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The 2012-13 Budget:

# Overview of the May Revision



2012-13 BUDGET

## EXECUTIVE SUMMARY

### **Governor Identifies \$15.7 Billion Budget Problem**

**Revenues Down Since January, but Proposition 98 Obligations Are Up.** In January, the 2012-13 Governor's Budget projected that the state needed to address a budget problem of \$9.2 billion to balance the 2012-13 General Fund budget. In the May Revision, the administration estimates that this budget problem has increased to \$15.7 billion. The increase mainly results from lower revenue projections, which have the counterintuitive effect of increasing the state's Proposition 98 minimum guarantee for schools and community colleges in 2012-13.

**May Revision Projects \$1 Billion Reserve if Governor's Proposals Are Adopted.** The May Revision includes a few billion dollars of additional expenditure reductions and other budget-balancing actions to address the larger budget problem and assumes passage of the Governor's revised tax initiative, which is expected to generate more tax revenue than the original tax initiative measure he included in his January budget plan. The Governor also has updated his trigger cut proposals—which continue to be heavily focused on schools—to take effect if voters reject the tax proposal. In total, the administration estimates that its May Revision package would address the \$15.7 billion projected budget problem and leave the state with a \$1 billion reserve at the end of 2012-13. The administration also estimates the plan would leave the state with a small structural surplus in the coming few years and make progress in reducing what the Governor has termed the state's "wall" of budgetary debts.

### **Revenue Forecast Reasonable, but Redevelopment Estimates Are Uncertain**

**Budget Problem Likely Somewhat Larger Than Governor Estimates.** We find the Governor's May Revision economic and revenue forecasts to be reasonable. Our 2011-12 and 2012-13 revenue estimates are just a few hundred million dollars below the administration's in each year. We are concerned, however, that the administration is overstating the amount of property tax revenues from former redevelopment agencies (RDAs) that will be distributed to schools in 2011-12 and 2012-13. Our rough estimate is that this causes the state's budget problem to be around \$900 million greater than assumed by the administration because these lower property tax revenue distributions would increase the state's "workload budget" Proposition 98 obligations.

**Estimate for RDA Liquid Asset Shift Highly Uncertain.** One of the largest May Revision proposals is to strengthen the state's authority to expedite the transfer of the former RDAs' liquid assets (cash) to local governments, including school and community college districts. The administration estimates that the proposal would generate \$1.4 billion of General Fund benefit in 2012-13 and \$600 million in 2013-14 by reducing General Fund Proposition 98 obligations. We find that the administration's estimate of liquid assets available for distribution is subject to considerable uncertainty. While it is possible that schools will receive more than is estimated (generating greater General Fund benefit), it is more likely that schools would receive significantly lower amounts in 2012-13 (generating much less General Fund benefit). Part of our concern relates to the likelihood that lawsuits will delay distribution of these funds.

## How Should the State Approach the 2012-13 Budget?

***What Should Be the State's Key Budgetary Goals Now?*** The state should address two key budgetary goals now: (1) retiring the accumulated deficit of recent years, now estimated by the administration to be \$7.6 billion; and (2) making additional solid progress toward addressing the ongoing annual operating, or structural, deficit—which we think is somewhere around \$10 billion—through realistic and ongoing budget actions. Adopting various one-time actions to address the \$7.6 billion accumulated deficit is appropriate, as the Governor proposes. Continuing to make progress on the operating deficit, however, requires more ongoing actions—principally multiyear or permanent reductions in program spending; revenue increases; and reductions in tax expenditures, such as tax deductions, credits, and exemptions. The Governor has proposed numerous ongoing actions that would go a long way to addressing the operating deficit. (We will release a summary of our updated forecast of the state's future annual deficits or surpluses under the Governor's plan next week on our website.)

***Need for Realistic Budgetary Solutions Particularly Significant Now.*** There are some particularly strong reasons for the state to focus this year on adopting realistic budgetary solutions. Economic and revenue forecasting is very difficult now due to a variety of issues, including uncertain federal fiscal policies, difficulties in forecasting recent corporation tax policy changes, the usual issues of stock market volatility, and Facebook. Given these forecasting challenges, state leaders should not be surprised if 2012-13 state revenues end up several billion dollars lower (or higher) than current projections. This makes the adoption of realistic budgetary actions—including realistic trigger cuts—particularly important if the state is to continue making progress toward eliminating the stubborn structural deficit.

## Alternatives to the Governor's Proposals

In this report, we describe and assess the administration's major May Revision proposals. In some cases, we offer alternative ways to achieve the savings targeted by the Governor. With regard to Proposition 98, we offer alternatives to both the Governor's basic budget plan and his trigger plan. The alternative to the Governor's basic budget plan would reduce the 2012-13 minimum guarantee by \$1.9 billion but still maintain programmatic spending at virtually the same level as the Governor. This would free up funds that could be used to mitigate proposed reductions in other areas of the budget. The alternative to the Governor's trigger plan would achieve somewhat less total budget solution than the Governor but has the significant benefits of (1) cutting programmatic funding for schools and community colleges notably less than the Governor and (2) avoiding problematic new rebenchings. It would, however, require other parts of the budget to share more in trigger reductions.

## OVERVIEW

### Projected 2012-13 Budget Problem

**Budget Problem Rises to \$15.7 Billion.** In January, the *2012-13 Governor's Budget* projected that the state needed to address a budget problem of \$9.2 billion in order to balance the 2012-13 General Fund budget. Spring tax collections showed that the estimates included in the Governor's budget were too optimistic about 2011-12 tax revenues. Required state expenditures on schools under current law and tax policies also are estimated to be higher. In total, the administration's estimate of the size of the budget problem increased by \$6.5 billion between January and May to now total \$15.7 billion. The various changes to the administration's estimate of the budget problem between January and May include:

- **Lower Revenue Assumptions (\$4.3 Billion).** As a result of the weak spring tax collections, the Governor's May Revision reduces projected 2011-12 revenues substantially. In addition, the administration has lowered its estimates of current-law personal income tax (PIT) and corporation tax (CT) collections in 2012-13. These lowered revenue assumptions increase the size of the state's budget problem by \$4.3 billion. (Revenue assumptions would have been even lower than this but for the inclusion in the May forecast of an estimated \$1.5 billion of PIT collections related to the Facebook initial public offering [IPO]. The IPO had not yet been announced in January and thus was not a factor in the earlier administration forecast.)
- **Higher General Fund Proposition 98 Costs (\$2.4 Billion).** While revenues are

lower and the minimum school funding guarantee—Proposition 98—typically drives off trends in state revenues, the May Revision reflects *higher* school funding requirements in 2012-13 than the administration estimated in January. Essentially, this is because the year-to-year growth of General Fund revenues from 2011-12 to 2012-13 now is considerably higher. This results from the large drop in 2011-12 projected revenues and the much smaller drop in 2012-13 revenues (in part, due to the newly included effects of the Facebook IPO). In addition, the Proposition 98 May Revision forecast reflects assumptions about lower local property taxes available to school districts (\$883 million over the two years), including lower assumptions about the amount of former redevelopment agency (RDA) property tax revenue distributions. In the May Revision, these property taxes available to fund schools are estimated to total \$1.8 billion in 2011-12 and 2012-13 (down from \$2.1 billion in January). In total, due to higher funding requirements and lower local property tax estimates, the administration projects that Proposition 98 General Fund costs under current tax policies is now \$2.4 billion higher in 2012-13 than it estimated in January.

- **Lower Anticipated Net Costs in Other Areas (-\$0.2 Billion).** The administration estimates that various categories of health and human services costs in 2011-12 and 2012-13 increased by \$1.3 billion due largely to federal and court actions blocking previously adopted budgetary

reductions. In addition, prison medical care costs managed by the court-appointed Receiver are expected to be over \$400 million higher in the two fiscal years than previously estimated. Offsetting these \$1.7 billion of projected expenditure increases are \$1.9 billion of expenditure declines, partially due to lower-than-expected caseload in Medi-Cal and various social services programs. In total, current-law General Fund expenditures outside of Proposition 98 are now forecast to be about \$200 million less than they were in January.

**Governor’s May Revision Proposals**

**\$16.7 Billion of Budget Actions Proposed.** In the May Revision, the administration estimates that its revenue, expenditure, and other budget proposals produce \$16.7 billion of General Fund fiscal benefit in 2011-12 and 2012-13. These actions would address the projected \$15.7 billion budget problem and leave the state with an estimated reserve of \$1 billion at the end of 2012-13, as shown in Figure 1.

Figure 2 summarizes the administration’s major May Revision budget-balancing proposals. We characterize \$8.8 billion of the administration’s budget actions as revenue actions, \$5.2 billion as expenditure actions, and \$5.4 billion as other actions (principally non-recurring fund shifts, transfers, and loans). These are offset by the \$2.9 billion increase that the administration projects in the Proposition 98 guarantee due to higher revenues from the Governor’s tax measure. (As in our review of the January budget proposal, we list the administration’s estimates for each of its proposals but two—the administration’s cap-and-trade and mandate proposals.)

**Revised Tax Initiative Proposal Is Centerpiece of Governor’s Plan.** In March, the Governor introduced a revised temporary tax initiative with lower sales and use tax (SUT) rates and higher PIT rates on higher-income Californians. The Governor’s revised tax proposal includes two temporary tax increases, resulting in additional state revenues estimated by the administration at \$8.5 billion in 2011-12 and 2012-13 combined.

- **0.25 Percent SUT Rate Increase for Four Years.** The measure would temporarily

increase the state SUT rate by 0.25 percent for four years—from January 1, 2013, through the end of 2016. Under the measure, the average SUT rate in the state would increase to around 8.4 percent. The SUT increase is projected by the Governor to generate \$605 million of additional revenues in 2012-13 (half year) and about \$1.3 billion and more annually in subsequent years.

**Figure 1  
Governor’s May Revision  
General Fund Condition**

| <i>General Fund and Education Protection Account Combined (In Millions)</i> |                     |                      |                   |
|---|---------------------|----------------------|-------------------|
|   | Proposed<br>2011-12 | Proposed for 2012-13 |                   |
|   |                     | Amount               | Percent<br>Change |
| Prior-year fund balance   | -\$2,844            | -\$2,535             |                   |
| Revenues and transfers  | 86,809              | 95,689               | 10.2%             |
| Total resources available   | \$83,965            | \$93,154             |                   |
| Expenditures  | \$86,500            | \$91,387             | 5.6%              |
| Ending fund balance   | -\$2,535            | \$1,767              |                   |
| Encumbrances  | \$719               | \$719                |                   |
| <b>Reserve<sup>a</sup></b>  | <b>-\$3,254</b>     | <b>\$1,048</b>       |                   |

<sup>a</sup> Reflects the administration’s projection of the balance in the Special Fund for Economic Uncertainties. (The 2012-13 Governor’s Budget proposes to continue suspending transfers to the Budget Stabilization Account.)



- PIT Rate Increase for Higher-Income Taxpayers for Seven Years.** The initiative would temporarily increase marginal PIT rates for roughly the 1 percent of California taxpayers with the highest annual incomes. Specifically, their marginal PIT rates would rise by 1 percent, 2 percent, or 3 percent—depending on the level of their income—starting in the 2012 tax year and ending at the conclusion of the 2018 tax year. The PIT increase is projected by the administration to generate \$7.9 billion of

**Figure 2**

**Budget-Balancing Actions Proposed by the Governor<sup>a</sup>**

*2011-12 and 2012-13 General Fund Benefit (In Millions)*

|   |                             |
|---|-----------------------------|
| <b>Revenue Actions</b>  |                             |
| Increase personal income and sales and use taxes through voter initiative                         | \$8,479                     |
| Make permanent the existing tax on Medi-Cal managed care plans                                    | 188                         |
| Implement changes to unclaimed property program   | 78                          |
| Expand Franchise Tax Board authority to issue wage garnishments                                   | 38                          |
| Implement other revenue actions (net)   | 54                          |
| Subtotal  | (\$8,837)                   |
| <b>Increased Proposition 98 Costs Due to Proposed Tax Increases</b>                               |                             |
| -\$2,908  |                             |
| <b>Expenditure Actions</b>  |                             |
| Make various Proposition 98 adjustments   | \$1,498                     |
| Restructure and reduce CalWORKs and subsidized child care program costs                           | 1,332                       |
| Defer payments to Medi-Cal providers and other related actions                                    | 663                         |
| Reduce Medi-Cal costs through program efficiencies and other changes                              | 556                         |
| Negotiate state employee compensation reductions  | 402                         |
| Change Cal Grant awards and eligibility requirements and other higher education actions           | 292                         |
| Reduce In-Home Supportive Services costs and services   | 225                         |
| Defer payment on pre-2004 local mandate obligations <sup>b</sup>                                  | 100                         |
| Reduce Healthy Families Program managed care rates  | 49                          |
| Reduce various other program costs  | 115                         |
| Subtotal  | (\$5,230)                   |
| <b>Other Actions</b>  |                             |
| Use cash assets of former redevelopment agencies to offset Proposition 98 General Fund obligation | \$1,405                     |
| Delay loan payments to special funds  | 1,158                       |
| Delay court construction, use local trial court reserves for operations, and other actions        | 544                         |
| Use part of cap-and-trade program auction revenues to offset General Fund costs <sup>c</sup>      | 500                         |
| Use weight fee revenues to offset General Fund costs  | 385                         |
| Borrow from disability insurance fund to pay costs of federal unemployment insurance loans        | 313                         |
| Transfer funds from the Motor Vehicle Fuel Account  | 312                         |
| Borrow from the Motor Vehicle Account   | 300                         |
| Use proceeds from mortgage settlement to fund housing debt service and other activities           | 292                         |
| Shift funds from Proposition 10 state commission to General Fund programs                         | 80                          |
| Suspend county share of child support collections on one-time basis                               | 32                          |
| Implement other fund shifts and transfers   | 31                          |
| Subtotal  | (\$5,353)                   |
| <b>Total</b>  | <b>\$16,512<sup>d</sup></b> |

<sup>a</sup> Reflects administration scoring of all May Revision proposals, including revised estimates of many January Governor's budget proposals. Excludes some proposed program augmentations.

<sup>b</sup> Contrary to the Governor's approach, does not list as a solution \$729 million related to past-year costs of suspended mandates.

<sup>c</sup> Although the administration's workload budget includes those funds, we continue to characterize this as a budget-balancing proposal.

<sup>d</sup> The administration characterizes the Governor's proposed budget-balancing actions as totaling \$16.7 billion. Our estimate is \$229 million lower due to the differences described in footnotes b and c above.

additional revenues in 2011-12 and 2012-13. (While essentially all of this revenue would be received in 2012-13, a portion would be attributed to 2011-12 under the Governor's January revenue accrual proposal.) The \$7.9 billion administration projection includes about \$400 million related to the Facebook IPO.

The additional revenues generated from these tax increases result in an increase in the Proposition 98 minimum guarantee. The administration estimates that this increase totals \$2.9 billion in 2012-13. Accordingly, the *net* benefit to the General Fund from the tax measure would be \$5.6 billion in this budget under the May Revision projections.

**Various Expenditure Actions.** As Figure 2 shows, the largest expenditure action relates to Proposition 98. The \$1.5 billion consists of a variety of actions, including counting \$450 million of 2011-12 funding toward a specific statutory obligation, thereby saving a comparable amount in 2012-13 funding for the Quality Education Investment Act (QEIA) program (with no impact on services). Also among the largest administration expenditure proposals are restructurings of the California Work Opportunity and Responsibility to Kids (CalWORKs) and subsidized child care programs, as well as various changes to the Medi-Cal Program. The May Revision modifies and adjusts estimates for various January proposals, including the CalWORKs and child care proposals mentioned above. It also includes major new proposals to reduce state employee compensation costs (\$402 million), Medi-Cal payments to hospitals (\$325 million, in addition to other Medi-Cal savings proposals), and hours in the In-Home Supportive Services (IHSS) program by 7 percent (\$99 million, in addition to other IHSS savings proposals).

**Other Actions.** Other proposed budget actions shown in Figure 2—principally non-recurring

shifts of funding responsibility from the General Fund to other funds, loans, loan extensions, and transfers—contribute over \$5 billion in budgetary solutions. The largest action is the administration's new proposal to facilitate the transfer of liquid assets of former RDAs to local governments, thereby increasing school district property tax moneys and reducing the state's near-term Proposition 98 General Fund obligations. The administration predicts that this proposal would generate \$1.4 billion of General Fund savings in 2012-13 (in addition to the \$1.8 billion of former RDA tax increment mentioned earlier, which is reflected in the administration's "workload budget"). The May Revision proposes extending the General Fund's repayment dates for \$490 million of outstanding loans from state special funds (in addition to \$668 million of savings from loan repayment extensions, including ones originally proposed in January). The May Revision includes new proposals to transfer to the General Fund certain excise taxes for fuel purchased for off-highway vehicles (\$312 million of 2011-12 and 2012-13 General Fund benefit, with ongoing future savings), borrow \$300 million from the Motor Vehicle Account, and use proceeds from the recent national mortgage settlement to offset General Fund housing debt-service costs and other expenses (\$292 million of General Fund benefit in this budget cycle, plus an additional \$118 million in 2013-14).

**Administration Forecasts Small Structural Surpluses if May Revision Adopted.** The administration's out-year budget forecast indicates a current-law budget problem of around \$8 billion per year in 2013-14 and 2014-15 and a \$5.6 billion budget problem in 2015-16. If the Governor's May Revision is approved in full—including the proposed tax initiative—the Department of Finance (DOF) projects small structural surpluses of \$300 million to \$800 million in future fiscal



years through 2015-16. (This estimate assumes collection of no state estate taxes, given the low likelihood that the federal government will take actions providing these collections in the future.)

**Trigger Cuts Focused on Schools if Voters**

**Reject Tax Measure.** Figure 3 shows the Governor’s updated trigger cut proposal to take effect if voters reject the proposed tax measure in November. Proposition 98 funding for schools and community colleges would be cut in that event by \$5.5 billion under the Governor’s proposal. This amount equals 90 percent of the total statewide trigger cuts of \$6.1 billion.

**How Should the State Approach the 2012-13 Budget?**

**How Did We Get Here?** The state now has had a recurring operating, or structural, deficit (a regular shortfall of annual General Fund revenues compared to expenses) for over a decade. This deficit is the result of many actions taken by the Legislature, Governors, the state’s voters, the federal government, and the courts. These include past decisions making ongoing commitments (both spending increases and tax reductions) with uncertain revenue increases, constraining legislative decision making as a result of prescriptive ballot initiatives, and relying too heavily on temporary budget solutions (such as accounting shifts and borrowing). This difficult situation was exacerbated by the effects of the worst economic downturn since the Great Depression—a worldwide recession from 2007 to 2009. Its impact was particularly severe in California, as marked by a devastating collapse of the housing market and

the construction industry. The state’s key tax bases—particularly our volatile income taxes—declined precipitously, resulting, among other things, in the need to address a \$60 billion state budget problem in 2009 alone.

Since the end of the recession, the state’s economic and tax bases have recovered gradually, and the state and many local governments have relied on temporary infusions of cash from the federal government, temporary tax increases, program reductions, and one-time measures to bridge budget gaps. With the nation now about three years into a slow economic expansion, the finances of California and its local governments remain fragile, with many difficult decisions still required to restore operational balance. The gap between the state’s two key financial indicators—General Fund revenues and General Fund expenditures—has fallen substantially, but remains stubbornly high at somewhere around \$10 billion per year, based on our out-year revenue estimates.

In addition to that operational deficit, the state also must address the deficit accumulated over the last several years. In its problem definition—before accounting for its tax proposals and other proposed budget actions—the administration estimates this accumulated deficit at \$7.6 billion.

**Figure 3**  
**Proposed Trigger Reductions if Voters Reject Governor’s Tax Initiative**

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*2012-13 General Fund Benefit (In Millions)*

|   |                |
|---|----------------|
| Proposition 98 funding for schools and community colleges | \$5,494        |
| University of California                                  | 250            |
| California State University                               | 250            |
| Department of Developmental Services                      | 50             |
| Local water safety patrol grants                          | 11             |
| CalFire   | 10             |
| Department of Water Resources flood control programs      | 7              |
| Department of Fish and Game                               | 4              |
| Department of Parks and Recreation                        | 2              |
| Department of Justice law enforcement programs            | 1              |
| <b>Total</b>  | <b>\$6,077</b> |

**What Should Be the State's Key Budgetary Goals Now?** We believe the state should address two key budgetary goals now: (1) retiring the accumulated deficit of recent years, now estimated by the administration to be \$7.6 billion, and (2) making additional solid progress toward addressing the ongoing annual operating deficit of approximately \$10 billion through realistic and ongoing budget actions. The \$7.6 billion problem is essentially a one-time issue. Adopting some one-time actions to address this problem is appropriate. Continuing to make progress on the operating deficit, however, also requires ongoing actions—principally multiyear or permanent reductions in program spending, revenue increases, and reductions in tax expenditures (deductions, credits, and exemptions). Economic growth over the next few years should aid this effort, but the state's revenue estimates already assume a strengthening economic recovery.

Since 2009, the Legislature has adopted various ongoing expenditure reductions across most of state government, along with temporary tax increases that expired last year. In essence, state leaders have taken a multiyear approach to solving the state's operating deficit problem, similar to what we suggested in our November 2010 publication, *California's Fiscal Outlook*. In fact, with the help of recent growth in the state's economy and revenues, the state appears to be roughly on the schedule we suggested in November 2010 to eliminate annual operating deficiencies.

This year, it is important for the state to continue its progress towards eliminating the persistent operating deficit. To do this, the state needs to adopt additional *ongoing* budget-balancing actions. If the Legislature chooses to reject one of the Governor's ongoing expenditure reductions, for example, it should try to adopt an alternative ongoing action in its place. Moreover, as it adopts these actions to keep "chipping away" at the budget

problem, the Legislature needs to ensure adoption of *realistic* budget solutions—those that have a high probability of achieving budgeted savings in the 2012-13 budget. As we noted in November 2010, the Legislature can maximize the probability of achieving such realistic solutions by providing clear authority to the administration in well-crafted legislation that describes specifically how the reductions are to be realized.

**Need for Realistic Budgetary Solutions Particularly Significant Now.** There are some particularly strong reasons for the state to focus this year on adopting realistic budgetary solutions. As we discuss later in this report, economic and revenue forecasting is unusually difficult now due to a variety of issues, including uncertain federal fiscal policies, difficulties in forecasting recent CT policy changes, the usual issues of stock market volatility, and Facebook. Given these forecasting challenges, state leaders should not be surprised if 2012-13 state revenues end up several billion dollars lower (or higher) than current projections. Adopting hundreds of millions of "extra" budget-balancing actions to accumulate a state reserve is one possible response to this uncertainty, but we advise the Legislature to focus instead on developing realistic, ongoing budget-balancing actions, even if those actions result in only a small projected year-end reserve.

Finally, given that the Governor's proposal assumes that voters approve his tax increase initiative in November, the Legislature will likely need to adopt something like the proposed trigger mechanism to implement automatic reductions in school, university, and other spending if voters reject the tax initiative. (Triggers will be necessary in order to facilitate the state's required annual cash-flow borrowing from investors.) Triggers also need to involve realistic and, preferably, ongoing budget solutions if the state is to continue its progress toward restoring annual operating balances.

By focusing on ongoing and realistic budget actions both in the triggers and its other budgetary actions, the Legislature can make important progress toward restoring the stability of state

finances, ending the cycle of annual legislative sessions focused largely on budgetary issues, and restoring public trust in the budget process and state government itself.

## REVENUES AND THE ECONOMY

**Administration’s Forecasts for 2011-12 and 2012-13 Are Reasonable.** The administration’s overall economic and revenue forecasts for the 2012-13 budget cycle are reasonable. Figure 4 summarizes our office’s updated General Fund revenue forecast, which, like the administration’s official budget projections, assumes passage of the Governor’s tax initiative in November (with increased tax revenues deposited to the proposed Education Protection Account or EPA).

For total General Fund and EPA revenues and transfers, our forecast of \$86.7 billion is \$158 million (0.2 percent) below the administration’s in 2011-12, and our forecast of \$95.3 billion is \$392 million (0.4 percent) lower than the administration’s in 2012-13. For revenue estimates, these differences are extremely small,

especially given the variability and volatility involved in forecasting state revenues (see below).

**Administration’s Out-Year Revenues Are Higher Than Ours.** For fiscal years after 2012-13, our estimates diverge. For instance, in 2013-14, our revenue forecast is \$1.3 billion lower than the administration’s. In 2014-15 and 2015-16 (the last year of the administration’s multiyear forecast), we forecast revenues to be around \$3.5 billion to \$4 billion lower than the Governor each year. The out-year forecast differences are attributable mainly to differences in PIT estimates, as well as the administration’s inclusion of estate taxes in its revenue forecast. (We omit estate taxes entirely from our budget projections, given the low likelihood that federal action will permit resumption of state estate tax collections. The

**Figure 4**  
**LAO May 2012 Revenue Forecast<sup>a</sup>**

*General Fund and Education Protection Account Combined (In Millions)*

|                                      | 2011-12         | 2012-13         | 2013-14         | 2014-15          | 2015-16          | 2016-17          |
|--------------------------------------|-----------------|-----------------|-----------------|------------------|------------------|------------------|
| Personal income tax                  | \$52,366        | \$59,368        | \$58,844        | \$64,475         | \$68,998         | \$72,876         |
| Sales and use tax                    | 18,927          | 20,765          | 22,772          | 24,280           | 25,725           | 26,296           |
| Corporation tax                      | 8,623           | 8,869           | 9,375           | 9,580            | 10,095           | 10,180           |
| Subtotals, “Big Three” taxes         | (\$79,916)      | (\$89,003)      | (\$90,991)      | (\$98,335)       | (\$104,818)      | (\$109,352)      |
| Insurance tax                        | \$2,150         | \$2,093         | \$2,239         | \$2,323          | \$2,405          | \$2,489          |
| Other revenues <sup>b</sup>          | 2,800           | 2,712           | 2,679           | 2,746            | 2,815            | 2,886            |
| Net transfers and loans <sup>c</sup> | 1,784           | 1,489           | -1,042          | -668             | -831             | 130              |
| <b>Total Revenues and Transfers</b>  | <b>\$86,650</b> | <b>\$95,297</b> | <b>\$94,867</b> | <b>\$102,736</b> | <b>\$109,207</b> | <b>\$114,857</b> |

<sup>a</sup> Assumes passage of Governor’s tax and other policy proposals, including the Governor’s personal income tax and sales and use tax initiative. Includes amounts deposited to the proposed Education Protection Account. Includes revenues related to the Facebook initial public offering. Assumes Bush tax cuts expire at the end of 2012, with resulting accelerations of personal income tax revenue from 2013 to 2012.

<sup>b</sup> Includes no estate tax revenues, given what we assess as the low likelihood that anticipated future federal legislation will include provisions that allow a resumption of California’s state-level estate tax. If the current-law estate tax were to resume, it could generate over \$1 billion per year in General Fund revenue by the end of this forecast period.

<sup>c</sup> Does not reflect any transfers to the Budget Stabilization Account.

administration's multiyear estimates, however, project that the budget would remain balanced with higher PIT collections than we forecast, even if the state collects estate tax revenues.)

***Backup Data Available on Our Website.*** For more information on our revenue and economic estimates, select the "Revenues" policy area on the "2012-13 Budget Recommendations" page of our website.

### **Both "Upside" and "Downside" to the 2012-13 Revenue Forecast**

***Large Level of Variability Around Both LAO and Administration Forecasts.*** As noted above, the administration's and our revenue estimates are now similar for both 2011-12 and 2012-13. We want to emphasize, however, the large level of variability inherent in both the administration's revenue estimates and our own. The variability in General Fund revenue estimates probably is much greater now than is usually the case. Specifically, General Fund revenues could easily be billions of dollars lower or higher than either of our forecasts in 2012-13 for the reasons noted below.

***What Will Congress and the President Do?*** The May Revision economic forecasts—the administration's and ours—effectively assume that Congress and the President will agree later this year to extend the "Bush tax cuts" and recent payroll tax cuts for at least one year. The economic forecasts also assume that federal leaders agree to a more gradual reduction of federal spending than included in the current-law budget sequestration for both domestic and defense spending. If Congress and the President cannot reach agreement on sequestration or tax policy changes or if they decide to take significantly different policy actions, this could decrease or increase projected economic activity in 2013. Moreover, if the process for negotiating these changes diminishes consumer and business confidence—as appeared to occur

during the summer of 2011 during the federal debt ceiling debate—economic performance could be weaker than projected. In addition to the debates about taxes and spending, the federal government also will have to consider raising its debt ceiling again by early 2013. Billions of dollars of projected 2012-13 state revenues could be affected by these federal decisions and perceptions about those decisions by businesses and consumers.

***What Will Investors Do?*** The May Revision forecasts estimate how much income investors will accelerate in response to the assumed expiration of the Bush tax cuts at the end of this year. Specifically, before the tax reductions expire, investors—particularly those who are high-income taxpayers—will have an incentive to realize capital gains and certain other income sooner than they would otherwise in order to take advantage of the current lower tax rates. As in our February 2012 "base forecast," our revenue forecast now assumes that investors will accelerate 20 percent of the capital gains they otherwise would realize in 2013 to 2012, as well as small portions of their wage income and income from dividends, interest, and rent. The administration makes similar assumptions in its forecast. To some extent, what investors *assume* that federal leaders will do may matter more than whether or not the tax cuts for high-income taxpayers and others actually are extended. Some investors already are accelerating capital gains to 2012 in anticipation of higher tax rates in 2013. If, however, investors do not accelerate as much income to 2012 as our forecasts assume, General Fund revenues could be hundreds of millions of dollars lower than we project in 2012-13 (with similar increases in later fiscal years).

***What Will Happen to California's Corporate Taxes?*** Recent CT policy changes at the state level have greatly complicated our ability to predict what level of profits multistate companies will apportion to California, what level of deductions and credits

they will claim, and even when they will pay their taxes. These challenges magnify the difficulty that would be present anyway due to uncertainty about how the economy will recover from the recent recession. Receipts of the CT in recent months have been far below prior expectations. Accordingly, both our office and the administration have reduced our CT forecasts substantially in recent months. Currently, our lowered CT forecast is still higher than the administration's by \$415 million in 2011-12 and \$381 million in 2012-13. This reflects many factors, including our expectation that tax collections in late June 2012 will come in higher than DOF forecasts. If the DOF forecast is closer to correct, our revenue estimates may end up being too high by a few hundred million dollars. Policy makers should expect these forecasting challenges to continue for several years until clearer information is available on the impact of recent CT policy decisions, including the revenue effects of the elective single sales factor apportionment policy, recent changes related to credit and net operating loss deduction usage, and other issues. Additional information on tax year 2011 CT returns will begin to be available late this fall and next spring.

***What Will Happen to the Global and U.S. Economies?*** State revenue forecasts are premised on dozens of key assumptions about the U.S. and global economies, as well as the California economy itself. Our forecast assumes that job growth and strengthening of the housing market continue in 2012 and beyond, as the current tepid economic recovery continues.

In the U.S. and California, consumer demand actually has been quite strong recently due in part to increased credit availability, improving household balance sheets, and pent-up demand from the recent recession. Among other assumptions, our forecast anticipates significant weakening of economic growth in the U.S.'s

major-currency trading partners in 2012—mainly due to the recession in Europe (where a 0.5 percent contraction in gross domestic product is assumed in 2012). By comparison, China's economy is assumed in our forecast to be headed for a "soft landing" rather than a severe decrease in that country's significant rate of economic growth. Our forecast also assumes that refiners' acquisition costs for crude oil—\$102 per barrel in 2011—averages \$113 per barrel in 2012 due to emerging market demand and heightened geopolitical risks (such as international tensions related to Iran). Significant changes from some of these key assumptions could materially affect revenue results in 2012-13.

***What Will Happen With Facebook and Capital Gains?*** Both our forecast and the administration's assume that California will experience a revenue boost due to the Facebook IPO of about \$2 billion spread across 2011-12 and 2012-13, assuming passage of the Governor's tax measure. (We described our respective forecasts related to the IPO in a recent post on our website.) As we noted, there are many unknowns in forecasting California's revenues related to the IPO, including Facebook's share price six months after the IPO (which is, by far, the most important variable related to state tax revenue resulting from the IPO) and the extent to which current Facebook investors who are Californians choose to realize capital gains in the coming months. Because of such uncertainties, IPO-related revenues could be hundreds of millions of dollars lower than our forecasts or, in some scenarios, \$1 billion to \$2 billion higher.

Our forecast assumes that California residents will realize \$88 billion of non-Facebook net capital gains in 2012 (including capital gains accelerated due to the anticipated increase in federal tax rates) and \$62 billion in 2013. These estimates are above those that we published in our February revenue update and are now more optimistic than

the administration’s assumptions. Our updated forecast for 2012 stock market growth is stronger based on: (1) stock market data through April 2012 and (2) 2010 tax return information reported by the Franchise Tax Board in late April showing that capital losses (one component of net capital gains) were running below our expectations.

Between January and April 2012, the stock market experienced considerable gains that are incorporated into our more optimistic stock market forecast. The S&P 500 stock index, for example, increased from 1258 on December 30, 2011 to 1398

on April 30, 2012 (an increase of 11 percent). As of the time this publication was written, the stock market had experienced losses during the month of May. The S&P 500 stock index, for example, had declined from 1398 on April 30 to 1305 on May 17 (a decline of 6.7 percent). If this weaker trend continues, our current forecast of stock-related gains may be too optimistic. If, for example, net capital gains in 2012 and 2013 end up closer to the lower levels we assumed in February, 2012-13 state revenues could be around \$2 billion below our May Revision forecast.

## PROPOSITION 98—K-14 EDUCATION

### GOVERNOR’S MAY REVISION PROPOSAL

***Updated Revenue Estimates Result in Lower Current-Year Guarantee, Higher Budget-Year Guarantee.***

As shown in Figure 5, the Governor’s revised revenue estimates affect the Proposition 98 minimum guarantee for both the current and budget years. In the current year, the \$2.1 billion drop in General Fund revenues contributes to a \$1.3 billion reduction in the Proposition 98 minimum guarantee—lowering the guarantee from \$48.3 billion to \$47 billion. In the budget year, despite a \$300 million drop in projected revenues between January and May, the minimum guarantee *increases* by \$1.2 billion—from \$52.5 billion to \$53.7 billion. Because revenues fall further in 2011-12 than 2012-13, the year-to-year General Fund growth rate increases, resulting in a larger maintenance factor payment and higher corresponding guarantee compared to January.

(Whereas the January budget contained a \$1.4 billion maintenance factor payment, the May Revision contains a \$2.9 billion maintenance factor payment.)

***Revises Rebenching Adjustments.*** Under the May Revision, the Proposition 98 minimum guarantee is affected not only by updated revenue estimates but also by various rebenching adjustments. The May Revision makes a number of these types of adjustments to account for shifts of local property taxes to schools as well as shifts of programs in or out of the Proposition 98 minimum guarantee. In some cases, the May Revision rebenches using the “current-year method.” Using the current-year approach ensures that shifts result in dollar-for-dollar effect. (For example, shifting \$1.4 billion in one-time local property tax revenues to schools and community colleges results in \$1.4 billion in Proposition 98 General Fund savings.) In other cases, the May Revision rebenches using the “1986-87 method,” whereby the minimum guarantee is adjusted to reflect the value of shifts had they occurred back in 1986-87.

**Figure 5**  
**Changes in Proposition 98 Minimum Guarantee**  
*(In Millions)*

|                           | January  | May      | Change   |
|---------------------------|----------|----------|----------|
| 2011-12 minimum guarantee | \$48,288 | \$47,024 | -\$1,264 |
| 2012-13 minimum guarantee | 52,527   | 53,735   | 1,208    |



In particular, the May Revision uses the 1986-87 approach for the rebenching associated with the shift of *ongoing* local property tax revenues from dissolved RDAs to schools and community colleges. Relative to the current-year method, using the 1986-87 method in this case increases the guarantee by slightly more than \$200 million.

**Makes \$785 Million in Current-Year**

**Accounting Adjustments.** The May Revision recognizes slightly higher current-year revenue limit costs (\$183 million) relative to the January estimates—increasing spending from \$47.6 billion to \$47.8 billion. (Under the Governor’s January budget plan, current-year Proposition 98 spending was \$661 million *below* the minimum guarantee, such that a new settle-up obligation would have been created.) With the drop in the guarantee resulting from lower revenues, spending is now estimated to be \$785 million *above* the current-year guarantee. Rather than making programmatic cuts, the May Revision proposes to maintain spending at \$47.8 billion but count \$785 million of that spending toward unmet prior-year Proposition 98 obligations. Specifically, the May Revision counts \$450 million toward a statutory obligation from 2005-06 (discussed further below) and \$335 million toward outstanding settle-up obligations for 2006-07, 2008-09, and 2009-10. The first of these payments results in corresponding General Fund savings of \$450 million in the budget year.

**Increases Budget-Year Spending by \$1.2 Billion.**

As shown in Figure 6, the May Revision contains a number of proposed

changes in budget-year spending. One of the most notable changes is a proposal to pay down an additional \$446 million in K-14 deferrals—bringing the total proposed pay down to \$2.8 billion.

Intended to conform to one of the current-year accounting changes, the May Revision also counts \$450 million for QEIA toward the Proposition 98 minimum guarantee. In addition, the May Revision officially reflects both the restoration of Home-to-School Transportation funding (\$496 million) and the cost of ensuring no district’s per-pupil funding is reduced in 2012-13 due to the implementation of the proposed weighted student formula (\$90 million)—both commitments the Governor made earlier this year. Other notable changes include recognizing less savings from the proposal not to initiate the Transitional Kindergarten program and increasing (rather than cutting) funding for preschool.

**Makes Significant Changes to Weighted Student Formula Proposal.** In addition to making specific adjustments in Proposition 98 spending, the May Revision includes a number of policy adjustments, including notable changes to the Governor’s January proposal to restructure the

**Figure 6**  
**Changes in 2012-13 Proposition 98 Spending**

(In Millions)

|   | January        | May            | Change         |
|---|----------------|----------------|----------------|
| Baseline adjustments                                    | \$2,775        | \$2,333        | -\$442         |
| Pay down K-14 deferrals                                 | 2,369          | 2,815          | 446            |
| Create K-14 mandate block grants <sup>a</sup>           | 110            | 110            | —              |
| Do not initiate Transitional Kindergarten               | -224           | -92            | 132            |
| Modify preschool funding                                | -58            | 33             | 92             |
| Swap with one-time funds                                | -57            | -112           | -55            |
| Eliminate Early Mental Health Initiative                | -15            | -15            | —              |
| Restore Home-to-School Transportation <sup>b</sup>      | —              | 496            | 496            |
| Fund QEIA program                                       | —              | 450            | 450            |
| Hold harmless for weighted student formula <sup>b</sup> | —              | 90             | 90             |
| <b>Total Changes</b>                                    | <b>\$4,900</b> | <b>\$6,108</b> | <b>\$1,208</b> |

<sup>a</sup> Proposes no change in overall spending but shifts \$11 million from schools to community colleges.

<sup>b</sup> Reflects proposals the administration made shortly after releasing the January budget.  
QEIA = Quality Education Investment Act.

way the state allocates K-12 funding. While the weighted student formula is maintained, the May Revision increases the value of the associated base grant, decreases the value of the supplemental grant for English Learners and low-income students, excludes two large programs from the formula (Home-to-School Transportation and the Targeted Instructional Improvement Block Grant), and lengthens the phase-in period to seven years. The Governor also proposes to delay implementation of the new formula if voters do not approve his tax measure in November as well as delay implementation in future years if Proposition 98 funding does not meet predetermined growth thresholds. Additionally, the revised proposal includes intent language that future growth in Proposition 98 funding be split evenly between deferral pay downs and increases in general purpose funding, with existing revenue limit formulas and the new formula increasing in tandem over the phase-in period. (Under the January plan, most growth in Proposition 98 funding had been designated for deferral pay downs.)

***Makes Notable Changes to Education***

***Mandates Proposal.*** The May Revision also makes notable changes to the Governor's earlier education mandates proposal. Though the Governor still proposes to target virtually the same set of K-14 mandates for ultimate elimination (roughly half of all existing education mandates), he now proposes to eliminate six of the costliest of these education mandates immediately (rather than suspending them in the budget year). He also modifies his proposal such that local education agencies would be able to receive funding for the remaining mandated activities only through the block grant. (The Governor previously had proposed allowing local education agencies to choose whether to accept block grant funding or receive reimbursement through the existing

mandate claiming process.) The May Revision also establishes a uniform block grant rate of \$28 per pupil for all local education agencies (districts, charter schools, county offices of education, and community colleges) rather than providing different per-pupil rates for different types of agencies. This revision results in a shift of \$11 million from the K-12 portion of the mandate block grant to the community college portion.

***Guarantee Drops \$2.8 Billion Under Revised Trigger Plan.*** Just as the May Revision contains several changes to the Governor's basic budget plan, it also contains a number of changes to the Governor's January trigger plan. Figure 7 summarizes the Governor's proposed changes to his trigger plan—both as it affects the minimum guarantee (top part) and spending (bottom part). Were voters to reject the Governor's tax measure in November, the administration proposes to maintain the rebenching for debt-service payments (\$194 million) but eliminate the rebenching associated with the shift of additional student mental health services to schools (-\$103 million). When combined with the estimated loss of tax revenues, the Proposition 98 minimum guarantee would drop \$2.8 billion (to \$50.9 billion).

***Proposes Deeper Trigger Reductions to Schools and Community Colleges.*** Though the guarantee would drop by \$2.8 billion, the trigger plan contains about double that level of reductions. This is because the Governor proposes to accommodate both facility debt-service payments (\$2.6 billion) and the Early Start program (\$238 million) within the guarantee (thereby generating equivalent non-Proposition 98 General Fund savings). As shown in the bottom part of Figure 7, the May Revision trigger plan proposes to rescind the \$2.8 billion associated with paying down K-14 deferrals and cut \$2.8 billion in K-14 general purpose funding. Whereas rescinding the deferral pay downs would have little or no programmatic

effect, the cut in general purpose funding would equate to a programmatic loss of \$415 per K-12 student and \$275 per community college student. Were this programmatic reduction to be implemented, the May Revision proposes to allow districts to reduce the school year by a combined total of 15 days in 2012-13 and 2013-14.

**LAO ASSESSMENT**

**Despite Larger Budget Problem, Governor’s May Revision Spends More on Education.** Despite a major decline in state revenues resulting in a worsened state budget problem over the next 14 months, the Proposition 98 funding requirement has increased significantly. Given the deterioration in the state’s fiscal estimates relative to the Governor’s January estimates, the Legislature may want to reconsider the Governor’s overall May Revision package—a package that spends more on schools and community colleges while simultaneously cutting other areas of the state budget (primarily health, social services, courts, and state employee compensation) more deeply.

**Governor’s Plan Continues to Rely on Questionable Maintenance Factor Application.** One of the main reasons the Proposition 98 minimum guarantee *increases* despite the *drop* in state revenues is due to the way the administration makes the 2012-13 maintenance factor payment. For the first time since the inception of Proposition 98, the

administration proposes to make a maintenance factor payment on top of Test 1 rather than Test 2. (The Proposition 98 model is based on a complicated comparison of three underlying tests—commonly known as Test 1, 2, and 3.) As a result, maintenance factor payments are made such that they permanently ratchet up Proposition 98 base funding above the level needed to address prior shortfalls. Using the administration’s approach fundamentally delinks the creation and payment of maintenance factor obligations. It also results in the Proposition 98 requirement being \$1.7 billion higher relative to the alternative approach. If, instead, the maintenance factor payment were applied to Test 2, the 2012-13 guarantee would have dropped from the January level by about \$500 million due to the drop in revenues rather than increasing \$1.2 billion. Moreover, \$1.7 billion in proposed May Revision cuts to other areas of the budget would not have been necessary.

**Figure 7**  
**Changes to Governor’s Proposition 98 Trigger Plan**  
*(In Millions)*

|   | January         | May                         |
|---|-----------------|-----------------------------|
| <b>Changes in 2012-13 Minimum Guarantee</b>             |                 |                             |
| Revenue drop due to measure failing                     | -\$2,444        | -\$2,907                    |
| Rebench for debt-service payments                       | 200             | 194                         |
| Eliminate rebenching for student mental health services | —               | -103                        |
| <b>Total Changes</b>                                    | <b>-\$2,244</b> | <b>-\$2,815<sup>a</sup></b> |
| <b>Changes in 2012-13 Proposition 98 Spending</b>       |                 |                             |
| Accommodate debt-service payments                       | \$2,593         | \$2,551 <sup>b</sup>        |
| Accommodate Early Start program                         | —               | 238                         |
| Rescind deferral pay downs                              | -2,369          | -2,815                      |
| Reduce general purpose funding                          | -2,468          | -2,789 <sup>c</sup>         |
| <b>Total Changes</b>                                    | <b>-\$2,244</b> | <b>-\$2,815</b>             |

<sup>a</sup> As estimated in the May Revision, the Proposition 98 minimum guarantee would drop from \$53.7 billion to \$50.9 billion.  
<sup>b</sup> Reflects updated amounts. The May Revision had relied on earlier point-in-time estimates.  
<sup>c</sup> Reflects updated general purpose reduction assuming administration wants to fund at minimum guarantee.

**Rebenching Adjustments Inconsistent.** As described above and as shown in Figure 8, the administration is inconsistent in its rebenching adjustments—in some cases using the current-year method and in other cases using the 1986-87 method. Specifically, the May Revision uses the current-year method in three cases and the 1986-87 method in three other cases. Using different rebenching methods within the same budget plan (as well as changing rebenching methods across years) at least creates the perception that the state likely is selecting the method that always works to its maximum benefit. (Despite this perception, one of the rebenchings in the May Revision does not work to the General Fund benefit to the state.) It also calls into question the meaningfulness of the Proposition 98 calculations if the same types of local property tax and programmatic shifts can affect the minimum guarantee in different ways depending on the rebenching method used.

**Specific Spending and Policy Changes: Some Modifications Improve Earlier Versions.** In reviewing the specific May Revision Proposition 98 proposals, we think some modifications represent improvements whereas others appear to weaken the Governor’s original proposals. In particular, we think some of the changes the administration

makes to the weighted student formula and mandate proposals reflect at least modest improvements. For example, (1) adding grade-span weights to the weighted student formula would better align funding rates with underlying costs and (2) immediately eliminating rather than suspending the six costliest education mandates would improve transparency. Given the additional spending contained in the May Revision, we also think dedicating more to paying down deferrals is reasonable, as it enables the state to make more payments on time as well as minimizes midyear disruptions if the administration’s tax measure were to be rejected.

**Concerns With Other May Revision Modifications.** We have serious concerns, however, with several other May Revision modifications, including: (1) pulling Home-to-School Transportation and the Targeted Instructional Improvement Block Grant out of the weighted student formula and creating two separate pots of funding as permanent “add-ons,” (2) retaining activities as formal mandates but eliminating the formal mandate reimbursement process, and (3) applying a confusing and inconsistent policy regarding funding for districts that operate two-year kindergarten programs. We

**Figure 8**  
**Inconsistency in Rebenching Adjustments**

|   | Rebenching Method Used: |                |              |
|---|-------------------------|----------------|--------------|
|   | 2011-12 Budget Act      | January        | May          |
| <b>Shift:</b>                           |                         |                |              |
| ERAF and triple flip                    | 1986-87                 | 1986-87        | 1986-87      |
| Ongoing redevelopment-related revenues  | Current-year            | 1986-87        | 1986-87      |
| One-time redevelopment-related revenues | Not applicable          | Not applicable | Current-year |
| Gas tax swap                            | Current-year            | None           | None         |
| Child care                              | Current-year            | 1986-87        | Current-year |
| Student mental health services          | Current-year            | 1986-87        | Current-year |
| Debt-service payments <sup>a</sup>      | Not applicable          | 1986-87        | 1986-87      |
| Early Start <sup>a</sup>                | Not applicable          | Not applicable | None         |

<sup>a</sup> Applicable only under Governor’s trigger plan.  
ERAF = Educational Revenue Augmentation Fund.

have also raised issues with the Governor's overly optimistic budget assumptions relating to RDA property tax distributions (as discussed in more detail in a later section of this report). Additionally, we are concerned that the May Revision substantially overfunds the QEIA program.

***Even More Serious Concerns With May Trigger Plan.*** In *The 2012-13 Budget: Proposition 98 Education Analysis* (February 2012), we raised issues with the Governor's January trigger plan, particularly its rebenching approach for debt-service payments. The May trigger plan not only retains the questionable rebenching approach for debt-service payments but also (1) shifts the Early Start program into the guarantee without any rebenching at all and (2) eliminates the 2012-13 rebenching for the shift of student mental health responsibilities to schools (which the state had planned to implement as the second phase of a rebenching already undertaken in the current year). Such inconsistent treatment across years and among programs is problematic from both a fiscal and a policy perspective. From a budgetary perspective, the May Revision appears arbitrary in adjusting the guarantee by a small amount when a large expenditure (debt service) is shifted within it and not adjusting the guarantee at all when two other programs are included. Moreover, from a policy perspective, the May Revision appears arbitrary in its decisions regarding what constitutes an "education" program—seemingly identifying a new education program when expedient for budget purposes.

## **AN ALTERNATIVE PROPOSITION 98 PACKAGE**

Given the concerns expressed above, the Legislature could consider a different overall Proposition 98 package. This section lays out an alternative to the Governor's basic Proposition 98 budget plan. (The following section lays out an alternative to the Governor's Proposition 98 trigger plan.)

As discussed below, both the alternative basic plan and the alternative trigger plan assume that maintenance factor is paid from the Test 2 level and rebenchings are calculated using the current-year method. (Whereas the maintenance factor assumption significantly affects the Proposition 98 minimum guarantee, the rebenching assumption has a relatively minor effect.) These two components are not dependent upon each other. The Legislature, for example, could adopt the maintenance factor application but not the rebenching approach contained in the alternative plans. Both the alternative basic plan and the alternative trigger plan also contain a number of specific spending components. These spending components can be assessed independently too, such that the Legislature could adopt certain aspects while rejecting others.

***Alternative to Governor's Basic Plan Achieves More State Budget Solution.*** Figure 9 (see page 20) lays out a possible alternative package to the Governor's basic Proposition 98 budget plan. The alternative spends \$1.9 billion less on schools and community colleges, thereby representing an additional budget-balancing action relative to the May Revision. It does so by making what we believe to be a series of reasonable adjustments with little to no additional programmatic impact on schools and community colleges. Moreover, the \$1.9 billion in freed-up funding could be used for restoring May Revision cuts to other areas of the state budget or addressing other likely budget holes. Below, we highlight the major components of this alternative plan.

***Use Historical Method for Paying Maintenance Factor Application.*** Making the required maintenance factor payment on top of the Test 2 level would reduce the minimum guarantee by \$1.7 billion in 2012-13—dropping the guarantee from the May Revision level of \$53.7 billion to \$52 billion. This method has significant conceptual benefits over the administration's approach in that it retains

the fundamental link between maintenance factor creation and payment. That is, it creates maintenance factor whenever state revenues are relatively weak and pays maintenance factor such that Proposition 98 funding over the long run is unaffected by prior-year reductions due to weak state revenues (or suspension).

**Use the Current-Year Method for Rebenchings.**

Using the current-year method consistently for all rebenchings would lower the current- and budget-year minimum guarantees slightly (\$108 million in 2011-12 and \$113 million in 2012-13). Not only is such an approach consistent, but it would allow the state to retire a small amount of additional settle up in the current year as well as generate a small amount of additional savings in the budget year.

**Reduce Deferral Pay Down.** Rather than increasing the deferral pay down to \$2.8 billion as under the May Revision, this alternative would provide \$1.5 billion toward this purpose.

Though notably less than the amount in the May Revision, it is only somewhat less than the amount the Governor proposed to pay down under his February proposal, reflects a 14 percent reduction in total deferrals, and would allow the state to convert about one month of late payments to on-time payments. More importantly, it would allow the state to reduce spending to the lower minimum guarantee without affecting programmatic support for schools and community colleges.

**Pay Off More Settle Up, Cover QEIA Costs.**

Under the alternative, the state would score an additional \$108 million as a settle-up payment in 2011-12 due to rebenching adjustments. Relative to the May Revision, this approach achieves some additional one-time savings in future years. As under the May Revision, the alternative would fund the QEIA program using Proposition 98 General

**Figure 9**  
**An Alternative Proposition 98 2012-13 Budget Package**

(In Millions)

|  | Governor       | Alternative       | Difference                  |
|--|----------------|-------------------|-----------------------------|
| <b>Spending Changes</b>                    |                |                   |                             |
| Baseline adjustments                       | \$2,333        | \$2,333           | —                           |
| Pay down K-14 deferrals                    | 2,815          | 1,525             | -\$1,290                    |
| Restore Home-to-School Transportation      | 496            | 496 <sup>a</sup>  | —                           |
| Fund QEIA program within Proposition 98    | 450            | 328               | -122                        |
| Create K-14 mandate block grants           | 110            | 110               | —                           |
| Hold harmless for weighted student formula | 90             | 90                | —                           |
| Modify preschool funding                   | 33             | —                 | -33                         |
| Use unspent prior-year EIA monies          | —              | -350 <sup>b</sup> | -350                        |
| Swap with one-time funds                   | -112           | -186 <sup>c</sup> | -73                         |
| Do not initiate Transitional Kindergarten  | -92            | -75               | 17                          |
| Eliminate Early Mental Health Initiative   | -15            | -15               | —                           |
| <b>Totals</b>                              | <b>\$6,108</b> | <b>\$4,257</b>    | <b>-\$1,851<sup>d</sup></b> |

<sup>a</sup> Alternative would treat this program comparable to other flexed categorical programs rather than maintain as permanent “add-on.”

<sup>b</sup> Offsets districts’ 2012-13 EIA allocation by unspent prior-year funds.

<sup>c</sup> Recognizes an additional \$74 million in *available one-time* monies.

<sup>d</sup> Reflects reduction in the minimum guarantee if maintenance factor is paid using historical approach (\$1.739 billion) and the current-year method is used for all rebenchings (additional reduction of \$113 million). Minimum guarantee would be reduced from May Revision level of \$53.735 billion to \$51.884 billion. This amount reflects savings that could be redirected to other state budget purposes.

QEIA = Quality Education Investment Act and EIA = Economic Impact Aid.



Fund monies. The alternative, however, would provide only what is needed to cover projected program costs in 2012-13 (\$328 million). (Program costs have been declining for several years due to declining enrollment and are expected to decline further in 2012-13 due to some participating schools not meeting programmatic requirements.)

**Modify Certain May Revision Policy**

**Proposals.** In addition to these spending changes, the Legislature could consider alternatives to the Governor’s May Revision policy proposals. For example, we recommend the Legislature fold funding for Home-to-School Transportation and the Targeted Instructional Improvement Block Grant into districts’ existing revenue limit allocations rather than creating two separate “add-ons” to the weighted student formula. Such an approach holds districts harmless in the near term but still equalizes per-pupil funding rates in the long term. Regarding mandates, we continue to recommend the Legislature replace the existing mandate reimbursement process with a discretionary block grant. If the Legislature, however, were to adopt the Governor’s May Revision proposal to retain certain mandated activities, then we recommend the Legislature retain the mandate reimbursement process. This would help avoid constitutional issues and reduce the risk of associated litigation (and likely not increase state costs significantly, as few school districts would have fiscal incentives to file reimbursement claims). Regarding

kindergarten, we recommend the Legislature adopt a consistent statewide policy that would disallow districts from receiving funding for two-year kindergarten programs (but still would allow children on a case-by-case basis to enroll in traditional kindergarten prior to turning five years of age).

**AN ALTERNATIVE PROPOSITION 98 TRIGGER PLAN**

**Step 1: Count Overappropriation in 2011-12 as Settle-Up Payment.** In addition to exploring an alternative to the Governor’s basic budget plan, the Legislature could consider an alternative to the Governor’s trigger plan. As shown in Figure 10, if the Governor’s tax measure were rejected, the Proposition 98 minimum guarantee would drop to \$45.6 billion in 2011-12. The primary cause of the drop in the guarantee is due to the loss of tax measure-related revenues. To address the drop in the 2011-12 guarantee, the Legislature could count all spending above the guarantee (\$1.4 billion) toward unmet prior-year settle-up obligations. Such action would achieve out-year savings for the state

**Figure 10**  
**Comparing Proposition 98 Trigger Plans**

(In Millions)

|  | Governor        | Alternative     | Difference                 |
|--|-----------------|-----------------|----------------------------|
| <b>2011-12</b>   |                 |                 |                            |
| Ongoing Proposition 98 funding                         | \$47,024        | \$45,637        | -\$1,387                   |
| Settle-up payment                                      | 335             | 1,722           | 1,387                      |
| QEIA-related payment                                   | 450             | 450             | —                          |
| <b>Totals</b>  | <b>\$47,810</b> | <b>\$47,810</b> | <b>—</b>                   |
| <b>2012-13</b>   |                 |                 |                            |
| Ongoing Proposition 98 funding excluding new shifts    | \$48,131        | \$49,384        | \$1,253                    |
| New shifts proposed in May revision <sup>a</sup>       | 2,789           | —               | -2,789                     |
| Fund debt service and Early Start as under current law | —               | 2,789           | 2,789                      |
| <b>Totals</b>  | <b>\$50,920</b> | <b>\$52,173</b> | <b>\$1,253<sup>b</sup></b> |

<sup>a</sup> The Governor’s May Revision trigger plan funds K-14 general obligation debt-service payments and the Early Start program using Proposition 98 funds.

<sup>b</sup> Due to higher costs, the alternative plan provides this amount less in budget solution than the Governor’s trigger proposal. QEIA = Quality Education Investment Act.

without any near-term programmatic impact on schools and community colleges.

**Step 2: Fund at Lower Minimum Guarantee in 2012-13.** The above action would lower the minimum guarantee in 2012-13 by \$1.4 billion (assuming the Test 2 method of paying maintenance factor). Taken together with the loss in tax measure-related revenue, the 2012-13 minimum guarantee would be \$49.4 billion. Given the drop in the minimum guarantee, the Legislature could first rescind all deferral pay downs (similar to the Governor’s plan) with little or no programmatic effect on schools and community colleges. In addition, the Legislature could reduce school and community college general purpose funding by \$1 billion and adopt some corresponding flexibility measures to help districts respond. (These could include removing restrictions on contracting out, modifying the “50 percent law” that applies to community colleges, and allowing for the school year to be shortened a few days on a one-time basis.) This alternative would cut a total of \$4.4 billion from schools and community colleges.

Though still a steep reduction, less education-related budget solution would be achieved, thereby requiring additional budget

actions to be adopted in other areas of the state budget. This loss of savings is the major drawback of the alternative trigger plan.

**Alternative Trigger Plan Has Significant Benefits.** Despite this drawback, the alternative has major advantages over the Governor’s trigger plan. One of the significant advantages is that it involves shifting no programs in or out of the minimum guarantee and no corresponding rebenchings. Another significant benefit is that districts have a better “worst-case” scenario in 2012-13, which would allow districts to sustain a bigger and/or better educational program in the coming school year. That is, under the alternative trigger plan, districts could plan for only \$1 billion in programmatic cuts rather than \$2.8 billion in cuts. As repeatedly emphasized by districts over the last few months, even though the tax measure would provide considerable benefits beginning in 2013-14, it would provide little immediate benefit for districts in the 2012-13 school year. The alternative trigger plan attempts to achieve the best possible outcome in 2012-13 for districts regardless of the outcome of the tax measure. Were the tax measure to be approved, it would provide significant benefits thereafter.

## STUDENT FINANCIAL AID

### GOVERNOR’S MAY REVISION PROPOSAL

In his January budget, the Governor proposed \$766 million in fund shifts and \$302 million in Cal Grant program reductions. The May Revision recognizes \$135 million in additional Cal Grant costs relative to the January proposal, including additional spending to cover the California State University’s approved 2012-13 tuition increase, fix an unintended consequence of 2011 legislation limiting student eligibility, and revise January

savings estimates for Cal Grant reductions. To offset these higher costs, the Governor proposes additional fund shifts and two major policy changes.

**Additional Fund Shifts.** The Governor proposes to replace \$107 million of General Fund support for Cal Grants with expanded fund shifts from two different sources of funding: (1) \$67.4 million from the federal Temporary Assistance for Needy Families Block Grant and (2) \$30 million from the Student Loan Operating Fund. These fund shifts depend

on the availability of funds from other sources and would have no programmatic effect on Cal Grants.

***Tighter Restrictions on Institutional Eligibility.*** Recently enacted legislation prohibits certain institutions with federal student loan default rates of 24.6 percent or more from fully participating in Cal Grant programs. The default limit is scheduled to rise to 30 percent in 2012-13. In January the Governor proposed to freeze the limit at its current level. The May Revision now proposes to reduce the default rate limit to 15 percent, slightly above the national average for all institution types. In addition, the Governor proposes to disqualify certain institutions with student graduation rates below 30 percent. The administration estimates savings of \$38.4 million from this proposal beginning in 2012-13.

***Prorated Cal Grant Award Amounts.*** Beginning in 2013-14, the Governor proposes to reduce Cal Grant tuition awards for some students, using a federal financial need calculation. Specifically, Cal Grants would be prorated based on the size of the federal Pell Grant for which a student qualified. For example, a University of California (UC) student who qualifies for half of the maximum \$5,550 Pell Grant would receive half the Cal Grant tuition award (which currently covers full systemwide tuition and fees). This proposal would have no budget-year impact, but would provide out-year savings in the hundreds of millions of dollars.

## **LAO ASSESSMENT**

The Governor's May Revision proposals address important policy concerns. The proposals collectively would strengthen incentives for institutions to improve their student financial and academic outcomes, eliminate from Cal Grant participation institutions with poor outcomes, and better tailor the size of Cal Grant awards to relative need.

***Tightened Institutional Criteria Should Be Phased In.*** We think the Governor's focus on institutional performance makes substantially more sense than reducing grant amounts solely based on the type of institution a student attends, as another of the Governor's proposals would do. While we believe the general approach merits consideration, we are concerned that this proposal overreaches. It could immediately disqualify from Cal Grant participation institutions that currently serve about one-third of Cal Grant students in the proprietary sector, giving neither students nor institutions sufficient time to adjust to new requirements. In addition, the Governor's savings estimates fail to account for the likely movement of students from ineligible schools to eligible ones. As a result, the Governor's savings estimates are likely overstated in the budget year and significantly overstated in out-years. We recommend adopting the Governor's January proposal to freeze the default rate limit at the current-year level—or an incrementally lower level—and phasing in tighter restrictions over a few years.

***Prorating Proposal Should Be Part of Larger Reform.*** The Governor's proposal to prorate award amounts, in contrast, does not go far enough. We have recommended a more comprehensive approach to reform of Cal Grant programs that could include adjusting grant amounts based on financial need as well as changes to eligibility determination, maximum award levels, and other features of the programs. The Governor's proposal makes one significant change in isolation, missing the opportunity to improve the operation and performance of the programs more fundamentally. Furthermore, proposing such a major departure from existing policy one month before the budget must be adopted leaves insufficient time for a thorough evaluation of its implications and could result in unintended consequences in the near

term. We recommend the Legislature direct an independent study of the state’s student financial aid programs with the purpose of addressing

reform in a more comprehensive, deliberative way through the policy process in the next legislative session.

## FUNDS FROM REDEVELOPMENT DISSOLUTION

### OVERVIEW

The May Revision assumes K-14 districts will receive a total of \$3.3 billion in the current and budget year from the dissolution of RDAs. This amount includes (1) \$1.8 billion in RDA property tax revenues (down from \$2.1 billion assumed in the January budget) and (2) \$1.5 billion in RDA cash and other liquid assets (a new budget solution in the May Revision). As shown in Figure 11, the May Revision proposes to count \$3.2 billion of these funds as an offset towards meeting the state’s Proposition 98 minimum funding guarantee. Districts would receive the remainder in a manner that would *not* count as a Proposition 98 offset.

### SCHOOL PROPERTY TAX REVENUES

*How RDA Dissolution Increases K-14 District Property Tax Revenues.* Chapter 5, Statutes of 2011-12 First Extraordinary Session (ABX1 26, Blumenfeld),

dissolved RDAs and requires county auditors to deposit each RDA’s property tax revenues into trust funds. Money in these trust funds are used to pay:

- Financial obligations of the former RDA that are identified by dollar amount on a Recognized Obligation Payment Schedule (ROPS) that is approved by DOF and a local oversight board. (A nearby box provides information on the ROPS approval process.)
- Certain administrative costs.
- Under the administration’s interpretation of ABX1 26, local agency pass-through payments. (We discuss the implications of this interpretation in our February 2012 report, *The 2012-13 Budget: Unwinding Redevelopment.*)

After paying these obligations, ABX1 26 directs county auditors to distribute any remaining trust fund revenues as property taxes to schools and other local agencies. Based on the state’s property tax distribution laws, K-14 districts receive about half of the remaining trust fund revenues. County auditors make these trust fund distributions twice a year: on June 1<sup>st</sup> and January 1<sup>st</sup>.

**Figure 11**  
**Administration Estimates:**  
**K-14 District Redevelopment Funds**

(In Millions)

|                       | 2011-12      | 2012-13        | Totals         |
|-----------------------|--------------|----------------|----------------|
| <b>Property Tax</b>   | <b>\$818</b> | <b>\$991</b>   | <b>\$1,809</b> |
| Proposition 98 offset | (818)        | (981)          | (1,799)        |
| Not an offset         |              | (10)           | (10)           |
| <b>Assets</b>         | <b>—</b>     | <b>\$1,478</b> | <b>\$1,478</b> |
| Proposition 98 offset | —            | (1,405)        | (1,405)        |
| Not an offset         | —            | (74)           | (74)           |
| <b>Totals</b>         | <b>\$818</b> | <b>\$2,469</b> | <b>\$3,287</b> |
| Proposition 98 offset | (818)        | (2,386)        | (3,204)        |
| Not an offset         | —            | (84)           | (84)           |

Detail does not add due to rounding.

**May Revision Estimate of K-14 District RDA Trust Fund Revenues.** The May Revision assumes \$818 million of RDA trust funds will be distributed to K-14 districts in the current year and \$991 million in 2012-13. These amounts are about \$300 million lower than anticipated in the administration's January budget proposal. Beginning in 2012-13, the May Revision proposes to exclude 1 percent (\$10 million) of the revenues K-14 districts receive from RDA trust funds for purposes of calculating the Proposition 98 guarantee.

**Assessment: Current-Year K-14 Revenues Overstated.** On May 1, county auditors submitted to DOF estimates of the amounts they expect to distribute on June 1 from RDA trust funds to schools and other local agencies. (For reasons that we discuss in a box on page 26, this June 1 distribution will be the *only* distribution from the RDA trust funds to schools and local agencies in 2011-12 and, thus, will represent a partial-year implementation of ABX1 26.) In these reports, county auditors informed DOF that virtually all RDA trust funds will be used to pay ROPS,

administrative costs, and pass-throughs, leaving little or no funds to distribute to schools and other local agencies.

After reviewing these county auditors' reports—and adjusting them to reflect the likelihood that DOF will (or already has) reduced the amounts shown on many ROPS—we estimate that K-14 districts could receive about \$200 million in June, or over \$600 million less than the May Revision anticipates. This funding shortfall reflects (1) partial-year implementation of ABX1 26, (2) successor agency ROPS totaling sums that sometimes exceed the level of property tax revenues the former agency received, and (3) payment of a backlog of pass-through payments (caused by some RDAs failing to make pass-through payments in January after the court upheld their dissolution).

**Assessment: Budget-Year K-14 Revenues Also Overstated.** Going forward, schools and other local agencies will receive two disbursements annually from the redevelopment trust fund and the backlog of pass-through payments will be cleared. In addition, it is likely that some obligations listed on agencies' ROPS will be retired and that county RDA

### ROPS Approval Requirement

Given the direct fiscal link between items listed on an entity's Recognized Obligation Payment Schedule (ROPS) and trust fund distributions to schools and other local agencies, Chapter 5, Statutes of 2011-12 First Extraordinary Session (ABX1 26, Blumenfeld), requires redevelopment agencies' (RDAs) "successor agencies" (entities managing the dissolution of RDAs) to update their ROPS every six months and submit them to local oversight boards and the Department of Finance (DOF) for approval. Over the five months since the court upheld ABX1 26, oversight boards have assembled and reviewed ROPS, but typically not made significant changes to them (even when proposed ROPS spending exceeds the amounts previously spent by the dissolved RDA).

The DOF's review, in contrast, often has resulted in successor agencies removing items from proposed ROPS, reducing the total payable amounts by 10 percent to 20 percent. Even with these DOF-ordered changes, however, items on some ROPS add to a level of spending that is higher than the amounts spent by the former RDAs, a factor that reflects the difficulty associated with state review of complex local contracts within a short period.

audits (due in July 2012) will determine that some ROPS obligations can be paid from revenues other than the redevelopment trust fund (such as RDA lease revenues or bond proceeds). All of these actions will leave more trust funds available to disburse to schools and other local agencies. Accordingly, we anticipate that annual K-14 revenues from redevelopment will increase significantly in 2012-13 to \$700 million, \$300 million less than the \$1 billion assumed by the administration.

## REDEVELOPMENT AGENCY ASSETS

**How K-14 Districts Receive Funds From RDA Assets.** Prior to 2011, RDAs had considerable resources, including several billion dollars of cash and other liquid assets. After the Governor proposed RDA dissolution in January 2011, RDAs began shifting these assets to other entities, such as their sponsoring city or county and economic development corporations. The RDA asset transfers continued until early 2012. Seeking to preserve RDA assets so that they could be distributed to other local agencies, ABX1 26 directs the State Controller's Office (SCO) to order the return of

RDA assets transferred to another public agency after January 1, 2011, provided that the asset has not been contractually committed to a third party.

**RDA Liquid Assets Included as Budget Solution.** The May Revision assumes \$1.5 billion of former RDAs liquid assets will be distributed to K-14 districts in 2012-13 and over \$600 million in 2013-14. Similar to the administration's proposal related to redevelopment property tax trust funds, the May Revision proposes to count 95 percent of these revenues as an offset to the state's Proposition 98 minimum funding guarantee. The remaining 5 percent (\$74 million in 2012-13) would be provided to K-14 districts in addition to funds provided under Proposition 98. To facilitate recapture and distribution of redevelopment assets, the May Revision proposes legislative changes that (1) set deadlines for successor agency asset transfer and distribution and (2) authorize reductions of local sales and property tax revenues from agencies not complying with DOF and SCO orders regarding redevelopment assets.

**Assessment: Significant Risk.** Updated estimates of the amount of unencumbered funds

### Distributing RDA Property Taxes Before and After the Supreme Court Ruling

Before they were dissolved, redevelopment agencies (RDAs) received over \$5 billion in property tax revenues annually. While county property tax disbursement policies varied, auditors typically distributed over 50 percent of this amount in December and most of the remaining property taxes in the spring. Because the Supreme Court had not ruled on Chapter 5, Statutes of 2011-12 First Extraordinary Session (ABX1 26, Blumenfeld), by mid-December, auditors distributed over \$2 billion of property taxes directly to RDAs at that time. (That is, auditors did not put RDA funds into trust funds and follow the payout provisions of ABX1 26.)

The upcoming June 1, 2012 disbursement, therefore, will be the first time that county auditors follow ABX1 26's procedures and distribute revenues from the RDA trust funds to schools and other local agencies. As part of the May Revision, the administration proposes legislation that seeks to recapture some of the funds auditors provided RDAs in December 2011. Our estimate assumes that a portion of these funds would be captured in the June 1, 2012 distribution and that more will be captured in future years' distributions.



held by RDA successor agencies will not be available until county audits are complete in July. In addition, the SCO's review of transferred RDA assets is in its early stages and the Controller's authority to order the return of transferred assets likely will be challenged in court. (We note, for example, that some cities contend that economic development corporations are not public agencies subject to the return provisions of ABX1 26.) Finally, some RDA assets transferred over the last year have been spent or contractually committed to third parties. As a result, the administration's estimate of RDA liquid assets available for distribution to local agencies in 2012-13 and

2013-14 is subject to considerable uncertainty. Specifically, while it is possible that schools could receive more than \$1.5 billion in 2012-13 from redevelopment assets, we think it is much more likely that schools will receive significantly lower amounts—at least in the budget year. To maximize the administration's and SCO's capacity to recoup transferred redevelopment assets and have them distributed to schools in the budget year, we recommend the Legislature carefully review the administration's legislative proposals and take actions to clarify and, where appropriate, strengthen their authority.

## HEALTH AND HUMAN SERVICES

### CALWORKS AND CHILD CARE

#### Governor's Proposal

*Continues to Propose Redesigned CalWORKs Program Structure, but With Several Significant Changes.* The Governor's January budget proposed to redesign the California Work Opportunity and Responsibility to Kids (CalWORKs) program by replacing it with a three-part system, consisting of two CalWORKs subprograms—CalWORKs Basic and CalWORKs Plus—and a Child Maintenance program. Accompanying this redesign, the Governor proposed three significant policy changes to create budgetary savings: (1) reducing cash grants for the majority of cases, (2) shortening the adult time limit for receipt of benefits, and (3) modifying work requirements. Altogether, the Governor's January proposals would have resulted in \$985 million in budget-year savings. The May Revision policy changes discussed below result in roughly equivalent net savings as the policy changes proposed in January.

The May Revision maintains this framework but introduces three significant changes by: (1) permitting recipients to meet work requirements through any combination of activities allowed by current state law—as opposed to aligning to more restrictive federal requirements—for the first 24 months of CalWORKs Basic, (2) expanding the CalWORKs Basic time limit to 48 months for adults meeting federal work participation requirements through any combination of activities allowed by federal law (such as unsubsidized and subsidized employment, education, and training), and (3) eliminating the counting of prior months in exemptions and sanction toward the adult time limit. Under these proposed changes, the CalWORKs Basic program would essentially maintain the CalWORKs program as it exists now for 24 months for all work-eligible recipients and for 48 months for all adults meeting federal work participation requirements (by any combination of allowable work activities). As with the Governor's January proposal, the CalWORKs Plus program would provide an increased cash grant to families

that are meeting federal work requirements through unsubsidized employment. All non-work-eligible cases, as well as those that fail to meet work requirements, would be placed in the Child Maintenance program, which remains unchanged from the Governor's January proposal.

***Phases In Work Requirements for Previously Exempt CalWORKs Cases.*** In each of the last three years, the state has reduced county single allocation funding for employment services and child care as a means of achieving budgetary savings. In 2011-12, single allocation funding was reduced by \$377 million. These reductions have been accompanied by expanded exemptions from work requirements, known as "young child" exemptions, which allow counties to manage the single allocation reduction by reducing employment services and child care caseloads. Under current law, the young child exemptions enacted as part of the 2011-12 budget will expire on June 30, 2012, at which time all previously exempt cases will become subject to work requirements and therefore eligible for county-provided child care and employment services. The May Revision proposes to: (1) postpone expiration of the young child exemptions until October 1, 2012 and (2) require counties to engage all previously exempt cases in welfare-to-work activities during a 12-month period beginning in October 2012. While the administration intends for counties to phase these exempt cases into the welfare-to-work system over a 12-month period, discretion is provided to counties as to how this process would take place. During the 12-month phase-in period, cases would maintain their exemption status until the county engages them in welfare-to-work services.

***Maintains Same Overall Level of Child Care Reductions, but Changes Mix of Cuts.*** As in January, the May Revision proposes to reduce child care funding by roughly \$400 million compared to 2011-12 levels. January savings proposals included

reducing family income eligibility thresholds, lowering payment rates for both child care vouchers and state-run child care centers, and limiting eligibility to parents who were working a required number of hours. The May package maintains many of these proposals, but notably loosens the proposed work eligibility restrictions. Specifically, the revised proposal would allow parents to receive subsidized child care benefits for two years while they attend educational or training programs, and restores funding for an associated 25,000 child care slots. To offset the \$180 million cost of this expanded eligibility, the May Revision proposes to make additional reductions—beyond what was proposed in January—to the maximum voucher amount the state would provide for families to purchase child care. Specifically, the proposal would drop maximum voucher rates from the 85<sup>th</sup> percentile to the 40<sup>th</sup> percentile of regional market rates (RMR) based on data collected in 2005. (The January proposal would have reduced voucher rates to the 50<sup>th</sup> percentile based on 2009 RMR data.)

### **LAO Assessment**

#### ***Revisions Address Several Concerns With January Proposal, but Some Concerns Remain.***

In our prior analysis of the Governor's January CalWORKs proposal, we recommended two specific changes be made: (1) not counting prior months in exemption towards the adult time limit and (2) making allowances for mental health and substance abuse services that would be overly restricted by aligned state and federal work requirements. The May Revision has incorporated both of these changes into the Governor's CalWORKs proposal. It also addresses other concerns raised by the Legislature. By allowing recipients to meet work requirements through participation in education and training after 24 months of aid, the May Revision addresses a

primary concern raised by the Legislature that the January proposal would too severely limit educational opportunities for CalWORKs families. Also, the Governor's proposal to gradually phase out the young child exemptions would avoid a potentially impractical increase in employment services caseloads for the counties.

Despite these improvements, some significant concerns remain with the Governor's proposal. Specifically, it still focuses reductions on child-only cases, which may face comparatively more barriers to self-sufficiency. In addition, the Governor's proposal likely continues to underfund county responsibilities, as it includes a significant reduction to county single allocation funding which is not accompanied by commensurate reductions in county responsibilities.

***Proposal Cuts Child Care Voucher Rates Too Deeply.*** Our initial review suggests the Governor's proposal would drop current child care voucher levels by at least one-third. While the proposal generates savings without eliminating child care slots, we are concerned the reductions are so deep that families would struggle to find qualified providers willing to accept such low payments. Specifically, while the proposed rates would have provided families access to 40 percent of licensed child care providers in 2005, we estimate that in the current market families would be able to afford a notably lower proportion of licensed child care providers. (As under current law, families would have the option of selecting providers who charge more than the state's maximum voucher level, but they would be responsible for paying the difference.)

Moreover, our review suggests the proposed threshold is well below the policies adopted for subsidized child care in other states. Analyzing the feasibility and impacts of the proposal is complicated by the fact that the state does not currently maintain RMR survey data down to the

40<sup>th</sup> percentile. The administration is hoping to collect additional data to be able to set specific rates for each county and type of provider.

***Legislature Has Alternative Options for Making Reductions to CalWORKs and Subsidized Child Care.*** We have compiled a number of alternative approaches for the Legislature to consider should it desire to make different reductions from those proposed by the Governor. (A discussion of these alternatives can be found in our report, *The 2012-13 Budget: The Governor's CalWORKs and Child Care Proposals*.)

For CalWORKs, other options include enacting an across-the-board cash grant reduction, modifying the earned income disregard, continuing the current-year county single allocation reduction, and targeting cash grant reductions at cases that have received aid for extended periods of time (eight to ten years). For child care, alternatives include additional reductions to income eligibility ceilings, eliminating care for some school-age children, and raising parent fees. The Legislature could replace some of the Governor's proposals which raise concerns—including focusing cash grant reductions primarily on child-only cases and the dramatic reduction to child care provider rates—with some of these alternatives to create a budget package that best reflects how it wishes to balance the multiple objectives of these programs and achieves a desired amount of savings.

## **IN-HOME SUPPORTIVE SERVICES**

### **Governor's Proposal**

In January, the Governor proposed \$1.2 billion from the General Fund (\$5.3 billion total funds) for support of the In-Home Supportive Services (IHSS) program. The Governor's revised budget proposes \$1.5 billion from the General Fund for IHSS. This increase in General Fund costs is primarily due to (1) the elimination of previously assumed savings

from the implementation of the IHSS provider tax due to a lack of federal approval for the tax, (2) a reduction in the estimated savings from requiring recipients to obtain a health certificate, and (3) a later implementation date for both the Governor's January proposal to eliminate domestic and related care services for most recipients in shared living arrangements and for the previously adopted 20 percent across-the-board reduction in hours that currently has been enjoined by a federal district court judge. These increased costs are partially offset by a lower caseload than was estimated in January and a new savings proposal to implement a 7 percent across-the-board reduction in IHSS hours, which we discuss below.

Additionally, the Governor continues to propose to make IHSS a managed care benefit through his Coordinated Care Initiative (CCI). (Please see our comments on this initiative in the "Medi-Cal" section of this report.) For more information on the details of previously enacted IHSS policies and the Governor's January budget proposals, please see our March 2012 publication, *The 2012-13 Budget: In-Home Supportive Services Budget Update*.

**A 7 Percent Across-the-Board Reduction in Hours.** The Governor's May Revision proposes to implement a 7 percent across-the-board reduction in IHSS service hours effective August 2012. Under current law, effective in 2010-11, IHSS recipients have had their service hours reduced by 3.6 percent, but this reduction is set to expire at the end of June 2012. Similar to the 3.6 percent reduction currently in place, under the Governor's proposal recipients would determine which of their authorized services will be impacted by the reduction. This reduction is estimated to result in net General Fund savings of \$99 million in 2012-13. The administration estimates that the average IHSS recipient will lose 6.1 hours per month as a result of this reduction.

As previously mentioned, the budget continues

to assume that the state will ultimately prevail in current litigation and be able to implement a 20 percent across-the-board reduction in IHSS service hours effective April 2013. It is important to note that if the state is able to implement the 20 percent across-the-board reduction, the proposed 7 percent across-the-board reduction would be in addition to the 20 percent reduction.

### **LAO Assessment**

***Magnitude of a Proposed Reduction in Service Hours Impacts Legal Risk.*** Although the state has been able to implement a 3.6 percent across-the-board reduction in service hours without legal challenge to date, a federal district court judge has issued an injunction that prevents the state from implementing the 20 percent reduction in hours. There were various reasons for this injunction, one of them being that the reduction in hours could place recipients at risk of entering an institution, and could therefore violate the Americans with Disabilities Act. Although the 7 percent reduction is not as large as the 20 percent reduction, and therefore its impact on IHSS program beneficiaries would be significantly less, it is uncertain at what point the reduction would be significant enough in the eyes of the courts to place recipients at risk of institutionalization.

***LAO Savings Alternatives.*** In our March report, we offered two savings alternatives that we considered posed less legal risk than the Governor's January budget savings proposals for IHSS. The Legislature may also wish to consider these in light of the legal risk potentially posed by the Governor's May Revision proposal. These alternatives included (1) extending the current 3.6 percent across-the-board reduction in service hours (if the 20 percent across-the-board reduction were not implemented) and (2) reenacting a reduction in state participation in provider wages to a level, determined by a study, that does not impact recipient access to services. In January, we estimated

the General Fund savings from the extension of the 3.6 percent reduction in service hours to be about \$60 million in 2012-13. The level of savings associated with a reduction in state participation in wages would depend upon the amount of the reduction that is supported by the study.

## **MEDI-CAL**

The Governor's May Revision includes several significant policy changes to the budget for the Medi-Cal Program. In addition, lower caseload estimates and other budgetary adjustments are expected to result in reduced expenditures of \$200 million in 2011-12 and \$700 million in 2012-13. We describe some of the significant policy adjustments below.

### **Coordinated Care Initiative**

**Governor's Proposal.** As part of the January budget, the Governor proposed the CCI, which would integrate all services, including medical care and long-term supports and services, into managed care for nearly all seniors and persons with disabilities (including "dual eligibles," who are eligible for both Medicare and Medi-Cal) statewide beginning in January 2013. At the center of this proposal, the Governor proposed to expand a recently authorized demonstration project (originally scheduled to begin in January 2013) that will test this new model of integrated care in up to four counties. Our initial assessment of the CCI can be found in our February 17, 2012 report, *The 2012-13 Budget: Integrating Care for Seniors and Persons With Disabilities*.

Since the release of our initial assessment, the administration has provided more details on how certain aspects of the CCI would be implemented. In addition, as part of the May Revision, the administration is making several changes to the proposal, including: (1) reducing the number of initial implementation counties from ten to eight,

(2) delaying the start date from January 1, 2013 to March 1, 2013, and (3) indicating its intention to eventually transition IHSS collective bargaining from the local government level to the state. This revised proposal is estimated to reduce General Fund costs by \$663 million in 2012-13 (slightly lower than that assumed by the January budget proposal), savings which are largely achieved by delaying payments to Medi-Cal managed care plans and providers.

**LAO Assessment.** The administration has made several changes and updates to its proposal that begin to address many of the concerns we raised in our February report. For example, it has provided more information on its vision of how IHSS would be integrated as a managed care benefit, established a series of stakeholder workgroups to work out implementation details, and proposed to delay the initial implementation timeline to increase the likelihood of successful implementation. However, we continue to have many of the same concerns about the complex and difficult implementation issues that still need to be addressed. These issues include, for example, integration of IHSS as a managed care benefit, beneficiary outreach and enrollment, and setting rates paid to managed care plans. In addition, our primary concern remains—the proposal would prematurely expand a pilot project statewide before the results have been properly evaluated.

### **Hospital Payment Changes**

**Governor's Proposal.** The May Revision assumes combined General Fund savings of \$325 million in 2012-13 from implementing changes to Medi-Cal payments for three categories of hospitals: private hospitals, designated public hospitals (DPHs), and non-designated public hospitals (NDPHs). There are about 300 private hospitals in California. The state's 21 DPHs are operated by counties and the UC system, while the

46 NDPHs are generally operated by local health care districts and cities, with some NDPHs located in rural areas. The May Revision also proposes a six-month delay of the currently authorized switch to a diagnostic-related group methodology for private hospital payments, pushing the start date to July 1, 2013.

Under the May Revision, \$75 million in General Fund savings would be achieved by requiring NDPHs to certify their costs incurred from providing Medi-Cal inpatient services. Starting July 2012, these locally funded Certified Public Expenditures (CPEs) would replace General Fund expenditures as the non-federal share of Medi-Cal matching funds for NDPHs. The administration also proposes to seek federal approval for NDPHs to access additional federal funding to minimize the financial impact on these hospitals from switching to a CPE-based reimbursement mechanism.

The Department of Health Care Services has requested federal approval to reallocate

\$200 million in unspent federal funding to an uncompensated care funding pool for DPHs. Under the May Revision, \$100 million, or 50 percent, of this reallocated amount would be deposited in the state General Fund. The May Revision also proposes to reduce supplemental payments to private hospitals, eliminate public hospital grants, and eliminate increases to managed care plans for supplemental payments to DPHs—for savings of \$150 million General Fund in 2012-13.

**LAO Assessment.** We note that the proposal to adopt a CPE payment methodology and obtain additional federal funding for NDPHs requires federal approval of both a State Plan Amendment and an amendment to the 1115 Bridge to Reform waiver. The May Revision also proposes a seemingly aggressive timeline for transitioning NDPHs to the CPE methodology. A too-rushed transition could affect the short-term financial stability of some NDPHs, particularly those hospitals operating on tight margins.

## CRIMINAL JUSTICE AND JUDICIARY

### JUDICIAL BRANCH REDUCTIONS

**Proposal.** The Governor's May Revision proposes a \$544 million (\$125 million ongoing) General Fund reduction to the judicial branch in the budget year. (This reduction is in addition to the continuation of the \$350 million ongoing reduction enacted in 2011-12.) The administration proposes to achieve the \$544 million reduction in three ways.

- First, the Governor proposes to use \$300 million of local trial court reserves on a one-time basis to offset General Fund costs for the trial courts. The administration also proposes to eliminate the statutory authority allowing local

courts to retain reserves in the future, as well as authorizes the Judicial Council to retain funds as a statewide reserve to address budget shortfalls of individual trial courts.

- Second, the Governor proposes a delay of 38 court construction projects, thereby permitting the one-time redirection of \$240 million in court construction funds for trial court operations in 2012-13. (Beginning in 2013-14, the Governor proposes to redirect \$50 million in court construction funds on an annual basis.)
- Third, the Governor proposes generating \$4 million in ongoing savings by increasing

employee retirement contributions for all state judicial branch employees.

Additionally, the Governor proposes to establish a working group to evaluate the state's progress in achieving the goals of statewide trial court realignment initiated 15 years ago by the Legislature.

**LAO Comments.** While the Governor's May Revision proposals for the judicial branch merit consideration, they raise several issues for legislative review. For example, while the proposals to eliminate local court reserves and create a statewide reserve move the state closer to achieving the legislative goals of statewide trial court realignment, they raise questions related to the respective roles of local courts and the Judicial Council in setting fiscal and program priorities. The Legislature will want to consider how the elimination of local reserves affects individual trial court operations and fiscal planning practices, as well as how the proposed statewide reserve will be implemented and administered. (For more information on recent budget reductions to the judicial branch, as well as how those cuts have been addressed, please see our recent brief, *The 2012-13 Budget: Managing Ongoing Reductions to the Judicial Branch*.)

### **INCREASED FUNDING FOR INMATE MEDICAL CARE**

**Proposal.** The Governor's May Revision proposes a General Fund augmentation of \$295 million in 2011-12 for the federal Receiver's inmate medical care program. According to the administration, the additional funding is requested due to the inability to fully achieve the level of savings assumed in the 2011-12 budget (\$163 million), as well as higher-than-expected costs for inmate pharmaceuticals (\$86 million) and health care guarding (\$46 million). Similarly, the May Revision proposes an additional \$128 million for inmate medical care in 2012-13.

**LAO Comments.** We are concerned that the administration's request for additional funding for inmate medical care in 2011-12 circumvents the process established in the budget act for requesting a supplemental appropriation for unanticipated expenses. State law requires agencies to seek supplemental appropriations from the Legislature *prior* to the expenditure of funds. It appears that the Receivership has continued a pattern in recent years of expending state funds beyond its budget authority, then seeking supplemental funding from the Legislature *after the fact* to pay for these substantial additional costs. We are also concerned that the Governor's proposal to increase funding for inmate medical care in 2012-13 does not account for potential efficiencies that could be achieved. For example, in our recent report, *Providing Constitutional and Cost-Effective Inmate Medical Care* (April 2012), we identified tens of millions of dollars in savings that could be achieved from more consistent application of the Receiver's utilization management system for determining when inmates should be referred to specialty medical care and from increased utilization of telemedicine technology. In addition, we note that the Receiver could achieve additional savings of \$20 million annually in inmate pharmacy costs from improving prescribing practices and inventory management.

### **DIVISION OF JUVENILE JUSTICE (DJJ)**

**Proposal.** The Governor's May Revision reverses a proposal made in his January budget plan to close the state's juvenile detention facilities and realign the responsibility for supervising all juvenile offenders to counties. Specifically, the May Revision maintains DJJ as a commitment option for juvenile offenders, as well as proposes various changes designed to achieve \$25 million in budget-year savings. Specifically, the Governor proposes to (1) reduce DJJ administrative staff,



(2) complete the realignment of juvenile parole on January 1, 2013 (rather than July 1, 2014, as specified under current law), and (3) charge counties \$24,000 per year for each ward committed to DJJ by the juvenile courts beginning July 1, 2012. In addition, the administration proposes reducing from 25 to 23 the maximum age at which an offender can be housed in a DJJ facility.

**LAO Comments.** In our recent report, *The 2012-13 Budget: Completing Juvenile Justice Realignment* (February 2012), we recommended approving the Governor’s January proposal to close DJJ and require counties to manage all juvenile offenders. While we still believe that proposal would promote efficiency and accountability in juvenile justice, we find that the alternative savings measures included in the Governor’s May Revision also warrant consideration. For example, the proposal to increase fees charged to counties would result in counties bearing a greater share of the costs of local decisions to send juvenile offenders to state facilities, as well as potentially increase the incentive for counties to identify less costly alternatives for managing these offenders.

While the plan warrants consideration, the Governor’s proposal to lower the DJJ age jurisdiction carries the risk that more juvenile cases would be filed in adult court rather than juvenile court. Because there is no upper limit on the adult court’s age jurisdiction, prosecutors may opt to pursue more eligible juvenile cases in adult court as a way to secure

longer sentences. To the extent this occurs, there could be some additional state prison costs in the future.

## ADMINISTRATION’S BLUEPRINT FOR REORGANIZATION OF STATE PRISONS

**Proposal.** The Governor’s May Revision includes a plan (referred to as the “blueprint”) to reorganize various aspects of California Department of Corrections and Rehabilitation (CDCR) operations, facilities, and budget in response to the effects of the 2011 realignment of adult offenders, as well as to meet various federal court requirements (such as reducing the inmate population to meet specified population cap targets). For example, the blueprint includes plans to (1) request court approval of increased prison capacity of 145 percent, (2) construct new or renovate existing prison facilities, and (3) end the use of out-of-state contract beds.

**LAO Comments.** As we discuss in our recent brief, *The 2012-13 Budget: State Should Consider Less Costly Alternatives to CDCR Blueprint*, much of the administration’s blueprint merits legislative consideration. However, we find that the General Fund costs of the planned approach—in particular, an estimated \$78 million in annual debt service—is a significant trade-off. The state could meet specified population cap targets at much lower ongoing General Fund costs than proposed by the administration, potentially saving the state as much as a billion dollars over the next seven years.

## OTHER PROPOSALS

### MORTGAGE SETTLEMENT

**Proposal.** As part of a nationwide settlement obtained against five major mortgage lenders, the state will receive about \$411 million in 2011-12. The use of these funds is restricted by the terms of the settlement agreement, which requires that

no less than 90 percent (\$370 million) be used to compensate the state for the harms caused by the allegedly unlawful foreclosure practices of the lenders and to facilitate direct relief to consumers. The remaining 10 percent (\$41 million) is paid as a civil penalty and may be used at the discretion

of the state. As part of his May Revision, the Governor proposes to use the entire \$411 million to benefit the General Fund in 2011-12 (\$171 million), 2012-13 (\$121 million), and 2013-14 (\$118 million). Specifically, the Governor proposes to (1) transfer the \$41 million civil penalty directly to the General Fund, (2) offset \$70 million in General Fund costs for the Division of Law Enforcement and the Public Rights Legal Division within the Department of Justice (DOJ), (3) offset \$12 million in General Fund costs for the Civil Rights Law program within the Department of Fair Employment and Housing, and (4) use \$287 million to support debt-service costs on housing bonds authorized by Propositions 46 and 1C.

**LAO Comments.** Given the state's current fiscal situation and the magnitude of General Fund savings achieved, we find that the Governor's proposal merits legislative consideration. However, some of the proposed expenditures could fall outside the intent of the settlement agreement to the extent that they do not directly relate to consumer fraud, borrower relief, services for homeowners, or other permitted uses. For example, the administration proposes to fully supplant General Fund support for DOJ's Division of Law Enforcement, which conducts investigations into organized crime, gangs, and drug trafficking. The Legislature will want to consider any potential legal risks associated with using the settlement proceeds for the proposed purposes.

## **TRANSFER FUNDS FROM MOTOR VEHICLE FUEL ACCOUNT**

**Proposal.** In 2010, the Legislature enacted a "fuel tax swap" to increase its flexibility over the use of transportation funds while maintaining fuel tax revenues at approximately the same level. Under the swap, the state no longer charges a sales tax on gasoline and instead imposes an additional excise tax (18 cents per gallon) on gasoline, with

the revenue deposited into the Motor Vehicle Fuel Account. An unintended effect of the swap has been a substantial increase in the amount of revenues transferred to several special funds that receive a specified percentage of the fuel excise tax attributable to fuel purchased for off-highway vehicles, including the Off-Highway Vehicle Trust Fund, the Harbors and Watercraft Revolving Fund, and the Department of Agriculture Account. These funds would otherwise have been available to support various transportation projects. The Governor's May Revision proposes to amend the 2010 fuel tax swap and transfer this increased revenue to the General Fund—\$184 million in 2011-12 and \$128.2 million annually beginning in 2012-13.

**LAO Comments.** The Governor's proposal is consistent with the intent of the fuel tax swap to increase the flexibility of the use of transportation funds in meeting the state's spending priorities. Unlike other transportation funds, the funds proposed to be transferred to the General Fund are not restricted in their use under the State Constitution. Given the state's current fiscal condition, we believe the proposed transfer merits legislative consideration.

## **EMPLOYEE COMPENSATION**

### **Governor's Proposal**

**Reduction in Employee Compensation.** Under Control Section 3.90, the administration proposes reducing the state's employee compensation costs by \$839 million (\$402 million General Fund). This represents about a 5 percent reduction in pay for state workers, equivalent to a one-day-per-month reduction. Under Control Section 3.90, as submitted to the Legislature on May 14th, the administration proposes to achieve these savings through "(1) the collective bargaining process, and/or (2) legislative reductions in the

state workweek and changes in work schedules, and/or (3) furloughs, and/or (4) other reductions for represented and non-represented employees achieved with existing administrative authority.” The proposed control section authorizes these actions “notwithstanding any other provision of law.” The May Revision summary document, however, suggests that the administration wishes to use the collective bargaining process “to avoid furloughs and to mitigate layoffs.” Specifically, the summary document suggests the administration plans to achieve the savings through (1) a reduction in pay resulting from employees working two fewer hours each week and (2) changes in employee and retiree health coverage to offset rising state health care costs.

**A New Workweek.** In the summary document, the administration proposes to achieve the reduction in employee work hours by adopting a four-day, 38-hour workweek for the majority of state employees. (The only exception to the new workweek appears to apply to employees who work at 24-hour institutions.) The administration suggests that this new workweek would allow the state to (1) offer better services to the public by being open longer than the traditional 8-hour workday and (2) reduce energy usage in state-owned and leased buildings.

### LAO Comments

**Four-Day Workweek Problematic.** The four-day workweek proposed by the administration may allow some departments to offer services outside of regular hours that are more convenient for some residents. We do, however, see a few potential problems with this idea. Specifically, a four-day workweek raises the following issues:

- **May Increase Leave Balances.** When an employee separates from state service, the state must compensate (or “cash out”) the employee for certain unused leave days.

Leave balances must be cashed out at an employee’s final salary level. A four-day workweek may result in increased leave balances. The work schedule would give employees three-day weekends each week. With more time off, employees could be less inclined to use vacation.

- **Hinder Services in Many Cases.** The proposal could hinder state services if applied to employees who interact with other governmental entities or businesses that operate on the traditional five-day workweek.
- **May Not Reduce Energy Costs or Be Convenient for Many.** The possible energy savings from a four-day workweek are difficult to quantify and are probably not significant (as the administration acknowledges). In 2008, Utah implemented a four-day state workweek to reduce energy costs. In 2011, Utah reverted to the traditional five-day workweek partly because the energy savings were not significant and lawmakers were concerned that the Monday through Thursday workweek was not convenient for many residents.

**Employee Compensation May Need to Be Part of Budget Solution, but No Ideal Options.** Employee compensation, including salaries and benefits, will cost the state’s General Fund \$10.5 billion in 2012-13. Given the severity of the state’s budget shortfall, we think the Legislature will need to consider reductions in these costs. There are, however, no ideal ways to achieve such reductions. In addition to the issues above related to a four-day workweek, the Legislature should take into account the following issues when considering other alternatives to reductions in employee compensation costs.

- ***Bargaining Typically Necessitates Concessions.*** While bargaining is probably the preferred approach to achieving savings, it often requires an employer to offer to employees some offsetting benefits. These typically increase costs in the future and can increase, rather than reduce, the state's ongoing structural deficit.
- ***Layoffs Take Months and Can Affect State Services.*** Layoffs reduce state employee compensation costs by reducing the size of the state workforce. There are a number of disadvantages to using layoffs including: (1) the potential ability of the Governor to decide where to take layoffs without considering the Legislature's priorities, (2) the slow layoff process, (3) the fact that layoffs typically are based on inverse seniority without any consideration of the quality of an employee, and (4) the effects of layoffs on a department's ability to fulfill its mission and serve the public.
- ***Furloughs and Leave Programs Have Future Costs.*** Authorizing the administration to impose furloughs or personal leave programs (known as PLPs) allows the state to cut employee compensation costs without reducing the size of the workforce. Data from the SCO suggest that the recent furloughs and PLPs created a liability for the state by greatly increasing some employees' leave balances. As a result, furloughs and PLPs increased out-year costs that offset the near-term savings.
- ***Non-Negotiated State Actions Raise Concerns.*** Under the Ralph C. Dills Act, the legislation authorizing collective bargaining for state employees, the Legislature

reserves the right not to approve or fully fund any provision of a memorandum of understanding which requires the expenditure of funds. Assuming the Legislature approves pending agreements that would extend four contracts, all 21 bargaining units will have contracts that expire in July 2013. If the Legislature authorized unilateral state actions to reduce pay in 2012-13 (and/or in future years), this could result in some savings, but could require the administration to negotiate with unions for new contracts under the terms of the Dills Act. Unilateral state actions of this type may produce significant state savings, but pose many concerns. Such concerns include negative effects on employee-management relations.

## VACANT POSITIONS

### Background

***State Has Many Vacant Positions.*** All state departments have some vacant positions due to normal personnel turnover and hiring delays. In past decades, a typical state vacancy rate was about 5 percent—meaning that 5 percent of authorized positions were vacant. According to the SCO, the current average vacancy rate is now about 15 percent and has hovered around that level for a number of years now. As shown in Figure 12 (see page 38), some departments have much higher vacancy rates. The Legislature authorizes positions so that departments may increase staffing levels to accomplish a specified activity. A high vacancy rate could mean that a department is not able to accomplish all intended activities or that the department has found ways to accomplish the activities without filling some positions (for example, by instead using overtime or contract personnel).

**Vacancies Generate Salary Savings.** When a position is vacant or filled by an employee at a pay level lower than the department’s budget assumes—the department captures “salary savings.” Since the early 1940s, the state budget has assumed that most departments have “normal salary savings”—historically, assuming vacancies equal to about 5 percent of authorized personnel—and reduces departments’ personnel budgets accordingly. (In other words, departments are not appropriated any funds for normal salary savings.) “Excess salary savings”—savings from vacant positions in excess of normal salary savings—typically can be used for personnel *or* operations expenditures but are displayed in a department’s personnel budget.

**State Policies Likely Caused High Vacancy Rates.** Over the past decade or so, a number of decisions made by both the administration and Legislature have contributed to high vacancy rates. The policies described below have created incentives for departments to generate excess salary savings by deliberately holding positions vacant.

- **Unallocated Cuts.** The Legislature has approved many unallocated cuts, especially to General Fund departments. When implementing unallocated cuts, the administration chooses how to achieve the reduction. We understand that it is common for departments to hold positions vacant to absorb unallocated cuts. As a result, departments largely funded by the General Fund have noticeably higher vacancy rates than special fund departments.
- **Leave Cash Outs.** The number of state retirements has increased as employees of the baby boom generation reach retirement age. Upon retirement, the state must compensate (or cash out) an employee for certain unused leave days. Generally, departments do not receive supplemental appropriations to cover these costs. Some departments cannot absorb these costs without holding positions vacant.
- **Overtime Costs.** Some departments, especially those with 24-hour institutions, consistently incur high overtime costs. Like leave cash outs, departments sometimes do not receive supplemental appropriations for these costs. Departments with high overtime costs often have high vacancy rates to generate excess salary savings.

**Figure 12**  
**Vacancy Rates Across Largest Departments**

| Department             | Established Positions | Vacancy Rate (%) |
|------------------------|-----------------------|------------------|
| Corrections            | 60,950                | 18.6             |
| Transportation         | 20,989                | 6.6              |
| Mental Health          | 11,429                | 13.1             |
| Highway Patrol         | 11,254                | 7.8              |
| Employment Development | 10,099                | 18.9             |
| Motor Vehicles         | 8,392                 | 6.1              |
| Developmental Services | 5,957                 | 15.7             |
| Franchise Tax Board    | 5,394                 | 11.6             |
| Justice                | 4,936                 | 21.8             |
| CalFire                | 4,773                 | 15.6             |
| Board of Equalization  | 4,666                 | 11.3             |
| Social Services        | 4,494                 | 21.0             |
| Public Health          | 3,742                 | 21.0             |
| Health Services        | 3,331                 | 18.4             |
| Water Resources        | 3,112                 | 7.8              |

Source: State Controller’s Office data.

**Proposal**

**Governor Proposes Significant Change to How the State Budgets for Positions.** In an effort that it claims will make the budget more transparent, the administration proposes several actions related to vacant positions.

- **Eliminate Large Number of Vacant Authorized Positions.** The administration proposes to eliminate a net number of about

11,000 “historically vacant” positions (after accounting for increases in temporary help included in the administration’s calculations). In most cases, we are told, these positions were unfunded positions as a result of normal salary savings. The positions proposed for elimination were selected through discussions within the administration after issuance of a “budget letter” (a DOF directive to departments) in March 2012.

- ***Eliminate Salary Savings.*** The budget would no longer reflect salary savings. No departmental budgets would be increased over their current levels in the administration’s plan. Instead, departments’ personnel and operations budgets would come closer to reflecting actual costs in those respective areas. In future position requests submitted to the Legislature, departments would ask for an amount of money needed to support the positions without any explicit provision for salary savings.
- ***Hold Departments Harmless.*** The proposal would shift money between a department’s operations and personnel budgets so that each reflects something closer to actual expenditures in those areas. As noted above, the total amount of money budgeted to a department would not be affected by the proposal.

### LAO Comments

***Why the Rush?*** The administration’s goal of making departmental budgets more transparent has merit. We are intrigued by this idea. We are concerned, however, that the proposal seems rushed and may not advance the goal of

transparency in some cases. We question the wisdom of undoing seven decades of budgetary decisions and precedent based solely on a nine-week internal administration drill. We have many questions about how this would work. During the next four weeks, it would be *impossible* for the Legislature to fully examine the proposal, particularly while it considers all of the administration’s other budget proposals.

***Legislative Priorities Not Considered.*** Each position proposed for elimination in this proposal previously has been authorized by the Legislature—in most cases, to staff a particular program intended to achieve some legislative priority. The list of each individual position proposed for elimination in each departmental program, once it is submitted to the Legislature, will be based *solely* on the administration’s priorities and not necessarily those of the Legislature.

### LAO Recommendation

***Reject Governor’s Proposal, Suggest Governor Submit Detailed Proposals Later.*** This proposal should be more fully developed by the administration and, if resubmitted later, fully vetted by the Legislature over at least several months in some future year. While the proposal seemingly would have no effect on the number of people currently employed by the state or the amount of money spent by departments, it could result in staffing levels far different from priorities of the Legislature. The proposal apparently would contribute nothing to balancing the 2012-13 budget. As a result, we recommend that the Legislature reject the Governor’s proposal now and suggest that the administration may choose to submit detailed proposals in the future justifying why vacant positions should be eliminated and how this new position budgeting process would work in future years. Legislative review of such a proposal would require extensive time of legislators and staff.

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