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May 19, 2008

To: Supervisor Yvonne B. Burke, Chair
Supervisor Gloria Molina
Supervisor Zev Yaroslavsky
Supervisor Don Knabe
Supervisor Michael D. Antonovich

From: William T Fujioka
Chief Executive Officer

SACRAMENTO UPDATE

Legislative Analyst Releases "Overview of the 2008-09 May Revision"

Today, the Legislative Analyst's Office (LAO) released its overview of the Governor's FY 2008-09 May Revision. The LAO confirmed that decreasing revenues and increased expenditures created a budget shortfall of \$22 billion, which has been reduced to \$15 billion through actions taken as part of the Special Session on the State Budget. While the LAO concurred with some of the Governor's revenue and expenditure assumptions, it questioned the Governor's growth estimates contained in the lottery securitization proposal and identified potential flaws with regard to his proposed budget reforms. In addition, the LAO updated its alternative budget approach, issued subsequent to the Governor's January 2008 Proposed State Budget.

The Governor's May Revision revenue and expenditure forecasts were deemed to be "reasonable" by the LAO, resulting in only a \$500 million difference in assumptions for the year-end reserve. Assuming the Legislature adopted all of the Governor's budget proposals, the LAO estimates the year-end reserve at \$1.5 billion as opposed to the Governor's \$2.0 billion target. The LAO projects expenditures to be higher than the Governor's May Revision. However, the LAO indicates that certain revenues, including local property taxes, may be higher than the Governor's proposal. Looking ahead, the LAO indicates that "multi-billion dollar shortfalls would reemerge in FY 2010-11" as one-time and short term fixes continue to be included in the overall solution.

Criticism of the lottery securitization plan included "overly optimistic" assumptions regarding the potential growth in lottery sales that could result in a shortfall in the projected lottery funding for education of \$5 billion over the next 12 years. In addition, the LAO notes that rejection of the lottery securitization plan by the voters or lawsuits could stall the issuance of lottery securitization bonds, triggering a temporary one-cent sales tax increase. The LAO indicates that the earliest that the temporary sales tax could be put in place is January 1, 2009, producing only six months of revenue, or approximately \$3 billion. Thus, if the sales tax increase is triggered in 2008-09, the State Budget would immediately be in deficit given the \$5 billion assumption for lottery securitization. In addition, Proposition 98 obligations would increase if sales tax is used in place of lottery proceeds.

The LAO also warned that certain reforms being proposed by the Governor, including a cap on revenues and diversion of funds to a new reserve, could restrict the ability of the State to access some of the lottery proceeds that were intended for use in solving the budget shortfall. In addition, the LAO suggests that reforms related to automatic across-the-board reductions fail to prioritize programs and undermine the Legislature's budgetary authority.

The LAO's Alternative Budget was updated to reflect the State's fiscal condition. An alternative approach to the securitization of lottery is included that would result in a \$5.6 billion augmentation to the General Fund over two years in contrast to the Governor's proposal that would yield an estimated total of \$15 billion in proceeds over three years. According to the LAO, this approach would have the affect of reducing risk to education funding derived from the lottery. Other major differences between the Governor's May Revision and the LAO's Alternative Budget include:

- State Special Fund Borrowing – The Governor proposed \$564 million of borrowing from State special funds as part of his May Revision. The LAO rejected this proposal.
- Budget Reform – The Governor's budget reforms include a cap on revenues in any year with automatic across-the-board reductions if a revenue shortfall exists. The LAO proposes to use the existing Budget Stabilization Account, as provided in Proposition 58, and increase the amount of this account in good budget years. The LAO also opposes automatic across-the-board reductions because they restrict budgetary flexibility.
- Revenue – The Governor proposes increasing revenue by \$21 million through a use tax on out-of-state vessels. The LAO proposes much more robust revenue increases of \$3.3 billion from various changes to tax credits, deductions, and exemptions.

Each Supervisor
May 19, 2008
Page 3

The LAO Alternative Budget proposal generally maintains health and social service programs at their July 1, 2007 levels, rejecting many of the cuts proposed by the Governor. With regard to criminal justice issues, the LAO continues to support the realignment of low level parolees to county supervision. The LAO also continues to support the Governor's decision not to pursue his original proposal to release inmates from prison with less than 20 months remaining on his or her prison sentence. The LAO also recommends a number of revenue enhancements and cost cutting measures related to criminal justice, including the imposition of a fee on those participating in traffic school, release of elder inmates with no prior history of violence, and a reduction of \$6 million in funding for local peace office training.

The LAO characterizes the task of the Legislature to develop a balanced FY 2008-09 State Budget as a "monumental challenge." This challenge includes addressing the ongoing structural deficit and dealing with the "consequences and tradeoffs" of the various budget solutions.

The LAO's report is available at <http://www.lao.ca.gov>.

We will continue to keep you advised.

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