The 2017-18 Budget:

Overview of the Governor's Budget

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EXECUTIVE SUMMARY

This publication is our office's initial response to the *2017-18 Governor's Budget* proposal, which was presented to the Legislature on January 10, 2017. (Over the next couple of months, we will publish analyses considering key parts of the proposal in more detail.)

Governor Identifies $1.6 Billion Budget Problem. In preparing the 2017-18 budget, the administration concluded that the state's fiscal condition has worsened. According to the administration, absent new budget solutions, the state would face a deficit of $1.6 billion at the end of 2017-18. The primary reason for this deterioration in the budget's position is the administration's lower estimates of revenues, particularly those from the personal income tax (PIT). The administration also identifies a net increase in General Fund costs relative to the June 2016 budget package, including $1.8 billion in costs related to Medi-Cal, the state's Medicaid program.

Governor Proposes $3.2 Billion in Actions to Reduce Spending Growth. To address this estimated $1.6 billion budget problem, the Governor's budget includes more than $3.2 billion in actions to reduce General Fund spending growth. The most significant of these actions is related to the Proposition 98 minimum funding guarantee for schools and community colleges. Altogether, the administration estimates these actions would eliminate their projected deficit and leave a balance in the 2017-18 year-end discretionary reserve of $1.6 billion. Under the administration's revenue assumptions, the state's Proposition 2 (2014) rainy day fund would grow to $7.9 billion—for a combined $9.4 billion in total reserves.

Budget's PIT Estimate for 2017-18 Seems Too Low. In 2017-18, the administration estimates that PIT will grow $2.7 billion, or 3.3 percent. In a normal growth year unaffected by recession or major policy changes, we expect PIT growth to exceed 5 percent. The weak growth that the Governor envisions for PIT is possible in 2017-18, but seems inconsistent with parts of the administration's own economic outlook. For these reasons, we believe the Governor's estimate of PIT growth in 2017-18 is probably too low. As a result, by the May Revision, the state could have considerably more General Fund revenue in 2017-18 than now projected by the administration. Part of any such increases would be required to go to schools under the Proposition 98 minimum guarantee as well as mandatory reserve deposits and debt payments under Proposition 2.

Plan for High Level of Uncertainty. We have long encouraged the Legislature to plan for the next economic downturn by building reserves and concentrating any new commitments on one-time purposes. In addition, the Legislature now faces new uncertainties, as federal actions could significantly affect the state budget's bottom line in future years. We encourage the Legislature as a first step in its budget deliberations to set a target level for the state's total reserves (that is, the combined amount of discretionary and mandatory reserves available to address future budget emergencies). Facing uncertainties about the future of the economy and federal policy, the Legislature may want to set its target for state reserves at—or preferably above—the level the Governor now proposes.

OVERVIEW

On January 10, 2017 the Governor presented his 2017-18 budget proposal to the Legislature. Figure 1 shows the General Fund's condition from 2015-16 through 2017-18 under the Governor's budget assumptions and proposals. (These numbers reflect actions the Governor took to address the administration's estimated budget problem, which we describe below.) The administration now estimates 2016-17 will end with $6.8 billion in total reserves. This is $1.7 billion less than assumed in the June 2016 state budget plan. Under the Governor's plan, the state would add to reserves in 2017-18, ending that fiscal year with $9.4 billion in total reserves. This would consist of: (1) $1.6 billion in the state's discretionary reserve, the Special Fund for Economic Uncertainties (SFEU), and (2) $7.9 billion in the state's mandatory reserve, the Budget Stabilization Account, which is governed by the terms of Proposition 2 (2014).

Governor Identifies $1.6 Billion Budget Problem

In preparing the 2017-18 budget, the administration concluded that the state's fiscal condition has worsened, and, absent new budget solutions, the state would have an SFEU reserve *deficit* of $1.6 billion at the end of 2017-18. (The estimated size of the SFEU deficit traditionally is called the "budget problem" that must be addressed during the annual budget process.) In this section, we discuss the major reasons that the administration is estimating a deterioration in the budget's condition.

Lower Revenue Estimates. Relative to the assumptions in the June 2016 budget plan, the administration estimates that revenues associated with the "Big Three" state taxes are down $3.2 billion in 2015-16 and 2016-17 combined. This includes downward revisions in the personal income tax (PIT) ($1.3 billion), the sales and use tax ($871 million), and the corporation tax ($1 billion). As shown in Figure 2 (see next page), the administration also assumes a modest 2.9 percent growth in Big Three revenues between 2016-17 and 2017-18.

Additional Medi-Cal Spending. The Governor estimates there are some increases in General Fund spending in the current year relative to the assumptions in the June 2016 budget package. The major net increase is related to Medi-Cal, the state's Medicaid program. The administration estimates Medi-Cal costs in 2016-17 are higher than June 2016 estimates by $1.8 billion. This is attributed to a one-time retroactive payment of drug rebates and a miscalculation of costs.

Figure 1

Governor's Budget: General Fund Condition

(In Millions)

	2015-16 Revised	2016-17 Revised	2017-18 Proposed
Prior-year fund balance	$3,508	$5,024	$1,028
Revenues and transfers	115,500	118,765	124,027
Expenditures	113,983	122,761	122,520
Ending fund balance	$5,024	$1,028	$2,535
Encumbrances	980	980	980
SFEU balance	4,044	48	1,555
Reserves			
SFEU balance	$4,044	$48	$1,555
BSA balance	3,529	6,713	7,869
Total Reserves	**$7,574**	**$6,761**	**$9,424**

SFEU = Special Fund for Economic Uncertainties (the General Fund's traditional budget reserve) and BSA = Budget Stabilization Account.

Figure 2

Governor's Budget: Near-Term Revenue Estimates

General Fund (Dollars in Millions)

	2015-16	2016-17	2017-18	Change From 2016-17 Amount	Change From 2016-17 Percent
Personal income tax	$78,947	$83,136	$85,866	$2,730	3.3%
Sales and use tax	24,890	24,994	25,179	185	0.7
Corporation tax	9,902	10,389	10,878	489	4.7
Subtotal, "Big Three" Revenues	($113,739)	($118,519)	($121,923)	($3,404)	(2.9%)
Other revenues	$4,799	$3,922	$3,815	-$107	-2.7%
Net transfers[a]	-3,038	-3,676	-1,711	—	—
Total, Revenues and Transfers	**$115,500**	**$118,766**	**$124,027**	**$5,261**	**4.4%**

[a] Includes transfers from the General Fund to the Proposition 2 (2014) Budget Stabilization Account.

Reductions in Other General Fund Spending. The administration also assumes some large expenditure reductions that improve the budget's bottom line condition. For example, the administration estimates over $600 million in General Fund savings when the statutory authority for the Coordinated Care Initiative ceases following the Director of Finance's determination that the program is not cost-effective. The administration also pays for some growth in the state's Medi-Cal spending using $1.2 billion in special fund resources from Proposition 56 (2016). (This measure increased state taxes on cigarettes and other tobacco products.)

Major Features of the Governor's Budget

$3.2 Billion in Proposed Actions to Reduce Spending Growth. To address its estimated $1.6 billion budget problem, the Governor's budget includes more than $3.2 billion in actions to reduce General Fund spending growth that otherwise might occur. Figure 3 summarizes the administration's estimates of the Governor's proposed actions. The most significant action is related to the Proposition 98 minimum funding guarantee for schools and community colleges. Compared to June 2016, the administration proposes adjusting required General Fund spending downward by $1.7 billion to meet new estimates of the minimum guarantee.

Figure 3

Governor's Proposed $3.2 Billion in Actions to Address Budget Problem

(In Millions)

Administration's Estimate of Budget Problem	**-$1,601**
Budget Actions	
Adjust Proposition 98 General Fund spending	$1,695
Eliminate affordable housing funding	400
Cancel scheduled transfer for state office buildings	300
Delay child care rate augmentations	104
Reduce California Health Facilities Financing Authority spending	85
Eliminate health care workforce augmentation	67
Eliminate Major Risk Medical Insurance Fund	65
Eliminate funding for housing and disability income advocacy	45
Phase out Middle Class Scholarships	36
Other actions, such as not funding timely implementation of some recent legislation	359
Governor's Budget Estimate of 2017-18 SFEU Balance	**$1,554**

SFEU = Special Fund for Economic Uncertainties.

The administration also proposes cancelling two 2016-17 budget items. These are: (1) a $400 million set-aside for affordable housing, which was contingent on changes in state law that have not occurred, and (2) $300 million for the replacement and renovation of state office buildings. Altogether, the administration estimates these actions would eliminate its projected $1.6 billion deficit and leave a balance in the 2017-18 year-end discretionary reserve of $1.6 billion.

Other Proposals. The Governor's budget also includes some other policy proposals. First, the Governor assumes the Legislature will ratify 13 labor agreements that include pay increases and implement the Governor's plan to prefund retiree health benefits. In addition, the budget assumes pension costs will rise as a result of the statewide pension boards' changing actuarial assumptions. Second, the Governor proposes a new interpretation of law that would create billions of dollars of new state spending capacity under the constitutional state appropriations limit (Proposition 4 of 1979) by changing the "Gann Limit's" complex calculations. Third, the Governor proposes transferring the operation of in-patient, mental-health treatment beds at three prisons from the Department of State Hospitals (DSH) to the California Department of Corrections and Rehabilitation (CDCR). The proposal would be effective July 1, 2017 and redirects $250 million from DSH to CDCR for this purpose. In addition, as discussed in the box on the next page, estimated special fund spending in the Governor's plan grows in 2017-18.

LAO Comments

Governor's PIT Estimate for 2017-18 Seems Too Low. The PIT is the state General Fund's dominant revenue source. In 2017-18, the Governor estimates that PIT will grow $2.7 billion, or 3.3 percent. In a normal growth year unaffected by recession or major policy changes, we expect PIT growth to exceed 5 percent. Between 2009-10 and 2016-17 (using the administration's estimates for 2015-16 and 2016-17), annual PIT growth has averaged over 8 percent. Moreover, PIT growth has exceeded the Governor's 2017-18 estimates in 18 of the past 21 years, with the three weaker years coinciding with the last two U.S. economic recessions. (Some of these years were affected by tax policy changes, but if we were to adjust for those factors, the story would be similar.)

The weak growth that the Governor envisions for PIT is possible in 2017-18, but seems inconsistent with parts of the administration's own economic outlook, which assumes economic and stock price growth for several years after 2016. For example, the administration assumes that the S&P 500 will grow 6.3 percent in 2017. Yet, the administration projects *declining* total capital gains in 2017. We cannot reconcile these conflicting projections. Currently, we also think that wage growth probably will exceed the administration's estimates in 2017-18. In conclusion, normal PIT growth may or may not materialize for 2017-18, but based largely on the administration's own economic outlook, we believe the Governor's 3.3 percent estimate of PIT growth in 2017-18 is too low.

The Budget Situation Will Change by May Revision. By the May Revision, the state will have more information on its fiscal condition. As noted above, it is possible that the state could have considerably more revenue in 2017-18 than now projected by the Governor. Any increased revenues would be partially offset by higher school spending requirements under Proposition 98 and higher budget reserve and debt payment requirements under Proposition 2. As such, only a portion of any increased revenues would be available for discretionary purposes. By May, the administration's expenditure estimates also will be

adjusted upward or downward, and the Legislature can consider whether it agrees with the proposed implementation of current state policies in the budget plan (such as the use of Proposition 56 revenues, which are being used to support growth in Medi-Cal spending under the Governor's plan). We will examine the administration's proposals in more depth in our budget analysis publications over the next couple of months.

Added Uncertainty at the Federal Level. The Governor's budget proposal assumes no major changes in federal policy. This is a reasonable assumption at this point as there is no way of knowing precisely what actions the new Congress and President will pursue. There may be some near-term benefit to state tax revenues based on changes in federal tax policies (perhaps requiring new state tax legislation to conform to those federal policies). Other possible federal policy changes, however, could affect the economy, reduce federal funding, and/or increase state costs substantially in future years—especially potential changes in federal health care programs.

Proposed Special Fund Expenditures and Reserves

Special Fund Spending Proposed to Grow by $6.5 Billion. Hundreds of state special funds receive fee and other revenues and typically pay for services provided to people and businesses that pay the fees. Total special fund spending is proposed at $54.6 billion in 2017-18—up from $48.1 billion in 2016-17. Some of the largest proposed items are:

- A nearly $1.2 billion increase in special fund spending for a variety of transportation programs. (We discuss the Governor's transportation funding package in more detail later in this report.)
- An additional $3.6 billion from special funds for various health and human services programs, including new money from the Proposition 56 (2016) tobacco tax and the hospital quality assurance fee that was extended by Proposition 52 (2016).
- $1.3 billion to allocate revenues from the Greenhouse Gas Reduction Fund, as well as changes in other special funds.

Growing Special Fund Reserves. The state borrowed from many special funds to help address General Fund budget problems during the last recession. Since then, the General Fund has paid back billions of dollars in loans to special funds. In 2011-12, aggregate reserves in California's special funds totaled $8 billion. During 2016-17, the administration estimates aggregate special fund reserves will reach $16 billion (excluding the mandatory Proposition 2 reserve). In 2017-18 the Governor proposes nearly $500 million more in loan repayments from the General Fund to various special funds. Even with the spending increases described above, special fund reserves—sometimes conservatively estimated in the past—are estimated to remain above $12 billion. We continue to advise the Legislature to scrutinize special fund finances closely. In some cases, after considering special funds' service and revenue levels and employee cost trends, one-time or ongoing reductions in special fund fees may be justified.

Plan for High Level of Uncertainty. We have long encouraged the Legislature to plan for the next economic downturn by building reserves and concentrating any new commitments on one-time purposes. In addition, the Legislature now faces new uncertainties, as federal actions could significantly affect the state budget's bottom line in future years. As we have suggested in the past, we encourage the Legislature as a first step in its budget deliberations to set a target level for the state's total reserves (that is, the combined amount of discretionary and mandatory reserves available to address future budget emergencies). Facing uncertainties about the future of the economy and federal policy, the Legislature may want to set its target for state reserves at—or preferably above—the level the Governor now proposes.

PROGRAM AREAS

Proposition 98

Below, we highlight the major components of the Governor's Proposition 98 package and provide some high-level comments about the package.

Major Features of Governor's Plan

Minimum Guarantees for 2015-16 and 2016-17 Revised Downward. Figure 4 compares the Governor's estimates of the 2015-16 and 2016-17 minimum guarantees with the estimates made in June 2016. Compared to the June 2016 estimates, the guarantee is down $379 million in 2015-16 and $506 million in 2016-17. These drops are primarily explained by the reductions in estimated state revenue. General Fund tax revenue counting toward the guarantee has been revised down $1.5 billion in 2015-16 and $1.6 billion in 2016-17. These changes in revenue have implications for the state's Proposition 98 maintenance factor obligations. As a result of the lower revenue in 2015-16, the state is no longer required to make the $379 million maintenance factor payment included in the June budget plan. In 2016-17, the state creates a somewhat higher new maintenance factor obligation ($838 million, as compared to the $746 million obligation assumed in the June budget plan).

2015-16 and 2016-17 Spending Reduced by Shifting and Deferring Payments. The administration proposes to reduce Proposition 98 spending to match the lower estimates of the 2015-16 and 2016-17 minimum guarantees. To reduce spending in 2015-16, the administration shifts certain one-time school payments from 2015-16 to 2016-17. To accommodate this shift

Figure 4

Tracking Changes in the Proposition 98 Minimum Guarantee

(In Millions)

	2015-16			2016-17		
	June 2016 Estimate	January 2017 Estimate	Change	June 2016 Estimate	January 2017 Estimate	Change
Minimum Guarantee						
General Fund	$49,722	$48,989	-$733	$51,050	$50,330	-$720
Local property tax	19,328	19,681	353	20,824	21,038	215
Totals	**$69,050**	**$68,671**	**-$379**	**$71,874**	**$71,368**	**-$506**

of payments and reduce spending in 2016-17 to the guarantee, the Governor proposes to defer an $859 million payment for the Local Control Funding Formula (LCFF). Specifically, the administration proposes to provide this funding in July 2017 rather than in June 2017, as originally scheduled. This delay would allow the state to count the payment toward the 2017-18 guarantee instead of the 2016-17 guarantee.

2017-18 Guarantee Increases $2.1 Billion Over Revised 2016-17 Level. The Governor's budget includes $73.5 billion in total Proposition 98 funding in 2017-18. As shown in Figure 5, this reflects a 3 percent increase over the revised 2016-17 level. Test 3 is operative in 2017-18, with the higher guarantee driven primarily by the increase in per capita General Fund revenue. The administration estimates that the state creates a new maintenance factor obligation in 2017-18 of $219 million, bringing the total outstanding obligation to $1.6 billion.

New K-12 Funding in 2017-18 Dedicated to LCFF and Deferral Repayment. The largest ongoing proposal is a $744 million augmentation to LCFF. The proposed augmentation is approximately equal to the cost of applying the statutory 1.48 percent cost-of-living adjustment (COLA). The Governor estimates LCFF would be 96 percent funded in 2017-18, about the same percentage as in 2016-17. The Governor proposes to use most of the remaining increase to eliminate the payment deferral created in 2016-17. Under this proposal, schools would receive 13 months of payments in 2017-18—12 normal monthly LCFF payments plus a one-time payment of $859 million related to the prior-year deferral.

About Half of New Community College Funding Is for Apportionments, Half for One-Time Initiatives. About half of new community college funding is for apportionments (consisting of $94 million for a 1.48 percent COLA, $79 million for 1.34 percent enrollment growth, and $24 million

Figure 5

Proposition 98 Funding by Segment and Source

(Dollars in Millions)

	2015-16 Revised	2016-17 Revised	2017-18 Proposed	Change From 2016-17	
				Amount	Percent
Preschool[a]	$885	$975	$995	$20	2.0%
K-12 Education					
General Fund	$42,719	$43,829	$44,811	$982	2.2%
Local property tax	17,052	18,236	19,200	965	5.3
Subtotals	($59,770)	($62,064)	($64,012)	($1,947)	(3.1%)
California Community Colleges					
General Fund	$5,304	$5,443	$5,465	$22	0.4%
Local property tax	2,630	2,803	2,959	156	5.6
Subtotals	($7,933)	($8,246)	($8,424)	($179)	(2.2%)
Other Agencies[a]	$82	$83	$80	-$3	-3.3%
Totals	**$68,671**	**$71,368**	**$73,511**	**$2,143**	**3.0%**
General Fund	$48,989	$50,330	$51,351	$1,021	2.0%
Local property tax	19,681	21,038	22,160	1,121	5.3

[a] Consists entirely of General Fund.

for an unallocated increase). The remainder is for categorical programs and is mainly one time. By far the largest of these initiatives is $150 million one time for community colleges to develop "guided pathways"—detailed, term-by-term roadmaps for students to complete academic programs, accompanied by early academic planning and ongoing student support services. The budget also includes $20 million one time for innovation awards to community colleges. Whereas the administration has been closely involved in implementing innovation awards in previous years, the proposal this year provides the Chancellor's Office substantial latitude to set award criteria and select winners.

Budget Plan Includes $601 Million in Additional Proposition 98-Related Funding. In addition to the $2.1 billion increase in the 2017-18 minimum guarantee, the Governor's budget includes $601 million in funding from one-time sources. Of this amount, $400 million is a proposed settle-up payment related to meeting the 2009-10 minimum guarantee and the remainder is unspent Proposition 98 funding from previous years. The Governor proposes to use the combined $601 million for (1) the K-12 mandates backlog ($287 million), (2) the Career Technical Education Incentive Grant program ($200 million), (3) deferred maintenance at the community colleges ($44 million), and (4) fund swaps totaling $70 million (using one-time funds to support ongoing programs).

Delays Implementation of Multiyear Child Care and Preschool Budget Agreement. As part of the 2016-17 budget package, the Legislature and the Governor agreed on a four-year plan to increase ongoing child care and preschool funding by roughly $500 million (roughly $200 million in Proposition 98 General Fund and $300 million in non-Proposition 98 General Fund). In 2016-17, the state provided $145 million for the first year of implementation ($137.5 million for rates and $7.8 million for 2,959 additional State Preschool slots). Though not formalized in statute, the agreement for 2017-18 assumed (1) annualization of the increases initiated the prior year, (2) 2,959 additional State Preschool slots, and (3) $86 million in non-Proposition 98 General Fund rate increases. The Governor's budget proposes suspending much of this agreement for 2017-18 and extending implementation of the plan through 2020-21.

LAO Comments

Minimum Guarantee Not Likely to Change Much in 2015-16, Could Change Somewhat in 2016-17. Within the range of potential revenue changes for 2015-16, the minimum guarantee likely would remain unchanged. For 2016-17, revenue estimates could be revised more substantially. For each dollar of higher or lower revenue, we estimate the minimum guarantee would rise or fall about 50 cents. This dynamic is a result of Test 3 being operative, with the minimum guarantee driven largely by the year-to-year growth in General Fund revenue.

Higher General Fund Revenue, Higher Minimum Guarantee Likely for 2017-18. As discussed earlier in this report, we believe the administration's estimate of state revenue is low given its other economic assumptions. By May, General Fund revenue in 2017-18 could be significantly higher than assumed in January. Holding other factors constant, higher revenue estimates would increase the 2017-18 guarantee. For example, if revenue were to increase in 2017-18 by $2 billion above the Governor's January level, the minimum guarantee would increase by roughly $500 million (due to the state being required to make a maintenance factor payment). If revenue were to increase by $4 billion, the minimum guarantee would increase by $1.5 billion (with the state needing to make an even larger maintenance

factor payment). Revenue increases beyond about $4 billion likely would have no effect on the minimum guarantee. (The General Fund likely would pay for all of these increases.)

Recommend Relying on Mix of Ongoing and One-Time Spending. The Governor's budget roughly balances new ongoing and one-time Proposition 98 spending in 2017-18. Regardless of the exact level of the 2017-18 minimum guarantee, we recommend the Legislature adopt a final budget plan that continues to rely upon on a mix of ongoing and one-time spending. Under this approach, the Legislature could dedicate a portion of any additional increases in the minimum guarantee to LCFF and California Community Colleges apportionments while using the remainder for one-time payments to reduce or eliminate the K-12 mandates backlog. We note that a stronger 2017-18 fiscal year does not necessarily imply a strong 2018-19 fiscal year. By setting aside some funding for one-time purposes, the state would be better positioned to accommodate a drop in the 2018-19 guarantee without needing to make cuts to LCFF or community college apportionments.

Universities

No Notable Changes in Governor's Budgetary Approach for Universities. The Governor's budget reflects the same basic approach to building University of California's (UC) and California State University's (CSU) budgets as proposed in the past several years. The Governor's main proposal for each segment is a General Fund base increase (of about 4 percent for UC and 5 percent for CSU). The Governor grants the segments considerable discretion in deciding how to spend these base increases, but, as in previous years, he loosely links these increases to expectations regarding UC and CSU performance. The Governor's budget sets forth no new enrollment growth expectations for UC and CSU.

Governor Sends Unclear Message Regarding Tuition Increases. As in recent years, the Governor's budget assumes UC and CSU do not raise resident tuition. Unlike recent years, however, he does not condition his proposed General Fund increases on the segments holding resident tuition levels flat. Both UC and CSU have indicated an interest in increasing resident tuition for 2017-18 (2.5 percent at UC and about 5 percent at CSU). The Governor has not taken a formal position on these proposals, though his *Budget Summary* declares that "any tuition increases must be viewed in the context of reducing the overall cost structure at UC and improving graduation rates at CSU."

Legislature Has Key Role in Crafting UC's and CSU's Budgets. The Legislature has a key role in setting state higher education priorities, examining the universities' budgets, and making associated spending decisions. Every year, the Legislature fundamentally decides (1) the total level of cost increases to support and (2) how to cover those cost increases. Some years, the Legislature has decided to cover all spending increases using state General Fund support, explicitly "buying out" tuition increases or otherwise holding student tuition levels flat. Other years, both state General Fund support and tuition levels have been raised. In still other years, state General Fund support has fallen or been held flat, with tuition levels rising to cover cost increases. In the coming months, the Legislature will have an opportunity to decide what UC and CSU cost increases to support for 2017-18 and how best to cover those cost increases.

Coordinated Care Initiative

Coordinated Care Initiative (CCI). In June 2012, the Legislature authorized the CCI as a county pilot project that would ultimately be implemented in seven counties. The policy goals of the CCI demonstration project included improved

coordination of health care and long-term care for seniors and persons with disabilities (SPDs) and a reduction in the overall costs of caring for this population. To achieve these goals, the CCI made the following major policy changes in the demonstration counties:

- Integration of Medi-Cal and Medicare benefits under Medi-Cal managed care for SPDs eligible for both Medi-Cal and Medicare ("dual eligibles") opting into the demonstration program (known as Cal MediConnect).
- Mandatory enrollment of Medi-Cal recipients who are also on Medicare in managed care for their Medi-Cal benefits.
- Integration of long-term services and supports (LTSS), including the In-Home Supportive Services (IHSS) program and other long-term care programs, into Medi-Cal managed care.
- Introduction of state-level collective bargaining for IHSS provider wages and benefits.

In addition, on a statewide basis, the CCI replaced counties' share of IHSS program costs (historically 35 percent of the nonfederal portion of costs) with a maintenance-of-effort (MOE) requirement whereby counties have been required to maintain their 2011-12 expenditure levels for IHSS, with an annual growth factor of 3.5 percent plus any additional costs associated with locally negotiated IHSS wage increases.

State law authorizing the CCI contains a "poison pill" provision that automatically discontinues the pilot program if the Director of Finance determines that the CCI does not generate annual net General Fund savings and is therefore not cost-effective.

Rising General Fund Costs a Result of the IHSS MOE. Total IHSS program costs have increased from around $6 billion to around $10 billion between 2012-13 and 2016-17. Since the MOE was instituted, the General Fund has borne a disproportionate amount of these IHSS program costs, growing at an average rate of 20 percent annually, from $1.7 billion in 2012-13 to an estimated $3.5 billion in 2016-17. County IHSS program costs, by contrast, have increased at an average rate of around 5 percent annually over the same period.

Determination That the CCI Is Not Cost-Effective Automatically Terminates the CCI. The Governor's budget reflects the determination that the CCI is not cost-effective, automatically ending the program in 2017-18. According to the administration, the increased General Fund costs associated with the IHSS MOE were the primary factor in its determination that the CCI does not produce net General Fund savings.

However, Governor's Budget Proposes Continuation of Major Components of the CCI. The Governor's budget proposes the continuation of major components of the CCI in the program's demonstration counties, including:

- Cal MediConnect.
- Mandatory enrollment of dual Medi-Cal and Medicare recipients in managed care.
- The integration of LTSS other than IHSS under Medi-Cal managed care.

In effect, on net, the Governor proposes to (1) end the IHSS MOE and reintroduce state-county IHSS cost sharing at historic levels, saving the General Fund approximately $600 million in 2017-18; (2) remove—in demonstration counties—IHSS from managed care and return its funding directly to counties (as opposed to being part of managed care capitation rates); and

(3) eliminate—in demonstration counties—state-level bargaining for IHSS provider wages and benefits. Statutory approval is required to continue the components of the CCI that the Governor has proposed extending.

Issues for Legislative Consideration. Below, we highlight several issues that the Legislature might consider as it evaluates the administration's proposal:

- ***Distinct Policy Considerations in Evaluating Governor's Proposal.*** The IHSS financing structure and the coordination of health care and long-term care under managed care represent distinct, though related, policy considerations. The Legislature might independently evaluate the fiscal and policy merits of what counties' contribution to IHSS costs should be (whether as a cost-sharing arrangement or an MOE requirement) and the extent to which health care and LTSS should be integrated under managed care.

- ***How Should IHSS Interface With Managed Care?*** The Legislature might consider how the removal of the IHSS program from the demonstration project will alternatively advance or hinder the policy goals of increasing care coordination and reducing the overall costs of health care and long-term care.

- ***IHSS MOE Impact on Counties.*** The elimination of the CCI shifts significant IHSS program costs from the General Fund back to the counties ($600 million in 2017-18). Legislative consideration might be given to how the state might help ease counties' transition to a higher share of IHSS costs as counties seek to rebalance their revenues and expenditures in light of the CCI's elimination.

Cap-and-Trade

Proposed Expenditure Plan Contingent on Extending Program With Two-Thirds Vote. As shown in Figure 6, the budget proposes to spend $2.2 billion in cap-and-trade revenue in 2017-18. This would be supported from $1.5 billion in auction revenue assumed to be collected in 2017-18 and almost $700 million in unallocated prior-year collections. Consistent with current law, 60 percent ($900 million) of 2017-18 revenue would be continuously appropriated to certain programs. Under the Governor's proposal, the remaining $1.3 billion in proposed discretionary spending would only be spent after the Legislature enacted—with a two-thirds vote—new legislation providing the Air Resources Board (ARB) with the authority to operate a cap-and-trade program beyond 2020. If the Legislature enacted such legislation, the budget would provide $500 million to support the Governor's transportation funding package. The remaining $755 million would be allocated for other categories of programs designed to reduce green house gas (GHG) emissions. In addition, under the Governor's proposal, the Department of Finance would have the authority to reduce allocations to discretionary programs proportionally if less auction revenue is available to support the proposed expenditures.

Extending Cap-and-Trade With Two-Thirds Vote Has Merit. The Governor's proposal to reauthorize cap-and-trade beyond 2020 and to do so with a two-thirds vote has merit. The Legislature recently enacted legislation to reduce statewide GHG emissions to 40 percent below 1990 levels by 2030. The cap-and-trade program is likely one of the most cost-effective policies to help the state achieve these new targets.

Moreover, extending cap-and-trade with a two-thirds vote, instead of a simple majority vote, has a couple of additional benefits. First, it provides

additional legal certainty regarding the ARB's ability to operate the cap-and-trade program that includes auctioning of allowances beyond 2020. (There is an ongoing court case challenging the ARB's authority to auction allowances and collect revenue.) Auctioning allowances, rather than giving all of the allowances away for free, is generally considered an important feature of a well-designed cap-and-trade program. Second, a two-thirds vote provides the Legislature greater flexibility to use cap-and-trade revenue on its highest priorities by removing the current legal requirement to spend revenue only on activities that reduce GHGs. For example, the Legislature could consider using revenue to offset costs to businesses and households through rebates or tax reductions and/or fund its highest priority programs, including potentially those that do not reduce GHGs. We discussed many of these considerations in greater detail in our 2016 report *Cap-and-Trade Revenues: Strategies to Promote Legislative Priorities.*

Figure 6

2017-18 Cap-and-Trade Expenditure Plan

(In Millions)

Program	Amount
Continuous Appropriations	
High-speed rail	$375
Affordable housing and sustainable communities	300
Transit and intercity rail capital	150
Transit operations	75
Subtotal, Continuous Appropriations	($900)
Discretionary Spending	
Public transit and active transportation projects	$500
Clean transportation and petroleum use reduction	363
Transformative Climate Communities	142
Carbon sequestration	128
Short-lived climate pollutants	95
Energy efficiency and renewable energy	28
Subtotal, Discretionary Spending	($1,255[a])
Total	**$2,155**

[a] Does not total due to rounding.

Reasonable to Consider Extension and Spending Proposal Together, but Proposal Unnecessarily Restricts Legislative Authority. The issues of ongoing authority for cap-and-trade and how to spend auction revenues are related, and it is reasonable to consider them together. For example, as described above, extending cap-and-trade with a two-thirds vote would give the Legislature a much wider range of spending options to consider, and the Legislature could choose to allocate funds differently than proposed by the Governor in 2017-18 if the Legislature had a different set of spending priorities. However, the Governor's proposal unnecessarily restricts Legislative spending authority. The Legislature does not have to make budget allocations contingent on future legislation to extend cap-and-trade. It currently has the authority to appropriate this funding regardless of whether it adopts the Governor's proposed policy change to extend cap-and-trade.

Transportation Funding Package

Governor's Proposal. The Governor's proposed budget for 2017-18 includes a package of proposals to increase funding for transportation programs. Except for a few key differences discussed below, the funding package is similar to the package proposed by the Governor in the fall of 2015 as part of a special session on transportation funding. Revenue from the proposed funding package

would phase in during 2017-18 and 2018-19 and provide a permanent ongoing increase thereafter. The budget estimates that the package would generate an average of $4.2 billion annually over the next ten years, which is somewhat higher than the Governor's earlier proposal. Specifically, the package includes annual revenues of: (1) $2.1 billion from a $65 vehicle registration tax, (2) $1.1 billion from increasing gasoline excise tax rates and indexing the rates for inflation, (3) $500 million from cap-and-trade auction revenues, (4) $425 million from increasing diesel excise tax rates and indexing the rates for inflation, and (5) $100 million from efficiencies at the California Department of Transportation. In addition, the budget package assumes that $706 million in prior loans from transportation accounts are repaid over the next three years.

Figure 7 shows how the increased annual transportation revenues would be allocated under the Governor's proposal. As shown in the figure, the package allocates two-thirds of the revenue to rehabilitate state highways ($1.6 billion) and for local roads ($1.2 billion). The package allocates $275 million for a corridor mobility program that was not included in the Governor's earlier proposal. The proposal also includes $120 million for highway maintenance.

LAO Comments. Much of the state's transportation infrastructure is aging and needs maintenance, rehabilitation, and improvements to meet current and future needs. It is generally agreed upon that current levels of funding for transportation programs are insufficient to meet these needs. Thus, we think the Governor's attention to transportation funding makes sense. However, in reviewing the proposed package the Legislature will want to consider its priorities for funding transportation and how they compare with the specific programs that the Governor's package would fund. In our 2016 report, *The 2016-17 Budget: Transportation Proposals*, we recommended making highway maintenance the highest priority for new funding. This is because such maintenance is more cost-effective than allowing highways to degrade to the point where they require major rehabilitation. The Governor's plan would significantly underfund the estimated need for highway maintenance projects.

Figure 7

Proposed Annual Expenditure of New Transportation Funds

(In Millions)

State highway rehabilitation	$1,600
Local roads	1,200
Transit and intercity rail capital	400
Corridor mobility improvements	275
Trade corridor improvements	250
Local partnership grants	250
Highway maintenance	120
Active transportation	100
Local planning grants	25
Total	**$4,220**

LAO Publications

The Overview section of this report was prepared by Ann Hollingshead and Ryan Miller, and many other LAO staff members (listed at www.lao.ca.gov/staff) also contributed to the publication. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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