to generate \$293 million in 2008-09, and \$585 million in 2009-10, to fund drug and alcohol treatment and prevention services.
- Increase vehicle registration fees by \$12, effective February 1, 2009, to offset a portion of General Fund cuts to public safety programs, estimated to generate \$150 million in 2008-09, and \$359 million in 2009-10, for the Motor Vehicle Account to backfill funds shifted from the Department of Motor Vehicles to support local public safety programs.

**For San José and San José Redevelopment Agency.** The Governor's proposal continues to not "borrow" and protect local revenues under Proposition 1A and Proposition 42 transportation revenues (sales tax on gasoline). The Governor's proposal does not increase or modify the current, one-year, one-time \$350 million ERAF shift of local redevelopment funds as part of the adopted 2008-09 State Budget. However, the LAO has proposed as an option to consider, a proposal to increase the current year's \$350 million ERAF shift from redevelopment agencies by an additional \$50 million and make the pass-through requirement permanent, resulting in a \$400 million annual loss to redevelopment agencies statewide.

**Funding for Local Public Safety Programs.** The Governor's proposal includes a vehicle license fee (VLF) increase of \$12, effective February 1, 2009. The VLF funds would be a dedicated funding source for public safety programs as a backfill for 50 percent of General Fund revenues allocated in the current year, including the Citizens' Option for Public Safety (COPS) and Booking Fee programs. The program shift from General Fund to VLF had potential for programs to be less vulnerable to future budget cuts. However, the Governor's proposal would represent a \$131 million cut in Local Government Program Funding for 2008-09. The proposal would reduce the adopted 2008-09 budget funding for COPS from \$107 million to \$92.8 million — a 13.4 percent reduction added to the 10 percent cut in the adopted 2008-09 budget. Funding for the same local government programs would be cut \$262 million in 2009-10. Funding for COPS in 2009-10 is identified at \$95.8 million and would represent an 11.1 percent reduction beyond a 10 percent cut in 2008-09. **San José's COPS funding level is \$1.71 million under the adopted 2008-09 Budget. The City's revised share of COPS funding is estimated at \$1.44 million. Funding for Booking Fee reimbursements will continue at \$31.5 million, a 10 percent reduction in current 2008-09 adopted level from full funding at \$35 million. The City's current estimated share of the 10 percent reduction in Booking Fee reimbursements is \$250,000.**

**Parole Supervision Funding.** This budget proposal would reduce funding by \$78.7 million in 2008-09, by eliminating parole supervision after release from prison for offenders without current or previous convictions for serious, violent or sexual crimes. The estimated savings is expected to grow to \$535.9 million in 2009-10. In addition, various other local assistance

11/26/08

**Subject: Update on State Budget and Special Session**

Page 4 of 6

programs administered by the Office of Emergency Services are also proposed to be eliminated, including Vertical Prosecution Block Grants, California Multijurisdictional Methamphetamine Enforcement Teams, the High Technology Theft Apprehension Program, and Sexual Assault Felony Enforcement Teams. Current year funding for these programs is \$28.7 million, and \$57.4 million in 2009-10.

**Transportation Funding – Proposition 42.** The revenue proposal for a temporary 1.5 percent increase in Sales and Use Tax for a total of 7.25 percent (plus local add-on rates up to 2 percent) with rates from 8.75 to 10.75 percent, effective January 1, 2009, would apply to the sales tax on gasoline for transportation purposes. This increase is estimated to generate \$354 million in 2008-09, and \$713 million in 2009-2010. The \$1.035 billion allocated under the Proposition 42 formula will provide 20 percent to cities (\$207 million), 20 percent to counties, 20 percent to transit and 40 percent to the State Transportation Improvement Program.

**Proposition 1B – Local Streets and Roads.** This proposal would accelerate the allocation of the remaining \$700 million in local streets and roads funds for projects that rehabilitate and improve local roads. Funding would be appropriated with \$250 million to cities and \$400 million to counties. As part of the economic stimulus plan, local agencies must be able to encumber these funds by December 31, 2009, and comply with other specified criteria. The City's share of Proposition 1B - local streets and roads funding is \$30 million. Staff has secured \$15.6 million and working to capture remaining \$14.4 million.

**Proposition 1B - Local Public Transit Projects.** As part of the economic stimulus plan to accelerate Proposition 1B projects, an additional \$800 million in Proposition 1B funding is provided to transit operators to begin construction on new transit systems or purchase transit vehicles.

**Proposition 1B Projects.** The economic stimulus plan also includes \$821.5 million (including \$384 million in Proposition 1B funding) to provide funding and exemptions for selected projects from California Environmental Quality Act (CEQA) and National Environmental Protection Act (NEPA) where required. The list of "early delivery" projects includes US-101 improvements from I-280 to Yerba Buena Road at \$63 million.

**Legislative Analyst's Office (LAO) – Overview of Governor's Special Session Proposals.**

The LAO has stated that the Governor's proposal is a credible plan as a starting point for deliberations to address the current year's shortfall and develop a fiscally responsible budget for 2009-10. The LAO is generally supportive of the administration's framework for closing the budget gap but the specifics of the proposals raise some policy and fiscal issues. For example, the Governor's temporary 1.5 percent increase in the State sales and use tax would raise \$3.5 billion in 2008-09, but would expire after three years leaving a budget shortfall. This compounded with the expected end of lottery funding after 2010-11, would create a \$9 to \$11 billion shortfall in the future. The LAO has also provided other alternative proposals, both old and new, as well as identifying revenue increases and program reductions "to minimize harm to the State's taxpayers and core programs." The following are some of the LAO's alternative options to the Governor's proposals which would have substantial local impacts:

11/26/08

**Subject: Update on State Budget and Special Session**

Page 5 of 6

- ERAF Redevelopment Pass-Through Payments – Increase current-year amount by \$50 million to \$400 million and make the pass-through requirement permanent. \$400 million in 08-09.
- Vehicle License Fee (VLF) Rate and Realignment – Increase the current VLF rate of 0.65 percent to a full 1 percent, shift VLF administrative costs, and use funds to realign some criminal justice and mental health responsibilities from the State to counties. \$1.6 billion in 2009-10.
- Proposition 10 – Eliminate the State First Five Commission and redirect 50 percent of funds to children's health or childcare programs. This targets resources to high-priority State programs while allowing some local priorities to be supported. This option requires voter approval. \$307.4 million in 2009-10.
- Corrections – Change so-called 'wobbler' crimes to misdemeanors. Offenders diverted from prison would still be subject to criminal sanctions at the local level. Release all non-lifer inmates 30 days early. Exclude inmates with less than six months to serve from prison. Reduce time served for parole revocations. Exclude parolees with technical and misdemeanor violations from prison. Offenders could be diverted to communities without local funding or sanctions. Implement earned discharge program for parolees. Implement supervision fees for parolees. Total of \$381 million in 2008-09.
- Office of Emergency Services (OSE) – Eliminate California Gang Reduction Intervention and Prevention Program (CalGRIP) and Internet Crimes Against Children Task Force. Program funds for the next few years could be transferred from the Restitution Fund to the General Fund. \$30 million in 2008-09.
- Animal Adoption Mandate – Repeal mandate and pay prior years' costs over time. Mandate does not promote the Legislature's objectives. \$25 million in 2009-10.

**The Economic Stimulus Package.** In addition to the fiscal and budget-related matters, the Governor and Legislature are considering legislation and proposals to stimulate the economy, including employment and workplace reforms, Unemployment Insurance Fund reform, and foreclosure relief and reforms. City staff is working in a coordinated effort to develop proposals, support programs and infrastructure initiatives to stimulate the economy and to create or retain employment. Proposals are being developed by City departments and agencies to maximize opportunities and benefits for the City and for inclusion in the State stimulus package that would be submitted at the federal level. Further information will be provided as it becomes available.

**Time Runs Out as Democrats' Plan to Reduce State Budget Shortfall Fails.**

Late Tuesday, November 25, the Legislature failed to pass a \$17.1 billion package sponsored by Democrats to reduce the estimated \$28 billion State budget deficit over the next 19 months. This was a last attempt by the lame-duck Legislature to close the budget gap before the 2007-08 Session is scheduled to adjourn November 30.

The Democratic Budget package would have reduced the State Budget deficit by \$17.1 billion including a balance of \$8.1 billion in cuts and \$8.1 billion in revenues. The proposal included a tripling of the annual Vehicle License Fee (VLF) from 0.65 percent to 2 percent of vehicle market value to raise \$5.7 billion from now until July 2010 and an additional \$2.4 billion by temporarily freezing the State's personal income tax brackets, eliminating the 2008 inflation

11/26/08

Subject: Update on State Budget and Special Session

Page 6 of 6

indexing adjustment at last year's rates. Cuts were largely to schools including \$4 billion from K-12 and community colleges. Even with the cuts and tax proposals, the Legislature would have still faced a \$10 billion shortfall through the end of FY 2009-10.

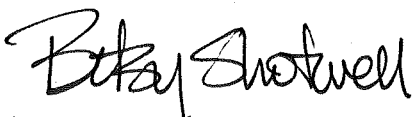
**Although the Democratic package failed to pass, it provides important indications of the direction and cuts the Democrats would be willing to make to bring the State Budget into balance. For San Jose and cities, the Democratic package did not include "borrowing" from Proposition 1A local property tax revenues or from Proposition 42 sales tax revenues. The package also did not include any increase or time extension beyond the current year, one-time \$350 million ERAF shift of local redevelopment funds. The Plan would have also made cuts to local law enforcement funding including reducing the Citizens Options for Public Safety (COPS) program by \$14.2 million which is equal to a 10 percent cut in the current year, and reducing funding for booking fee reimbursements by \$15.8 million. Both reductions were to be backfilled in part by a \$12 increase in the vehicle license fee revenues.**

With the defeat of the Democratic package, Governor Schwarzenegger characterized the efforts as a total failure on the part of the Legislature. The Governor also indicated he would not have signed the package because it did not include an economic stimulus package. Now, the Governor plans to declare a "fiscal emergency" to convene a special session when the new 2009-10 Legislature is scheduled to convene on Monday, December 1.

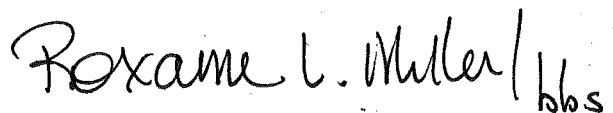
The Governor will call the special session, as authorized under Proposition 58, that will require legislators to cancel other work and concentrate on addressing the State's budget deficit within 45 days. It remains uncertain whether the Governor and Legislature will be able to reach agreement on budget-related issues and provide the necessary 2/3 vote to pass budget legislation or place budget-related measures on a 2009 statewide ballot. If a budget agreement cannot be reached to address the State's budget crisis by February 2009, the State will be in jeopardy of running out of revenue.

IGR and the Sacramento Office will continue to implement the City's and SJRDA's budget priorities and legislative strategies working with the Governor and his Administration, legislative leadership, the City's legislative delegation and a broad coalition of public and private partners to inform, protect and expand the City's interests in Sacramento.

Our office will continue to provide regular updates on State budget developments. For more information, please contact our offices.



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