LAO 75 YEARS OF SERVICE

The 2017-18 Budget:

California's Fiscal Outlook

MAC TAYLOR • LEGISLATIVE ANALYST • NOVEMBER 16, 2016

LAO

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Executive Summary

In this report, we describe our office's assessment of the condition of the California economy and budget over the 2016-17 through 2020-21 period.

Outlook Subject to Considerable Uncertainty. The condition of the state's budget depends on many volatile and unpredictable economic conditions, including fluctuations in the stock market. Even in the short term, these conditions cannot be predicted with precision. They are even more difficult to anticipate years in the future. As such, while we have reasonable confidence in our expectations about the economy's performance in 2017-18, we are much less able to anticipate the economic future in each year thereafter. To reflect these uncertainties, this report emphasizes one estimate of the near-term budget condition through 2017-18 and displays two different estimates of the budget's condition in 2018-19 through 2020-21.

Positive 2017-18 Budget Outlook. For the near term, under our current economic projections and assuming the state makes no additional budget commitments, we estimate the state would end the 2017-18 fiscal year with $11.5 billion in total reserves. This total includes $2.8 billion in discretionary reserves, which the Legislature can appropriate for any purpose, and $8.7 billion in required reserves, which will be available for a future budget emergency. These reserve levels reflect the continued progress California has made in improving its budget situation.

State Is Increasingly Prepared to Weather a Mild Recession. For the longer term, we estimate the condition of the state budget under two different economic scenarios. They are: (1) an economic growth scenario, which assumes the economy continues to grow, and (2) a mild recession scenario, which assumes the state experiences a mild economic downturn beginning in the middle of 2018. Under the growth scenario, we estimate the budget remains in surplus over the outlook period. Under the recession scenario, we find that the state would have enough reserves to cover almost all of its operating deficits through 2020-21. This means, under our assumptions, the state could weather a mild recession without cutting spending or raising taxes through 2020-21.

New Commitments or Policy Changes Would Affect Outlook. Importantly, these estimates assume the state does not make any changes in any year during the outlook period to its current policies and programs. In addition, the outlook also assumes no new changes in federal policy, even though the recent election results suggest some such changes are now likely. Any such state or federal policy changes could have a significant impact on the state's "bottom line."

Introduction

Each year, our office publishes the *Fiscal Outlook* in anticipation of the upcoming 2017-18 budget process. In this report, we summarize our office's assessment of the condition of the California economy and budget for the upcoming fiscal year (2017-18) as well as the following three years (through 2020-2021). Below, we explain the organization of this report and the basis for our projections.

Organization of This Report

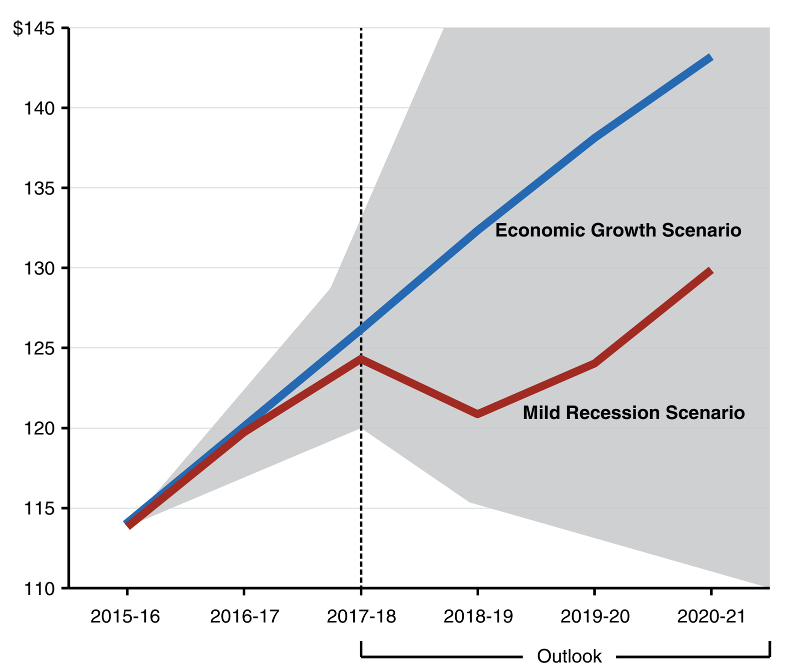
Uncertainty in the Outlook. As this report is published, the first day of the 2017-18 fiscal year is over seven months away. Our expectations about the budget's condition over the forecast period depend, in large part, on our assumptions about trends in the economy and the stock market. While there is uncertainty over these assumptions in the near term, that uncertainty becomes even greater in each subsequent year. As such, we have reasonable confidence in our expectations about the economy's performance in 2017-18, but we are much less able to anticipate the economic future in each year thereafter. Figure 1 illustrates this point with regard to General Fund revenues. The figure shows our revenue outlook for the near term, and our two separate revenue outlooks for the out-years, based on two different economic scenarios (described further below). The shaded area in the figure illustrates the uncertainty around these two scenarios. Through 2017-18, revenues could be a few billion dollars above or below our estimates. After 2017-18, revenues could be many billions of dollars above or below our illustrative scenarios, with uncertainty growing in each subsequent year.

This report is organized to reflect our uncertainty about our projections while still producing what we hope is a useful planning document for the Legislature. As such, we

Figure 1

More Uncertainty in Each Subsequent Year of the Outlook

Range of Possible Revenue Estimates (In Billions)



emphasize the near-term economic and budget outlook in Chapters 1 through 3 and present out-year budget and economic scenarios in Chapter 4. This organization is discussed in greater detail below.

Chapters 1 and 2 Present One Near-Term Scenario. In Chapter 1 of this report, we present our assessment of the condition of the state General Fund for 2015-16, 2016-17, and 2017-18. Chapter 2, similarly, discusses our estimates of key revenue trends and economic performance through 2017-18. All of our projections through 2017-18 are based on a consensus economic forecast (developed before the election). In these years, there is less uncertainty regarding our assumptions. Also, we hope that presenting one scenario will better assist the Legislature as it plans for the upcoming 2017-18 budget process. However, our estimates of revenues, expenditures, and reserve requirements will change in the following months—especially after the large influx of 2016 tax return payments in April 2017.

Chapter 3 Presents Outlook for State Spending. In Chapter 3 of this report, we discuss our state General Fund spending outlook, again emphasizing the near term. We also comment on key spending trends over the entire outlook period. Generally, these out-year trends are based on our economic growth scenario. The spending estimates aim to reflect the cost of maintaining the state's existing program commitments and budget act policies over the outlook period. (As such, we have generally provided adjustments to address the impact of inflation with the aim of maintaining the purchasing power of current legislative commitments.) Our estimates also assume the state makes no changes to its programs and policies in the future. This does not mean, however, we believe these policies *will* or *should* stay the same. On the contrary, the essence of budgeting is making year-to-year adjustments to spending to accommodate legislative priorities.

Chapter 4 Presents Two Out-year Scenarios. In Chapter 4, we present two estimates of the state's General Fund condition in 2018-19 through 2020-21. These estimates are based on two different examples of how the economy could perform over the outlook period. They are: (1) an *economic growth* scenario, which assumes the economy continues to grow throughout the outlook period, and (2) a *mild recession* scenario, which assumes an economic downturn—with a big stock market decline—begins in the middle of calendar year 2018. These alternate scenarios are only two of many possible future economic realities. Actual experience could be more positive than the growth scenario or more negative than the mild recession scenario.

How We Build Our Outlook

Three Main Outlook Techniques for Spending. In broad terms, we use three different methodologies to build our spending outlook in Chapter 3. They are:

- ***Formula-Driven Outlooks.*** These programs have constitutionally required minimum funding levels based on formulas with specified inputs. These include the formulas for determining schools and community college funding (Proposition 98) and reserve deposits and debt payments (Proposition 2).

- ***Outlooks Based on Caseload, Utilization, and Price.*** These programs experience changes in funding levels based on a combination of changes in their number of participants (caseload), the intensity at which participants use services (utilization), and the costs per enrollee (price). Examples include Medi-Cal, the state's insurance program for low-income Californians, and the California Department of Corrections and Rehabilitation, which operates the state's correctional facilities and parole system. The outlook for these programs use models that identify relationships between economic and demographic trends and spending levels.

- ***Discretionary Outlooks.*** These programs have funding levels that are generally determined by legislative priorities. We typically assume a continuation of recent budget practices—for example, funding for universities and employee salaries and health benefits.

Revenues Depend on Volatile Economic Indicators. Our revenue outlook depends, in large part, on our assumptions about the performance of the economy and the stock market. In particular, revenues from the personal income tax, which make up about 70 percent of General Fund revenues, depend on highly volatile estimates of capital gains. As a result, ordinary movement in the stock market—over just a period of weeks or months—can result in billions of dollars in higher or lower revenues for the state. Our revenue estimates also assume current laws and policies stay in place—both at the state and federal levels. For example, our outlook assumes the tax on managed care organizations will expire at the end of 2018-19, consistent with current law. Similarly, our estimates of growth in the sales and use tax reflects a quarter-cent reduction in the tax rate after December 2016 as that provision of Proposition 30 (2012) expires.

Effects of November 2016 Voter Initiatives Included. Our fiscal outlook reflects the fiscal effects of propositions approved by the voters on the November 8, 2016 ballot. (We have assumed that Proposition 66, which deals with the death penalty processes, is approved, although votes are still being counted.)

Chapter 1: General Fund Through 2017-18

This chapter summarizes our office's assessment of the near-term condition of the state General Fund, the state's main operating account.

OUTLOOK FOR THE 2017-18 BUDGET

Figure 2 displays our estimate of the General Fund condition through 2017-18. We estimate that 2016-17 will end with $7.5 billion in total reserves, about $1 billion lower than the assumptions in the budget act. Assuming no new commitments are made in the 2017-18 budget, we estimate total reserves will grow to $11.5 billion at the end of the fiscal year—an increase of $4 billion. This $11.5 billion total includes $2.8 billion in the Special Fund for Economic Uncertainties (SFEU), the state's discretionary budget reserve, and $8.7 billion in the Budget Stabilization Account (BSA), the state's required budget reserve.

Figure 2

LAO General Fund Condition

(In Millions)

	2015-16	2016-17	2017-18
Prior-year fund balance	$2,935	$3,715	$1,717
Revenues and transfers	115,643	119,991	128,123
Expenditures	114,863	121,988	126,109
Ending fund balance	$3,715	$1,717	$3,731
Encumbrances	966	966	966
SFEU balance	2,749	751	2,765
Reserves			
SFEU balance	$2,749	$751	$2,765
BSA balance	3,420	6,714	8,694
Total Reserves	**$6,169**	**$7,466**	**$11,459**

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

2016-17: Revised Reserve Levels of $7.5 Billion

The estimated $1 billion decrease in 2016-17 reserves is the net result of the following:

- ***$510 Million Downward Revision to Entering Fund Balance.*** We include two revisions to the budget condition before 2015-16 that affect the current budget situation. First, based on our estimates of required funding for schools and community colleges, we assume the state will pay an additional $351 million in "settle up" payments related to earlier minimum funding guarantees. (We discuss these settle up payments further in Chapter 3.) Second, our estimate reflects a $159 million reduction in prior years' estimated revenue collections and accruals.

- ***Revenues Lower by $1.7 Billion in 2015-16 and 2016-17.*** Between 2015-16 and 2016-17, we estimate revenues will be lower than the budget act estimates by $1.7 billion. In particular, our estimates for total revenues—across the two fiscal years—associated with the sales and use tax (SUT) and corporation tax (CT) are $2.6 billion lower than budget act assumptions. These shortfalls, however, are partially offset by net upward revisions in our estimate of personal income tax (PIT) revenues over the two fiscal years—$923 million below budget estimates in 2015-16 and $1.7 billion above estimates in 2016-17.

- ***Expenditures Lower by $1.2 Billion in 2015-16 and 2016-17.*** We estimate expenditures in 2015-16 and 2016-17 will be lower than budget act assumptions by a net $1.2 billion. Two factors explain most of the lower spending. First, General Fund Proposition 98 spending declines by $640 million in 2015-16, due to lower state revenues and higher local property taxes. Second, in 2016-17, we assume the $400 million set-aside for affordable housing in the budget package is not spent because it was contingent on changes in state law that did not occur.

- ***Required BSA Deposits Unchanged.*** Proposition 2 establishes a minimum amount that the state must deposit each year into the BSA, the state's required budget reserve. Under the measure's "true up" provisions, the state revisits these estimates twice: once in each of the two subsequent budgets. However, the 2016-17 budget package set aside a $2 billion optional deposit and specified that these funds would be used to meet true up requirements for 2015-16 and 2016-17. The estimated true up deposits associated with 2015-16 and 2016-17 are together less than $2 billion. As a result, we assume no additional true ups are made, leaving the already revised 2015-16 deposit and initial 2016-17 deposits unchanged.

2017-18 Outlook: Year Ends With $11.5 Billion Reserve

Revenues and Transfers Grow $8.1 Billion. We estimate that revenues and transfers will grow by $8.1 billion in 2017-18, including a $6.4 billion (5.4 percent) increase in the "Big Three" revenues: the PIT, SUT, and CT. Most of this growth is driven by a 6.9 percent year-over-year increase in the PIT.

Spending Grows $4.1 Billion. We estimate that General Fund expenditures—absent any new program commitments—would grow $4.1 billion between 2016-17 and 2017-18. This increase is in part attributable to a $1.4 billion increase in the General Fund share of the minimum funding guarantee for schools and community colleges. Another $1.5 billion is attributable to the net increase in spending related to health and human services programs, including about an $800 million increase in Medi-Cal, the state's health insurance program for low-income Californians. Various other spending items grow too. In contrast, spending declines between 2016-17 and 2017-18 due to the expiration of many one-time expenditures in the 2016-17 budget. These items include, for example, one-time spending on deferred maintenance, capital outlay, and several criminal justice programs.

Reserves Grow to $11.5 Billion. Based on our current estimates of revenues, particularly those related to capital gains, we estimate the state will be required to make an initial deposit of $2 billion into the BSA for the 2017-18 fiscal year. In addition, based on our estimates that growth in revenues will outpace expenditures, and assuming no new budget commitments are made, we estimate 2017-18 would end with additional reserves of $2 billion in the SFEU. Together, these reserves would build on the $7.5 billion balance estimated in 2016-17, bringing total reserves to $11.5 billion by the end of 2017-18.

LAO COMMENTS

Positive 2017-18 Budget Outlook. Based on our current economic and budget projections, we estimate the General Fund will end 2017-18 with $11.5 billion in total reserves, including $2.8 billion in discretionary reserves. (That $2.8 billion amount is displayed in our figures as the balance in the SFEU.) These reserve levels reflect the continued progress California has made in improving its budget situation. The state budget remains on steady footing.

Lower 2017-18 Revenue Estimates Would Mean Fewer Discretionary Resources. Our revenue outlook is based, in part, on assumptions about the stock market. As we describe in Chapter 2, this outlook makes certain assumptions about how estimated and final PIT payments will strengthen during the second half of 2016-17. We believe these assumptions are reasonable, but if they do not come to pass, our revenue estimates easily could be about $2 billion lower in both 2016-17 and 2017-18. In this case, 2017-18 would end with over $2 billion less in discretionary reserves. (The $4 billion revenue decline over the two fiscal years would be offset by lower Proposition 98 and Proposition 2 requirements.) In this scenario, the Legislature would have significantly fewer discretionary resources in the 2017-18 budget process.

Outlook for Future Shapes Decisions Today. Under our current estimates, the Legislature will face decisions in the 2017-18 budget process about how to allocate the $2.8 billion in discretionary reserves. The Legislature could opt to hold some or all of this in reserves or make some new one-time or ongoing commitments. The choices the Legislature makes for these funds may depend, in large part, on its consideration of the future prospects for the state budget. We present two possible out-year budget scenarios in Chapter 4 of this report. We hope these scenarios help inform the Legislature's decisions as the 2017-18 budget process begins.

Chapter 2:
The Economy and Revenues

THE ECONOMY

Our near-term projections are based on a consensus of economists about the likely trend of the U.S. economy through 2018, as reported in October (prior to the election) by Moody's Analytics, a national economics consulting firm. This differs from our most recent projections, which were premised on the analyses of just the economists at Moody's Analytics. (The administration's projections are based on analyses by a different firm.) Using these consensus views about the U.S. economy, our office develops a California-specific macroeconomic scenario.

Our near-term economic projections are summarized in Figure 3 and compared to the administration's May 2016 projections—the underlying basis for the revenue estimates in the 2016-17 state budget—in Figure 4 (see next page). Our near-term projections reflect the consensus

Figure 3

LAO Economic Assumptions Through 2018

Percent Change Unless Otherwise Noted

United States	2015	2016	2017	2018
Real gross domestic product	2.6%	1.6%	2.3%	2.2%
Personal income	4.4	3.3	4.3	4.8
Wage and salary employment	2.1	1.7	1.1	0.8
Unemployment rate (percent)	5.3	4.9	4.6	4.6
Consumer price index	0.1	1.1	2.3	2.2
Core Personal Consumption Expenditures price index	1.4	1.6	2.0	1.6
Federal funds rate (percent)	0.1	0.4	1.0	1.9
Housing permits (thousands)	1,178	1,158	1,294	1,366
S&P 500 (annual average)	2,061	2,078	2,165	2,231
California	**2015**	**2016**	**2017**	**2018**
Personal income	6.4%	3.9%	5.0%	5.6%
Wage and salary employment	3.0	2.6	1.9	1.6
Unemployment rate (percent)	6.2	5.4	5.3	5.2
Consumer price index	1.5	2.3	2.8	2.7
Housing permits (thousands)	98	96	98	100
Single-unit permits	45	47	50	52
Multifamily permits	53	49	48	48
Population growth	1.0	1.0	0.9	0.9

Note: Based generally on Moody's Analytics' October 2016 U.S. macroeconomic "consensus scenario," a scenario that incorporates the central tendency of a range of baseline projections from various institutions and professional economists. S&P 500 index levels, however, are lowered from those assumed in the Moody's Analytics' consensus scenario. The California-specific assumptions above reflect a California state macroeconomic scenario developed by the LAO based on the U.S. consensus scenario.

Figure 4

Comparison to 2016-17 Budget Act[a] Economic Assumptions

Percent Change Unless Otherwise Noted

	2016		2017		2018	
	Budget Act June 2016	LAO Nov. 2016	Budget Act June 2016	LAO Nov. 2016	Budget Act June 2016	LAO Nov. 2016
United States						
Real gross domestic product	2.1%	1.6%	2.8%	2.3%	2.7%	2.2%
Personal income	3.9	3.3	4.9	4.3	5.1	4.8
Wage and salary employment	1.9	1.7	1.4	1.1	0.9	0.8
Unemployment rate (percent)	4.8	4.9	4.7	4.6	4.7	4.6
Consumer price index	1.0	1.1	2.2	2.3	2.0	2.2
Federal funds rate (percent)	0.6	0.4	1.4	1.0	2.4	1.9
S&P 500 (annual average)	2,075	2,078	2,117	2,165	2,160	2,231
California						
Personal income	5.5%	3.9%	5.3%	5.0%	4.5%	5.6%
Wage and salary employment	2.1	2.6	1.7	1.9	1.1	1.6
Unemployment rate (percent)	5.3	5.4	5.2	5.3	5.1	5.2
Consumer price index	2.2	2.3	2.8	2.8	2.6	2.7
Housing permits (thousands)	107	96	126	98	142	100
Single-unit permits	51	47	62	50	71	52
Multifamily permits	55	49	64	48	71	48
Population growth	0.9	1.0	0.9	0.9	0.9	0.9

[a] The *2016-17 Budget Act* reflected the administration's May 2016 revenue assumptions, this figure, therefore, describes the administration's May 2016 economic assumptions as those reflected in the *2016-17 Budget Act*, which was passed in June 2016.

view that the economic expansion is likely to continue in the U.S. over at least the next couple of years. This, however, is not a certainty. The possibility exists that a slowdown or recession could emerge in the short term. In addition, the October consensus of economists does not reflect federal policy and budget changes that may result from this month's election of a new President and a new Congress.

The U.S. Economy

Long Economic Expansion Continues. The national economy has been expanding since the end of the last recession in June 2009. This month marks the 89th month of the expansion, which makes it the fourth-longest in the U.S. since at least 1854, as shown in Figure 5. Early next year, if the expansion continues, it will surpass the expansion of the 1980s to become the third longest in U.S. history.

Economic expansions do not die of old age. (Australia, for example, just marked 25 years of its current expansion—now the longest in the developed world.) Instead, expansions commonly

Figure 5

Current Economic Expansion Already Among Longest in U.S. History

Data Since 1854

Economic Expansion	Number of Months
April 1991 to March 2001	120
March 1961 to December 1969	106
December 1982 to July 1990	92
July 2009 to present	**89 (so far)**
July 1938 to February 1945	80
December 2001 to December 2007	73
April 1975 to January 1980	58
April 1933 to May 1937	50
Average Economic Expansion, 1945 to 2009	**58**

Source: National Bureau of Economic Research.

end because of imbalances that build up and "overheat" the economy. Economic shocks and major changes in the economy or public policy also can depress activity enough to end an expansion. While policy makers should note this expansion's age, they also should be aware that economic expansions have been getting longer. The last three lasted an average of 95 months—longer than the 58-month average for expansions since 1945. Improved management of U.S. monetary policy and other government policies have been credited with a reduction in macroeconomic volatility over time. Also credited are better management by businesses of inventories, the rise of the relatively stable service sector, and technological change.

When Will the Expansion End? Economists and other forecasters (including us) are not good at projecting the end of expansions far in advance. (That is one reason why—later in this publication—we consider one scenario of what could happen to the state budget if a mild recession hits around 18 months from now.) History provides us with a few instructive lessons to foreshadow the demise of the current expansion. The past few U.S. expansions have ended about three years after the economy reached what is considered "full employment." Once an economy reaches that point, wages and inflation may accelerate, necessitating tighter monetary policy (including higher interest rates). The U.S. unemployment rate has been at or below 5 percent—a commonly estimated level of full employment—since last October. If the experience of the past few expansions repeated itself, the current expansion would continue over the next couple of years.

Some economists, however, have been saying that the lack of robust wage growth, among other factors, suggests that full employment currently requires an even lower unemployment rate. That reasoning would be consistent with an expansion that continued for an even longer period of time. We note, however, that wage growth recently has picked up somewhat. A related uncertainty is how much "slack" remains in the labor market—as in, how many more people not currently seeking work will return to the labor force in the coming years. Labor market slack can help prolong the expansion by preventing the economy from overheating.

The California Economy

California's economy has grown at a good pace in recent years. Different groups and regions have shared in that growth to varying degrees.

Incomes Up. According to the Census Bureau's American Community Survey (ACS), median household income in California rose 4 percent in 2015—slightly outpacing the nationwide growth rate of 3.8 percent. California's $64,500 median household income ranked 9th among the 50 states. With 6.2 percent growth in 2015, median household incomes reported in the ACS data for the San Francisco-Oakland metro region was surpassed, among the nation's large metro areas, only by Atlanta's 7.1 percent growth. Median household incomes grew by 3.3 percent in the Los Angeles-Orange County region, 2.6 percent in the Inland Empire (Riverside and San Bernardino Counties), and 1.6 percent in San Diego County. (We note, however, that these ACS results have a relatively high margin of error for San Francisco-Oakland, San Diego, and the Inland Empire.)

Official Poverty Rate Down. According to ACS data, the official poverty rate in California fell from 16.4 percent in 2014 to 15.3 percent in 2015, representing about 370,000 fewer Californians counted under this poverty measure. While this official poverty measure (OPM) is just above the national average, California's high housing costs mean that its "supplemental poverty measure" (SPM)—which accounts for forms of public assistance not included in the OPM and adjusts poverty thresholds for housing costs and other factors—is much higher than the rest of the country's. Based on data from 2013 through 2015, California's SPM is 20.6 percent—versus 14.4 percent for the rest of the country.

Job Growth Has Been Outpacing the Nation. In September, the number of payroll jobs in California was up by about 380,000 over the prior year, a growth rate of 2.3 percent—better than the 1.7 percent job growth rate for the nation as a whole. California's job growth rate over the past year ranks 14th best among the 50 states. Among the state's major employment sectors, professional and technical services jobs (many of them in technology) are up 4.6 percent over the past year, and construction jobs are up 4.2 percent. Oil and gas jobs, which account for only a small fraction of the state total but are very important in some areas such as Kern County, are down 12.5 percent over the past 12 months, but losses have slowed with more stable energy prices recently.

While California's official unemployment rate—5.5 percent as of September—remains tied for 10th worst with three other states, it has dropped half a percentage point in the last year and 6.7 percentage points from its high point in October 2010. In Los Angeles County, the seasonally adjusted jobless rate was 5 percent in September 2016—down 1.2 percentage points from one year before. In September, unadjusted unemployment rates in the state ranged from just 3.1 percent in San Mateo County to 22.7 percent in Imperial County (among the nation's highest local unemployment rates). Imperial County's September unemployment rate was down 2.3 percentage points from one year before. Other rural and agricultural areas continue to have high unemployment rates.

Other Labor Market Improvements. By many measures, California's labor market has been heating up:

- ***Participation Up.*** Even as more and more baby boomers reach retirement age, California's labor force participation rate—those participating in the labor force as a percentage of the population aged 16 and older—grew from 62 percent in September 2015 to 62.6 percent in September 2016 (its highest level in over two years), according to U.S. and state labor surveys. On a seasonally adjusted basis, the number of those participating in the labor force grew by 380,000 statewide (an increase of 2 percent) over the past year, including 131,000 in Los Angeles County (an increase of 2.6 percent there). Those choosing not to be in the labor force because they were discouraged over their job prospects dropped more than 10 percent over the last 12 months to just 68,000 statewide—down from over 175,000 in early 2011.

- ***Full-Time Work Up.*** According to Current Population Survey data, almost all of the net growth in California jobs over the past year has been in full-time positions, as the percent of those employed working full-time in the state grew from 80.3 percent a year ago to 80.6 percent now. Between September 2015 and September 2016, the three-month moving average of private-sector hourly earnings grew by more than 3 percent. The number of those working part-time for economic reasons (generally because there is insufficient demand from their employer) dropped 11 percent over the past year to 946,000—down from over 1.5 million in 2010.

- ***Jobless Claims and Underemployment Down.*** Initial jobless claims have fallen to near prerecession levels—under 40,000 per week in some periods this year. California's "U-6" jobless rate—a broader jobless measure that counts those unemployed, marginally attached to the labor force, and working part-time for economic reasons—fell to 11.6 percent in September (down 1.7 percentage points from one year before). This remains high compared to the rest of the nation, but California's U-6 rate is far below its 22.1 percent annual peak in 2010.

LAO Projections for 2016 Through 2018. As shown in Figures 3 and 4, our office anticipates that personal income in California will grow a modest 3.9 percent in 2016—faster than the 3.3 percent growth rate expected for the U.S. as a whole. While the 3.9 percent growth rate is disappointing, we note that wages and salaries—the largest component by far of personal income subject to state taxation—are expected to grow by 5.2 percent, which is consistent with the fairly strong trend of personal income tax (PIT) withholding growth we have been seeing this year. The anticipated wage and salary growth in 2016 offsets weak growth in some other personal income categories like dividends, interest, and rent and transfers (such as Social Security payments), some parts of which are not subject to the state income tax. Our current projections anticipate stronger personal income and wage growth in 2017 and 2018, as California's unemployment rate dips below 5 percent. We anticipate less growth in jobs and more growth in wages over the next few years, as the labor market tightens more and nears full employment. California's minimum wage also will increase in future years under state law.

The Bay Area

While the Los Angeles area economy is bigger, the Bay Area has contributed disproportionately to state tax revenue and economic growth in recent decades. This continues to be the case today. Because of the Bay Area's importance to the economy and budget, we focus on it in this section.

Silicon Valley Job Growth. Jobs in the San Jose region (Santa Clara and San Benito Counties) grew by a net 3.6 percent during the 12 months ending in September—far outpacing job growth in the state and its other large metro areas. The bulk of the region's job growth came in professional and business services—primarily in technology-dominated job categories. Other contributors to Silicon Valley job growth have been private education and health facilities, construction, and restaurants. The San Francisco (San Francisco and San Mateo Counties) and East Bay (Alameda and Contra Costa Counties) regions recorded 2.6 percent year-over-year job growth through September, with noteworthy growth rates in technology, health care, and construction, among other sectors.

Bay Area Contributes Heavily to State Taxes. The state PIT makes up about 70 percent of state General Fund revenues. As shown in Figure 6 (see next page), Bay Area residents—16.8 percent of the state's population—receive 29.1 percent of the income reported on state resident tax returns as of 2014 and pay 37 percent of the income taxes assessed. This means that per capita PIT payments by Bay Area residents are far above those of any other region in the state. Among the state's major regions listed in Figure 6, the Bay Area's per capita tax payments are almost twice those of Orange County, the next highest area. Below Orange County on the list, all other major regions of the state have per capita PIT payments below the statewide average.

The Bay Area contributes so much to PIT because individuals there, on average, have higher incomes than those in other areas of the state. In California's income tax system, those with higher incomes pay taxes at higher marginal rates. In terms of median adjusted gross income shown on state tax returns, eight of the top ten counties in the state are in the Bay Area. Prior research by our office has shown that Bay Area residents also spend

Figure 6

Bay Area Contributes Disproportionately to State Income Tax Revenues

2014 Resident Tax Returns

County	2014 Population: Number (Millions)	2014 Population: Percent of Statewide Total	Adjusted Gross Income: Amount (Billions)	Adjusted Gross Income: Percent of Statewide Total	Personal Income Tax Assessed: Amount (Billions)	Personal Income Tax Assessed: Percent of Statewide Total	Personal Income Tax Assessed: Per Capita ($)
San Francisco/Oakland/ San Jose MSAs	6.5	16.8%	$346.2	29.1%	$22.6	37.0%	$3,474
Orange County	3.1	8.1	107.3	9.0	5.7	9.3	1,821
Ventura County	0.8	2.2	26.4	2.2	1.2	2.0	1,439
Los Angeles County	10.1	26.1	282.9	23.8	14.5	23.7	1,434
San Diego County	3.2	8.4	97.0	8.2	4.6	7.6	1,425
Central Coast[a]	1.4	3.7	39.1	3.3	1.8	3.0	1,282
Napa, Solano, and Sonoma Counties	1.1	2.7	31.4	2.6	1.3	2.2	1,267
Sacramento MSA	2.2	5.8	58.8	4.9	2.4	3.9	1,063
North State[b]	1.2	3.2	22.4	1.9	0.7	1.2	612
San Joaquin Valley[c]	4.1	10.7	72.1	6.1	2.4	4.0	593
Riverside and San Bernardino Counties	4.4	11.4	81.2	6.8	2.5	4.0	559
Other residents[d]	0.4	1.0	23.5	2.0	1.3	2.1	3,498
Totals	**38.7**	**100.0%**	**$1,188.2**	**100.0%**	**$61.2**	**100.0%**	**$1,581[e]**

[a] Includes Monterey, San Luis Obispo, Santa Barbara, and Santa Cruz Counties.
[b] Includes all counties north of San Francisco, Napa, Sonoma, Vallejo-Fairfield, and Sacramento MSAs.
[c] Includes Fresno, Kern, Kings, Madera, Merced, San Joaquin, Stanislaus, and Tulare Counties.
[d] Includes California resident tax returns with (1) an address in another California county or (2) an out-of-state address. Returns with out-of-state addresses collectively had $1.1 billion of tax assessed, the vast majority of the total shown on this line. Excludes nonresident tax returns, which collectively had $2.5 billion of tax assessed.
[e] Statewide average.
MSA = metropolitan statistical area.

more, on average, on goods subject to the sales tax, compared to other regions of the state. Per capita assessed valuation—for local property taxes—also is higher in the Bay Area than in other areas of the state.

Dependence on the Bay Area. The state's job growth has been centered in the Bay Area, and its key income, sales, and property taxes are all paid disproportionately by Bay Area residents. Boom times in the Bay Area tend to mean the statewide economy and the state budget are doing well. Economic weakness there hinders the economy and can throw the state budget into a tailspin. With the Bay Area economy dependent on what has been a thriving technology sector, one major risk to the state's near-term economic health is the possibility of a big slowdown in that sector. While venture capital investments in the Bay Area have fallen from 2014 and 2015 levels, they remain substantial and there is little evidence that a significant slowdown of the Bay Area technology sector is imminent.

Housing Costs a Growing Concern. Home prices and rents remain very high in both the Bay Area and Los Angeles, as well as other parts of the state. Housing affordability is a growing concern in California. Given the importance of the Bay Area to the state budget, as noted above, we focus below on housing affordability issues there.

Over the past year, the San Francisco-Oakland and San Jose metro areas have experienced home price growth of 5.7 percent and 4.7 percent, respectively. This is well below the double-digit growth that occurred in these areas in recent years. Nonetheless, home prices remain high compared to just about anywhere else. Median home prices in the San Jose ($944,000) and San Francisco-Oakland ($813,000) areas ranked first and second highest among major urban areas in the country.

Rents continued to rise quickly in the San Francisco-Oakland (12 percent) and San Jose (13 percent) areas in 2015, according to ACS data. Monthly rents in San Jose ($2,300) and San Francisco-Oakland ($2,000) were rivaled only by those in Honolulu among major urban areas. While there is some anecdotal and survey information showing that rents have stabilized or fallen slightly in 2016, other data sources, such as Zillow's rental index, show 3 percent to 4 percent growth in rental costs this year in parts of the Bay Area. (ACS data on rents for 2016—which is generally considered to be the most comprehensive—will not be available until next year.)

More residential construction would moderate home price growth over the long term. Building activity in the Bay Area generally has returned to prerecession levels. Building permits in San Francisco-Oakland are at their highest levels since 2006. Despite this recovery, building levels remain low relative to other urban areas throughout the country. Over the past year, the San Francisco-Oakland and San Jose areas approved about 2.8 building permits per 1,000 residents—well below the national average among major urban areas of 3.9 permits per 1,000 residents. Other urban areas with rapidly growing economies—such as Austin, Houston, Portland, and Raleigh—approved over six permits per 1,000 residents during the past year. Over the long term, a constrained supply of new housing may limit prospects for job and economic growth in the Bay Area.

REVENUES

Figure 7 displays our office's revenue outlook through 2017-18. This outlook reflects the U.S. economic projections of an October 2016 consensus of economists, described earlier. (In Chapter 4, we display revenue estimates through 2020-21 under two possible economic scenarios—an economic growth scenario and a recession scenario.)

Figure 7

LAO November 2016 Revenue Outlook

General Fund (Dollars in Millions)

				Change From 2016-17	
	2015-16	**2016-17**	**2017-18**	**Amount**	**Percent**
Personal income tax	$79,039	$85,085	$90,959	$5,874	6.9%
Sales and use tax	24,766	24,747	25,024	277	1.1
Corporation tax	10,032	9,892	10,162	269	2.7
Subtotals, "Big Three" Revenues	($113,837)	($119,724)	($126,144)	($6,420)	(5.4%)
Insurance tax	$2,561	$2,376	$2,456	$80	3.4%
Other revenues	2,219	1,779	1,650	-129	-7.3
BSA transfer	-1,814	-3,294	-1,979	1,315	—
Other transfers	-1,160	-593	-148	446	—
Totals, Revenues and Transfers	**$115,643**	**$119,991**	**$128,123**	**$8,132**	**6.8%**

BSA = Budget Stabilization Account.

Revenue Estimates $1.7 Billion Below Budget Assumptions for 2015-16 and 2016-17 Combined. Our revenue estimates for 2015-16 and 2016-17 combined are modestly lower than the administration's May 2016 estimates that served as the basis for the June 2016 budget plan, as shown in Figures 8 and 9. In particular, our estimates of sales and use tax (SUT) and corporation tax (CT) revenues are $2.6 billion below budget act assumptions for 2015-16 and 2016-17 combined. On the other hand, our estimate of PIT revenues is $768 million above budget assumptions for those two fiscal years combined, somewhat offsetting our weak SUT and CT estimates. After accounting for minor revenues and transfers, our bottom line estimates of General Fund revenues and transfers are $1.7 billion below budget assumptions.

Strong PIT Growth Drives Healthy Revenue Growth in 2017-18. Looking beyond the current fiscal year, we estimate that the state's "Big Three" revenues—PIT, SUT, and CT—will grow 5.4 percent in 2017-18, as shown in Figure 7. This growth is driven by a projected 6.9 percent year-over-year increase in the PIT, which makes up about 70 percent of General Fund revenues. We estimate SUT and CT to grow by 1.1 percent and 2.7 percent, respectively, in 2017-18. Year-over-year growth in the SUT would be higher were it not for the end of the quarter-cent Proposition 30 (2012) SUT rate after December 2016. We describe near-term estimates of these tax revenues in more detail below.

Personal Income Tax

June 2016 Cash Receipts Were Disappointing . . . As the Governor signed the *2016-17 Budget Act*, PIT cash collections for June came in $888 million below projections, as shown in Figure 10. June is an important revenue collection month as taxpayers submit estimated payments for that year's tax liability. (Estimated payments are quarterly payments made by individuals and businesses on expected taxable income for which there is no withholding, such as realized capital gains on sales of stocks and other assets.) Estimated payments fell short of projections by $622 million (about 9 percent) in June 2016. Moreover, withholding came in nearly 6 percent, or $250 million, below projections.

. . . But Recent Collections Have Been on Target. Since June 2016, however, cash receipts have largely hit their mark. Withholding and "other Franchise Tax Board collections" (such as final payments) exceeded budget projections by $72 million and $312 million, respectively. Offsetting these results, estimated payments and

Figure 8

Comparing LAO November 2016 Revenue Estimates With June 2016 Budget Act Assumptions

General Fund (In Millions)

	2015-16			2016-17			
	LAO Nov. 2016	Budget Act June 2016	Change	LAO Nov. 2016	Budget Act June 2016	Change	Total Change
Personal income tax	$79,039	$79,962	-$923	$85,085	$83,393	$1,691	$768
Sales and use tax	24,766	25,028	-262	24,747	25,727	-980	-1,242
Corporation tax	10,032	10,309	-277	9,892	10,992	-1,100	-1,377
Subtotals, "Big Three" Revenues	($113,837)	($115,299)	(-$1,462)	($119,724)	($120,113)	(-$389)	(-$1,851)
Other revenues and transfers	$1,806	$1,702	$104	$267	$197	$70	$174
Totals, Revenues and Transfers	**$115,643**	**$117,001**	**-$1,358**	**$119,991**	**$120,310**	**-$319**	**-$1,677**

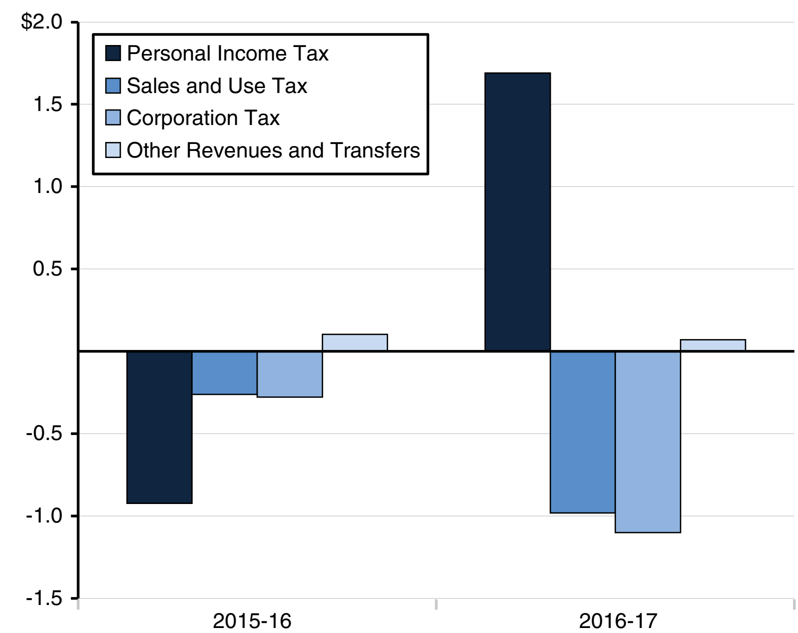
refunds were worse than projections ($198 million and $221 million, respectively). In total, PIT receipts over the July through October period fell short of projections by just $34 million (or about two-tenths of 1 percent).

June Collections and the Weak Early 2016 Stock Market. Our working theory is that much of the recent trend in estimated payments can be explained by stock market performance since early 2016. Figure 11 (see next page) shows S&P 500 index values from January 2016 through October 2016. As shown in the figure, the index was under 1900 for much of the first quarter of 2016. We think that this may help explain the disappointing level of estimated payments in June. Since then, however, the market has largely recovered. Our economic projections assume that the S&P 500 index will average 2,078 in 2016 and 2,165 in 2017, notably higher than early 2016 levels.

Figure 9

Comparing LAO November 2016 Revenue Estimates With June 2016 Budget Act Assumptions

General Fund (In Billions)



Assuming Steady Stock Prices, PIT Estimates Exceed Budget Projections Through 2016-17. If our assumptions come to pass, we estimate that taxpayers will make larger estimated and final payments beginning in December 2016 through early 2017 than was projected in the state budget package. This would essentially "make up" for

Figure 10

Recent PIT Cash Trends Better Than June 2016

(In Millions)

	June 2016			July 2016 Through October 2016		
	Actual	DOF Projections	Difference	Actual	DOF Projections	Difference
PIT withholding	$4,138	$4,388	-$250	$17,536	$17,464	$72
Estimated payments	6,187	6,808	-622	3,139	3,336	-198
Other FTB collections	685	618	66	2,796	2,483	312
FTB refunds	-450	-351	-99	-1,741	-1,520	-221
Proposition 63 allocation	-186	-202	16	-382	-383	1
Totals	**$10,373**	**$11,261**	**-$888**	**$21,347**	**$21,381**	**-$34**

PIT = personal income tax; DOF = Department of Finance; and FTB = Franchise Tax Board.

the weak June collections. Relative to budget act assumptions, this has the effect of shifting revenues from 2015-16 into 2016-17. On net, we estimate PIT revenues will be $768 million higher than assumed in the budget for 2015-16 and 2016-17 combined.

Healthy PIT Growth in 2017-18. Looking beyond the current fiscal year, our assumptions of wages and salaries and capital gains continue to be higher than the administration's most recent assumptions. While our estimates of personal income growth are below state budget assumptions, we currently project stronger growth in 2018. These and other factors result in healthy PIT growth of nearly 7 percent in 2017-18.

Risks to PIT Estimates. Our revenue estimates are premised upon our near-term projections about the economy and assumptions about the stock market. If those assumptions do not come to pass, revenues in 2016-17 and 2017-18 could be a few billion dollars higher or lower than the estimates reflected in Figure 7. If, for example, the S&P 500 index returns to first quarter 2016 levels, our estimates of taxpayers' estimated and final payments described above could prove billions of dollars too high for 2016-17 and 2017-18 combined.

Figure 11

S&P 500 Index Has Recovered From First Quarter Dip

Sales and Use Tax

Sales Tax Estimates Down. Estimated General Fund SUT revenue totaled $24.8 billion in 2015-16, $262 million lower than the amount assumed in the June 2016 budget plan. We estimate that SUT revenues remain steady at around $24.7 billion in 2016-17, about $1 billion lower than budget assumptions. Thereafter, estimated SUT revenues increase slightly to $25 billion in 2017-18.

Reasons for Sales Tax Weakness. This short-term weakness in SUT revenue is due to several factors, including: (1) lower-than-expected revenue in 2015-16, (2) a quarter-cent rate reduction, and (3) modest growth in California personal income. At the end of 2015-16, SUT revenue was about a quarter of a billion dollars below the budget's assumption, setting a lower starting point for subsequent growth. The temporary quarter-cent rate established by Proposition 30 will expire at the end of 2016. This rate expiration likely will reduce annual SUT revenue growth by about 3 percentage points in 2016-17 and in 2017-18 relative to revenue growth with constant tax rates. Finally, we project modest personal income growth of 3.9 percent in 2016, bringing down our near-term SUT estimates.

Corporation Tax

Corporate Profits Expected to Grow Slowly. The CT is levied on profits of California corporations and, for multistate corporations, a share of their total national profits. National corporate profits peaked in 2014 and declined over 2015. As described earlier in this chapter, our near-term economic projections are based on the consensus of various economists about the likely trend of the U.S. economy through 2018. In those projections, national corporate profits grow relatively slowly over the next several years, as rising wages and commodity prices offset increased consumer and business consumption. Consequently, we project CT revenue to decline by about 1 percent in 2016-17, followed by several years of growth that is roughly on pace with the broader economy.

CT Revenue Has Underperformed Budget Assumptions to Date. Our near-term estimates are consistent with recent cash flow trends. Through the first four months of 2016-17, net CT receipts are 14 percent below budget act projections. Last year had elevated levels of refunds, and we see this trend continuing in 2016-17.

Chapter 3:
Spending Outlook

Figure 12 displays our General Fund spending estimates, by major program, through 2017-18. (Our spending projections for the entire outlook period are discussed in Chapter 4.)

One-Time and Temporary Spending Obscure Underlying Growth Rates. One-time spending in the 2016-17 budget package obscures underlying growth in some of these programs. This includes, for example, one-time spending for deferred maintenance in the California Department of Corrections and Rehabilitation, the judicial branch, and the universities. The estimate of "remaining programs" includes one-time funding of $1 billion for the new State Project Infrastructure Fund and other, smaller one-time items. Similarly, the figure overstates the underlying growth in the California Work Opportunity and Responsibility to Kids (CalWORKs) program

Figure 12

General Fund Spending Outlook

(Dollars in Billions)

	Estimates		Outlook	
	2015-16	2016-17[a]	2017-18	Change From 2016-17
Education Programs				
Proposition 98[b]	$49.1	$51.0	$52.4	2.7%
UC[c]	3.2	3.4	3.4	1.3
CSU	3.0	3.3	3.3	2.3
Student Aid Commission	1.4	1.1	1.2	3.9
Child Care	0.9	0.9	1.1	17.5
Health and Human Services				
Medi-Cal	17.5	17.9	18.7	4.5
CalWORKs	0.7	0.7	1.0	48.2
SSI/SSP	2.8	2.9	2.9	1.5
IHSS	3.0	3.5	3.7	6.2
DDS	3.5	4.0	4.1	2.9
DSH	1.6	1.7	1.6	-4.3
Other major programs[d]	2.2	2.4	2.4	0.6
Criminal Justice Programs[e]				
CDCR	9.7	10.0	9.8	-1.1
Judiciary	1.6	1.8	1.8	-2.2
Infrastructure Debt Service[f]	5.3	5.4	5.5	1.7
Other Programs				
CalSTRS	1.9	2.5	2.6	6.5
Proposition 2 debt payments[g]	—	—	2.0	—
Remaining programs	7.4	9.7	8.6	-11.8
Totals	**$114.9**	**$122.0**	**$126.1**	**3.4%**

[a] Deferred maintenance spending, which the Department of Finance displays in a single line item, is allocated by department in 2016-17.

[b] Reflects General Fund component of Proposition 98 minimum guarantee.

[c] Excludes Proposition 2 payments for the UC Retirement plan. These payments are included under "other programs."

[d] Includes DHCS family health and state operations, DPH, DCSS, and DSS programs not itemized above. Smaller health and human services programs are included in "remaining programs."

[e] Excludes smaller departments—such as the Department of Justice—that are included in "remaining programs."

[f] Debt service on general obligation and lease revenue bonds generally used for infrastructure. Does not include: (1) lease revenue debt service for community colleges, which is included under Proposition 98, or (2) UC's and CSU's debt service, which is included in their respective line items.

[g] In 2015-16 and 2016-17, Proposition 2 debt payment amounts are reflected elsewhere. Included in 2017-18 is the entire estimate of Proposition 2 debt payment requirements.

IHSS = In-Home Supportive Services; DDS = Department of Developmental Services; DSH = Department of State Hospitals; CDCR = California Department of Corrections and Rehabilitation; DHCS = Department of Health Care Services; DPH = Department of Public Health; DCSS = Department of Child Support Services; and DSS = Department of Social Services.

because 2017-18 spending in that program reflects General Fund backfill of one-time federal funds carried in from prior years (see our "CalWORKs" write-up for more information).

EDUCATION

Education Spending. In this section, we focus on Proposition 98, the universities, student financial aid programs, and child care programs. The "Proposition 98" section estimates total combined spending for elementary and secondary education (commonly referred to as K-12 education), the California Community Colleges, and a large portion of the state's subsidized preschool program. The next section estimates spending for the University of California and the California State University. The "Financial Aid" section focuses on spending for Cal Grants and Middle Class Scholarships. The last section estimates non-Proposition 98 General Fund spending for the rest of the state's preschool program as well as most child care programs.

Proposition 98

Proposition 98 Minimum Guarantee for Schools and Community Colleges. State budgeting for schools and community colleges is governed largely by Proposition 98, passed by voters in 1988. The measure, modified by Proposition 111 in 1990, establishes a minimum funding requirement, commonly referred to as the minimum guarantee. Both state General Fund and local property tax revenue apply toward meeting the minimum guarantee. In addition to Proposition 98 funding, schools and community colleges receive funding from the federal government, other state sources (such as the lottery), and various local sources (such as parcel taxes).

Calculating the Minimum Funding Guarantee. The Proposition 98 minimum guarantee is determined by one of three tests set forth in the State Constitution (see Figure 13). These tests depend upon several inputs, including changes in K-12 average daily attendance, per capita personal income, and per capita General Fund revenue. Though the calculation of the minimum guarantee is formula-driven, a supermajority of the Legislature can vote to suspend the formulas and provide

Figure 13

The Tests and Basic Rules for Calculating the Minimum Guarantee

Test 1—Share of General Fund
- Ensures Proposition 98 General Fund is at least about 40 percent of state General Fund revenue.
- Applies when it results in a higher funding level than Test 2.
- Has been operative 4 of the last 28 years.

Test 2—Growth in Personal Income
- Adjusts prior-year Proposition 98 funding for changes in K-12 attendance and per capita personal income.
- Applies when it results in a lower funding level than Test 3.
- Has been operative 14 of the past 28 years.

Test 3—Growth in General Fund Revenue
- Adjusts prior-year Proposition 98 funding for changes in K-12 attendance and per capita General Fund revenue.
- Applies when it results in a lower funding level than Test 2.
- Has been operative 8 of the past 28 years.

Note: The state has suspended Proposition 98 twice.

less funding than they require. This happened in 2004-05 and 2010-11. In some cases, including as a result of a suspension, the state creates a higher out-year funding obligation referred to as a "maintenance factor." The state is required to make progress toward meeting this higher obligation when year-to-year growth in state General Fund revenue is relatively strong. Though in most years the state has provided an amount at or close to the minimum guarantee, the state has discretion to provide any amount above the minimum guarantee.

2015-16 and 2016-17 Updates

2015-16 Minimum Guarantee Down $378 Million From Budget Act Estimate. The decrease in the minimum guarantee (see Figure 14) is due to our estimated $1.4 billion drop in General Fund tax revenue relative to budget act estimates. As a result of this revenue drop, the state is no longer required to make the $379 million maintenance factor payment included the June budget package. This drop in the guarantee is offset by a $1 million increase due to various other adjustments.

2015-16 Local Property Tax Estimate Revised Upward. Though the minimum guarantee has fallen from budget act estimates, Proposition 98 local property tax revenue is up $262 million. The bulk of this increase is attributable to higher-than-expected transfers from Educational Revenue Augmentation Funds to schools and community colleges. The increase in property tax revenue reduces Proposition 98 General Fund costs on a dollar-for-dollar basis. Coupling the increase in property tax revenue with the decline in the guarantee results in Proposition 98 General Fund dropping $640 million.

Further Downward Revisions in General Fund Revenue Unlikely to Affect 2015-16 Minimum Guarantee. Under our latest revenue estimates, the operative test for calculating the guarantee in 2015-16 changes from Test 2 to Test 3. Whenever Test 3 is operative, statute requires the state to make a supplemental appropriation if needed to ensure Proposition 98 funding grows as quickly as the rest of the budget. In 2015-16, shifting to Test 3 results in the state needing to make a $53 million supplemental appropriation. This additional funding raises the guarantee up to the Test 2 level. In 2015-16, were General Fund revenue to be further revised downward by as much as $1.6 billion, the required supplemental appropriation would increase correspondingly, bringing the guarantee back up to the Test 2 level. That is, further revenue declines in 2015-16 likely would have no effect on the minimum guarantee.

2016-17 Minimum Guarantee Down $10 Million From Budget Act Estimate. At the time of budget enactment, Test 3 was the operative test in 2016-17. Even under our latest estimates, Test 3 remains operative. In Test 3 years, the minimum guarantee builds upon the prior-year funding level adjusted for changes in per capita General Fund revenue and

Figure 14

Updating Estimates of 2015-16 and 2016-17 Minimum Guarantees

(In Millions)

	2015-16			2016-17		
	June Budget Plan	November LAO Estimate	Change	June Budget Plan	November LAO Estimate	Change
Minimum Guarantee						
General Fund	$49,722	$49,082	-$640	$51,050	$50,973	-$77
Local property tax	19,328	19,589	262	20,824	20,891	67
Totals	**$69,050**	**$68,672**	**-$378**	**$71,874**	**$71,864**	**-$10**

K-12 attendance. Compared with June budget act assumptions, we estimate General Fund revenue is $1.4 billion lower in 2015-16 and $350 million lower in 2016-17. Because the drop in the prior year is greater than the drop in the current year, the year-to-year growth rate increases. The higher growth rate offsets the decline in the prior-year funding level. After updating for various other inputs, including slightly lower estimates of K-12 attendance, the minimum guarantee is only $10 million below the level assumed in June. Under the latest inputs, the state creates $321 million in new maintenance factor, for a total outstanding maintenance factor obligation at the end of 2016-17 of $873 million. The new maintenance factor created dropped from the June budget package level of $746 million, due largely to the higher General Fund growth rate.

Forecast Assumes State Funds at the Revised Estimates of the Prior-Year and Current-Year Minimum Guarantees. Although the 2015-16 minimum guarantee has fallen by $378 million, the state allocated funding to schools and community colleges based upon the higher June 2016 estimate of the guarantee. After adjusting for changes in various program costs, we estimate that currently authorized 2015-16 spending exceeds the minimum guarantee by $351 million. Historically, in virtually all cases when the prior-year or current-year guarantee has been revised downward, the state has acted to reduce associated spending. For purposes of our outlook, we assume the state designates the $351 million as payment toward its outstanding settle-up obligation. (The state currently has an outstanding settle-up obligation of about $1 billion, mostly related to the 2009-10 minimum guarantee. The state creates a settle-up obligation when the minimum guarantee rises above the level initially assumed in the budget act.) Under this approach, the $351 million is not built into the 2016-17 Proposition 98 base.

2017-18 Budget Planning

2017-18 Guarantee $2.6 Billion Higher Than Revised 2016-17 Level. As shown in Figure 15, we estimate that the minimum guarantee will grow

Figure 15

Proposition 98 Key Inputs and Outcomes Through 2017-18

(Dollars in Millions)

	2015-16	2016-17	2017-18
Minimum Guarantee[a]			
General Fund	$49,082	$50,973	$52,354
Local property tax	19,589	20,891	22,132
Totals	**$68,672**	**$71,864**	**$74,486**
Change From Prior Year			
General Fund	-$948	$1,891	$1,380
Percent change	-1.9%	3.9%	2.7%
Local property tax	$2,474	$1,301	$1,241
Percent change	14.5%	6.6%	5.9%
Total guarantee	$1,526	$3,193	$2,621
Percent change	2.3%	4.6%	3.6%
Operative Test	3	3	2
Maintenance Factor			
Amount created (+) or paid (-)	—	$321	-$894
Total outstanding[b]	$525	873	—
Growth Rates			
K-12 average daily attendance	-0.2%	-0.2%	-0.2%
Per capita personal income (Test 2)	3.8	5.4	2.7
Per capita General Fund (Test 3)[c]	3.7	4.4	4.9
K-14 cost-of-living adjustment	1.0	0.0	1.1

[a] Assumes state funds at revised estimate of minimum guarantee each year.

[b] Outstanding maintenance factor is adjusted annually for changes in K-12 attendance and per capita personal income.

[c] As set forth in the State Constitution, reflects change in per capita General Fund plus 0.5 percent.

from $71.9 billion in 2016-17 to $74.5 billion in 2017-18, an increase of $2.6 billion (3.6 percent). Test 2 is operative, with the guarantee adjusted for a 2.7 percent increase in per capita personal income and a 0.2 percent decline in K-12 attendance. In addition, because General Fund revenue is growing more quickly than per capita personal income, the state is required to make an $894 million maintenance factor payment. After making this payment, the state would end the year with no outstanding maintenance factor for the first time since 2005-06.

Nearly Half of Increase Covered With Property Tax Revenue. Of the $2.6 billion increase in Proposition 98 funding, state General Fund revenue covers $1.4 billion and local property tax revenue covers $1.2 billion. The main factor explaining the increase in property tax revenue is a 5.3 percent increase in assessed property values. This factor accounts for about $930 million of the increase. The other large contributing factor is a $340 million increase in the ongoing savings associated with the dissolution of redevelopment agencies. This increase is primarily due to the phase out of certain one-time costs related to recent changes in the dissolution process.

$2.8 Billion Available for Proposition 98 Priorities. As shown in Figure 16, the *2016-17 Budget Act* provided $71.9 billion in funding for schools and community colleges. Of this amount, $496 million was allocated for one-time activities. Though this funding is freed up for other purposes moving forward, the state already has committed through previous budget agreements to $276 million in higher 2017-18 spending. The net effect of these changes, in combination with the $2.6 billion increase in the minimum guarantee, results in the state having $2.8 billion to spend on its 2017-18 Proposition 98 priorities.

State Could Achieve Almost Full Implementation of the Local Control Funding Formula (LCFF) in 2017-18. In recent years, the state has dedicated most new Proposition 98 funding to implementing the LCFF. If the state continued this practice in 2017-18, we estimate it could fund 99 percent of LCFF's full implementation cost. Specifically, we estimate the state could spend $2.5 billion to close the remaining LCFF gap, increasing per-student LCFF funding by 4.5 percent over 2016-17 levels. Our estimate assumes community colleges continue to receive 11 percent of Proposition 98 funding, the state funds previously agreed-upon commitments, and

Figure 16

$2.8 Billion Increase in Proposition 98 Funding Projected for 2017-18

(In Millions)

***2016-17 Budget Act* Spending**	**$71,874**
Back out one-time actions:	
Secondary school career technical education grants (year two)	-$292
CCC maintenance and instructional equipment	-154
CCC Innovation Awards	-25
CCC intersegmental college partnerships	-15
CCC zero-textbook-cost degree startup funding	-5
Adult education consortia technical assistance	-5
Subtotal	(-$496)
Fund previously approved commitments:	
Secondary school career technical education grants (year three)[a]	$200
Preschool rate and slot increases[b]	76
Subtotal	($276)
New Funds Available in 2017-18	**$2,833**
2017-18 Minimum Guarantee	**$74,486**

[a] The state could fund all or a portion of this program with unspent prior-year funds.

[b] Reflects augmentations of $44 million for the full-year cost of increasing the Standard Reimbursement Rate effective January 1, 2017; $24 million for the full-year cost of additional slots that will begin on April 1, 2017; and $8 million for the partial-year cost of additional slots that will begin on April 1, 2018.

other K-12 categorical programs are adjusted for changes in attendance and cost of living.

2017-18 Guarantee Moderately Sensitive to Declines in State Revenue. We estimate that General Fund revenue could fall as much as $500 million below our estimates in 2017-18 with no change in the minimum guarantee. Even at this lower level, Test 2 would remain operative and year-to-year revenue growth would be large enough to require the state to pay down all remaining maintenance factor. For each additional dollar of revenue decline beyond this level, the guarantee would drop by about 40 cents. Regarding possible revenue increases, the minimum guarantee is mostly insensitive to any increase above the level assumed in our outlook. We estimate that 2017-18 General Fund revenue could increase about $5.5 billion before having any effect on the minimum guarantee. (An increase of this magnitude would make Test 1 operative and provide schools and community colleges about 40 cents of each dollar above the $5.5 billion threshold.) For the purpose of this sensitivity analysis, we assume prior-year revenue and other inputs remain constant. Changes to these factors could affect the thresholds and make the guarantee more or less sensitive.

Outlook for Later Years

Many Economic Scenarios Could Unfold Over the Period. State General Fund revenue over the next four years is likely to be affected by a variety of short-term developments (such as swings in the stock market) as well as long-term trends (such as growth in housing prices). In this section, we describe how the minimum guarantee would respond to two hypothetical economic scenarios—one assuming continued moderate growth over the period and one assuming a mild recession beginning in the middle of 2018. (These scenarios are discussed in greater detail in Chapter 4.) Both scenarios have built in the additional state General Fund revenue resulting from the recent passage of Proposition 55, which extended the income tax rates paid by high-income earners for an additional 12 years. (Though it does not affect the calculation of the guarantee, the recent passage of Proposition 51 is another significant development for schools and community colleges. The measure provides $9 billion in bonds for building and renovations school facilities.)

Under Growth Scenario, Minimum Guarantee Continues to Rise. As shown in the top part of Figure 17, the minimum guarantee under the growth scenario increases from $71.9 billion in 2016-17 to $83.5 billion in 2020-21. The average annual growth rate under this scenario is 3.8 percent. Under this scenario, the state creates little new maintenance factor, ending the period with about $200 million in outstanding maintenance factor obligation.

Under Recession Scenario, Minimum Guarantee Declines in 2018-19 and Remains Below Growth Scenario. As shown in the middle part of Figure 17, the guarantee under the recession scenario declines by $1.4 billion (1.9 percent) from 2017-18 to 2018-19. In 2018-19, the state creates more than $4 billion in new maintenance factor. Even with the state making maintenance factor payments the subsequent two years, the state ends the period with $3.1 billion in outstanding maintenance factor obligation. Under the recession scenario, the guarantee grows from $71.9 billion in 2016-17 to $78.1 billion in 2020-21, an average annual growth rate of 2.1 percent. As shown in the bottom section of Figure 17, by 2020-21 the minimum guarantee under the recession scenario is more than $5 billion below the level in the growth scenario. (Though this scenario assumes the recession does not begin until 2018-19, the 2017-18 year also is affected due to state accrual policies.)

Recession Scenario Serves as Cautionary Tale. Although the recession scenario illustrates one way an economic downturn could unfold, the timing and magnitude of the next recession is highly uncertain. Rather than being a prediction, the recession scenario serves as a cautionary tale about the volatility of Proposition 98 funding. To provide a measure of protection against such volatility, the state in recent years has allocated some of the available Proposition 98 funding for one-time activities. If the guarantee experiences a year-over-year decline, the expiration of this one-time funding provides a buffer that reduces the likelihood of cuts to ongoing school and community college programs.

Local Property Tax Revenue Projected to Rise Steadily Over the Period. Unlike the state General Fund, which tends to be highly sensitive

Figure 17

Proposition 98 Outlook Under Two Economic Scenarios

(Dollars in Billions)

	2016-17	2017-18	2018-19	2019-20	2020-21
Economic Growth Scenario					
General Fund Tax Revenue	$122.9	$129.5	$135.8	$142.0	$147.2
Minimum Guarantee	**$71.9**	**$74.5**	**$77.5**	**$80.7**	**$83.5**
Year-to-year change	—	$2.6	$3.0	$3.2	$2.8
Percent change	—	3.6%	4.1%	4.1%	3.4%
Operative Test	3	2	2	3	3
Maintenance Factor					
Amount created (+) or paid (-)	$0.3	-$0.9	—	$0.2	$0.0
Total outstanding[a]	0.9	—	—	0.2	0.2
Key Factors					
Per capita personal income (Test 2)	5.4%	2.7%	4.5%	4.7%	3.8%
Per capita General Fund (Test 3)[b]	4.4	4.9	4.6	4.3	3.4
Mild Recession Scenario					
General Fund Tax Revenue	$122.9	$127.6	$124.3	$128.0	$133.9
Minimum Guarantee	**$71.9**	**$73.8**	**$72.4**	**$73.8**	**$78.1**
Year-to-year change	—	$1.9	-$1.4	$1.5	$4.2
Percent change	—	2.7%	-1.9%	2.0%	5.7%
Operative Test	3	2	3	1	1
Maintenance Factor					
Amount created (+) or paid (-)	$0.3	-$0.2	$4.4	-$0.7	-$1.4
Total outstanding[a]	0.9	0.7	5.1	4.5	3.1
Key Factors					
Per capita personal income (Test 2)	5.4%	2.7%	4.5%	1.1%	1.7%
Per capita General Fund (Test 3)[b]	4.4	3.5	-2.9	2.7	4.4
Comparison of Scenarios					
Minimum Guarantee					
Economic Growth Scenario	$71.9	$74.5	$77.5	$80.7	$83.5
Mild Recession Scenario	71.9	73.8	72.4	73.8	78.1
Difference	**—**	**$0.7**	**$5.1**	**$6.9**	**$5.4**

[a] Outstanding maintenance factor is adjusted annually for changes in K-12 attendance and per capita personal income.
[b] As set forth in the State Constitution, reflects change in per capita General Fund plus 0.5 percent.

to short-term economic developments, property tax revenue typically grows at a steadier rate. Under both our scenarios, the outlook assumes that property tax revenue grows from $20.9 billion in 2016-17 to $25.6 billion by 2020-21. Property tax revenue covers about 40 percent of the annual increases in the minimum guarantee under the growth scenario and about 65 percent of the increases under the recession scenario. Property tax revenue projections are driven primarily by assumptions of growth in assessed property values. We assume assessed values grow about 5.5 percent per year over the outlook period.

K-14 Cost-of-Living Adjustments (COLA) Projected to Remain Low. The statutory COLA for most K-14 programs is based upon a national price index for state and local government goods and services. Our outlook assumes the statutory COLA remains low throughout the period—hovering around 1 percent.

K-12 Attendance Projected to Decline. Our outlook assumes that K-12 attendance declines by 0.2 percent per year in 2016-17 and 2017-18 and by 0.3 percent per year later in the period. The largest factor explaining this decline is the outlook for birth rates. Whereas the state had about 550,000 births in 2007-08, births had dropped to about 500,000 in 2010-11. We assume births remain at this lower level throughout the period and that the school-age population declines as these smaller cohorts of students replace their larger cohort predecessors. We also assume relatively stable rates of migration from other states and countries.

LCFF Could Reach Full Implementation Soon, Grow for COLA Thereafter. Under our growth scenario, we estimate the state could fully fund the LCFF as soon as 2018-19. In this and subsequent years, growth in Proposition 98 funding would be more than sufficient to cover the LCFF targets as adjusted for changes in attendance and cost of living. Under the growth scenario, after supporting LCFF, the Legislature would have an additional $1.5 billion to $2.5 billion per year to spend on other Proposition 98 priorities. Under the recession scenario, we estimate the state would not fully fund LCFF until 2020-21.

Pension Costs Rising Over the Period. Employer contributions to the California State Teachers' Retirement System (CalSTRS) and California Public Employees' Retirement System (CalPERS) are a key factor affecting the budgets of schools and community colleges. (CalSTRS administers the pension system for teachers and other certificated employees, whereas CalPERS administers the pension system for classified employees.) The 2014-15 budget included a plan to fully fund the CalSTRS pension system within about 30 years. Under the plan, district contribution rates increase from 8.25 percent of payroll in 2013-14 to 19.1 percent of payroll by 2020-21. In addition, the governing board of CalPERS has taken action in recent years to increase rates and pay down these liabilities more quickly. The latest actuarial estimates suggest that employer contribution rates for CalPERS will increase from 11.4 percent in 2013-14 to 21.1 percent by 2020-21. Compared with 2013-14 levels, total district contributions to CalSTRS and CalPERS are anticipated to be nearly $6 billion higher annually by 2020-21. (Of this total cost increase, about 70 percent relates to CalSTRS.) Under the growth scenario, these higher costs represents about one-quarter of the $24 billion cumulative increase in Proposition 98 funding districts would receive by 2020-21. Under the recession scenario, these costs represent about one-third of the $19 billion cumulative increase in Proposition 98 funding.

Universities

Overview of Public Universities. The state has two public university systems. The

University of California (UC) educates slightly more than 250,000 full-time equivalent (FTE) undergraduate and graduate students at ten campuses. The California State University (CSU) educates almost 400,000 FTE undergraduate and graduate students at 23 campuses. These counts include resident and nonresident students. Resident enrollment comprises 83 percent of total systemwide enrollment at UC and 94 percent at CSU. Both university systems receive support for their undergraduate and graduate programs from a combination of state General Fund and student tuition revenue. In 2015-16, UC received $3.2 billion in state General Fund and $3 billion in student tuition revenue. CSU received $3 billion in state General Fund and $2.3 billion in student tuition revenue.

Challenges in Basing UC and CSU Forecasts on Current Law, Base Instead on Current Practice. Whereas the State Constitution, state law, and federal law notably constrain some areas of the state budget (for example, K-14 education and health care), they do not notably constrain budgeting for UC and CSU. In any given year, the Legislature and the two university systems have significant discretion in deciding both what cost increases to fund and how to fund those increases. As current law does not contain explicit guidance relating to UC and CSU cost increases, we assume UC and CSU costs will increase similar to recent years. We describe the baseline and specific assumptions we use for the UC and CSU forecasts below.

The Baseline for the University Forecasts. We use UC's and CSU's main state General Fund appropriations as the starting point for our forecasts. These main appropriations include ongoing and one-time funding the state provided in 2016-17. For UC, however, we back out one-time Proposition 2 payments for outstanding pension liabilities. For CSU, we exclude cost increases for retiree health and most pension contributions, as we forecast these as part of overall state employee costs. (We include Hastings College of the Law in our consolidated forecast of relatively small state programs, as the state provides less than $15 million General Fund annually for the college.)

Assume Annual General-Purpose Base Increases Over Forecast Period. We assume the state will provide UC and CSU with annual base increases from 2017-18 through 2020-21. Consistent with state actions in 2013-14, 2014-15, and 2016-17, we assume UC and CSU receive the same dollar increases. Specifically, we calculate base augmentations for both university systems by increasing UC's General Fund appropriation by 4 percent annually. UC and CSU likely would use these base augmentations to cover increases in operational costs and state facility debt service costs, as well as support some enrollment growth.

Assume Two Other Increases for CSU in 2017-18. In addition to annual general purpose base increases, we assume CSU receives an ongoing augmentation of $26 million beginning in 2017-18 associated with savings generated from policy changes made to the Middle Class Scholarship program in 2015-16. We also assume an additional $5.1 million ongoing augmentation to cover projected increases in CSU's lease revenue debt service. Both assumptions are based on previously agreed schedules of payments implemented by the Legislature in prior years.

Based on These Assumptions, UC and CSU Spending Grows a Combined $118 Million in 2017-18. Under these assumptions, General Fund support in 2017-18 grows by $43 million (1.3 percent) for UC and $75 million (2.3 percent) for CSU. The increases in 2017-18 are less than 4 percent because of the significant amount of one-time funds the state provided to UC and CSU in 2016-17. For the remainder of the forecast period, state spending on UC and CSU increases each year by 4 percent and 4.1 percent, respectively. By

2020-21, state spending on UC and CSU reaches $3.8 billion for each system, reflecting increases of about 15 percent over their 2016-17 levels.

Spending Would Increase if State Funded Enrollment Growth on Top of Base Increases. The university forecasts assume UC and CSU fund enrollment growth from their base increases. If the Legislature funded enrollment growth *on top* of the base increases in 2017-18 (as it has the past two years), it would cost the state $29 million at CSU and between $11 million and $16 million at UC for each 1 percent growth. (The range for UC reflects the notably different per-student funding rates provided by the Legislature in recent budgets—$5,000 per student in 2015-16 and $7,400 per student in 2016-17.)

Spending Also Could Be Affected by Tuition Decisions. The UC and CSU forecasts noted above make no explicit assumption about tuition levels. Historically, however, state General Fund and tuition decisions have been closely intertwined. In some prior years, the state has provided additional General Fund on the condition UC and CSU do not raise tuition levels. In other years, when state General Fund has been reduced, UC and CSU have raised tuition levels. Since 2011-12, the main systemwide tuition charges at UC and CSU have been flat. In May 2015, the UC Regents endorsed a long-term plan that would increase tuition levels at about the rate of inflation beginning in 2017-18. CSU also has initiated discussions with stakeholders to adopt tuition increases (of 4.9 percent for undergraduates and 6.5 percent for graduates) in 2017-18. We estimate every 1 percent increase in the main systemwide tuition charge would raise $19 million and $16 million for UC and CSU, respectively, in 2017-18. If tuition levels were raised, the Legislature, as in the past, could decide whether the additional revenue should supplement or replace General Fund support.

Financial Aid

Overview of State's Financial Aid Programs. The California Student Aid Commission (CSAC) is responsible for administering most state financial aid programs. The largest of these programs is the Cal Grant program, which serves about 330,000 undergraduate students. This program primarily covers tuition for financially needy students who meet academic and other eligibility requirements. The program currently costs $2 billion and is funded almost entirely with a combination of state General Fund and federal Temporary Assistance for Needy Families (TANF) monies. The second largest CSAC program is the Middle Class Scholarship program. This program provides partial tuition coverage for UC and CSU students who do not meet the financial need criteria for a Cal Grant but whose family income and assets fall below certain thresholds. Currently costing less than $100 million, this program is funded entirely with state General Fund.

Key Assumption About Cal Grant Participation. For Cal Grants, we assume participation growth of 2 percent each year. This assumption is based on two factors. First, we assume Cal Grant participation grows in line with projections of high school graduates. We believe this is a reasonable assumption given the Cal Grant high school entitlement program accounts for three-quarters of Cal Grant recipients. Average annual growth in high school graduates over the forecast period is projected to be slightly less than half of 1 percent. Second, we assume Cal Grant participation increases another 1.5 percent each year due to ongoing efforts to increase the share of eligible students receiving awards. In recent years, such efforts appear to have increased Cal Grant participation beyond what would be expected based on demographic trends alone. Moreover, the federal government recently made additional changes to simplify the aid application process for students applying for the 2017-18 academic year.

Other Key Assumptions Underlying Forecast. For Cal Grants, we also assume the award amount for new students attending nonprofit colleges is reduced from $9,084 to $8,056 starting in 2017-18 (consistent with state law). Additionally, we assume the state continues to use the same amount of federal TANF funds to offset a portion of General Fund Cal Grant costs. For Middle Class Scholarships, we assume the final phase in of award amounts scheduled under current law, with maximum tuition coverage increasing from 30 percent in 2016-17 to 40 percent in 2017-18. We assume year-to-year changes in participation consistent with changes in high school graduates. Consistent with changes in tuition and fee levels over the past two years, we assume flat tuition at UC and CSU throughout the period as well as 5 percent annual increases in UC's Student Services Fee. Additionally, we assume the continued phase out of loan assumption programs and the removal of one-time state operations funding for CSAC.

Based on These Assumptions, General Fund Costs Increase $44 Million in 2017-18. Under these assumptions, financial aid costs grow from $2 billion in 2016-17 to $2.1 billion in 2017-18—growth of $44 million (2 percent). Of this amount, $28.3 million reflects higher net Cal Grant costs and $20.5 million is associated with higher Middle Class Scholarship costs. These two cost increases are offset by $5.2 million in reductions associated with the phase out of loan assumption programs and backing out prior-year one-time funds.

Costs Over Forecast Period Very Sensitive to Assumptions About Cal Grant Participation and Tuition Levels. Growth in Cal Grant participation could be higher than the level assumed in our forecast. For instance, had we assumed recent growth rates in participation continue throughout the forecast period, annual Cal Grant spending would be around $230 million higher by 2020-21. As a rule of thumb, assuming no other program changes, we estimate every 1 percent increase in Cal Grant participation increases annual costs by roughly $20 million. Financial aid costs throughout the period also could be higher if UC and CSU were to increase tuition. Assuming no other program changes, we estimate each 1 percent increase in tuition would increase financial aid spending by roughly $15 million annually.

Child Care

Overview of State-Subsidized Child Care. The state subsidizes child care for some low-income, working families. Specifically, the state guarantees subsidized care for families participating in the California Work Opportunity and Responsibility to Kids (CalWORKs) program. Slots for other families are capped, with the lowest-income families receiving priority. The 2016-17 budget provides $982 million in non-Proposition 98 General Fund for subsidized child care. Below, we discuss the forecast for non-Proposition 98 General Fund child care spending, excluding Stage 1 CalWORKs child care ($40 million non-Proposition 98 General Fund). We include Stage 1 in our forecast for the Department of Social Services. (Child care programs are supported with state and federal funding. In 2016-17, CalWORKs and non-CalWORKs child care programs received a total of $1 billion in federal funds, roughly two-thirds of which came from the Child Care and Development Block Grant and one-third from TANF.)

Assumptions Underlying Child Care Forecast. As part of the 2016-17 budget package, the Legislature and the Governor agreed on a multiyear plan to increase spending on child care and preschool. The plan would result in a roughly $300 million non-Proposition 98 increase in child care and preschool spending by 2019-20.

Some parts of the agreement, such as certain rate increases, were detailed in statute or provisional budget language. Other parts, such as set-asides for future rate increases, were reflected in back-up budget documents. For the child care forecast, we assume the state adheres to all associated statutory provisions as well as provides all the future set-asides included in the multiyear plan. In addition, the forecast assumes the state will adjust non-CalWORKs child care and preschool spending annually for COLA and the change in the birth-to-four population in California (consistent with state law).

Child Care Costs Projected to Increase Notably in 2017-18. We project General Fund child care spending to increase from $941 million in 2016-17 to $1.1 billion in 2017-18, an increase of $165 million (17.5 percent). The bulk of this increase ($158 million) is due to annualizing rate increases initiated in January 1, 2017 and implementing additional rate increases in 2017-18 consistent with the multiyear budget deal. The rest of the increase is due to applying a 1.12 percent COLA to non-CalWORKs programs and accounting for slightly higher projected Stage 2 caseload. These cost increases are partly offset by a projected 0.3 percent reduction in non-CalWORKs caseload (reflecting a decline in the birth-to-four population) coupled with a slight decline in projected Stage 3 caseload.

Out-Year Child Care Costs. We project child care spending will grow to nearly $1.2 billion in 2018-19, an increase of $56 million (5 percent). This is due largely to the set-aside for future rate increases specified in the multiyear budget deal. Costs grow slightly in the following two years.

California in Midst of Responding to New Federal Requirements. The federal government reauthorized the Child Care and Development Block Grant in 2014—creating a new set of requirements for states. Most notably, the federal government changed: how states are to set provider reimbursement rates, how frequently states are to inspect providers, how long a family can be eligible for child care, and how much states must spend on activities designed to improve the quality of child care. Decisions the Legislature makes in implementing the new federal requirements could significantly increase state costs. Any associated cost increases would be on top of the cost increases included in our forecast.

HEALTH AND HUMAN SERVICES

Overview of Health Services Provided. California's major health programs provide health coverage and additional services for various groups of eligible persons—primarily poor families and children as well as seniors and persons with disabilities. The federal Medicaid program, known as Medi-Cal in California, is the largest state health program both in terms of funding and number of persons served. The Medi-Cal population has grown substantially since January 2014, reflecting an expansion of those eligible for Medi-Cal and a streamlining of eligibility requirements under the Patient Protection and Affordable Care Act (ACA), also known as federal health care reform. In addition, the state supports various public health programs. Although state departments oversee the management of these programs, the actual delivery of many services is carried out by counties and other local entities. Health programs are largely federally and state funded.

Overview of Human Services Provided. The state provides a variety of human services and benefits to its citizens. These include income maintenance for the aged, blind, and disabled;

cash assistance and welfare-to-work services for low-income families with children; protection of children from abuse and neglect; the provision of home-care workers who assist the aged and disabled in remaining in their own homes; and community services and state-operated facilities for the mentally ill and developmentally disabled. Although state departments oversee the management of these programs, the actual delivery of many services is carried out by county welfare and child support offices, and other local entities. Most human services programs have a mixture of federal, state, and county funding.

Overall Spending Trends. The 2016-17 budget provides $33 billion in General Fund spending for health and human services (HHS) programs. We now estimate that these General Fund costs will be slightly higher—by $247 million—in part reflecting higher Medi-Cal costs to serve enrollees who are dually eligible for Medi-Cal and Medicare. Based on current-law requirements, we project that General Fund spending for HHS programs will increase to $34.7 billion in 2017-18 and $38.2 billion in 2018-19. A majority of the growth in 2017-18 reflects higher General Fund Medi-Cal spending, due mainly to underlying program growth in caseload and costs per enrollee and an increasing state share of costs for the optional Medi-Cal expansion population under federal health care reform. Other significant factors explaining this growth include increased caseload and costs per consumer in both In-Home Supportive Services (IHSS) and the provision of community-based developmental services, as well as a reduction of available federal TANF block grant funding in CalWORKs (which increases General Fund spending) assumed in our outlook in 2017-18 and subsequent years relative to 2016-17.

We project that spending for HHS programs will reach $45.4 billion in 2020-21 in our economic growth scenario. The bulk of the spending growth in the later years of the outlook reflect growth in Medi-Cal spending, due primarily to underlying program growth in caseload and costs per enrollee, assumed additional spending from Proposition 55, the increasing state share of costs for the optional Medi-Cal expansion population, and the assumed sunset of the managed care organization (MCO) tax at the end of 2018-19. Other significant factors explaining this spending growth include increased caseload, utilization of services per consumer, and costs due to statutorily scheduled minimum wage increases in both IHSS and the provision of community-based developmental services.

Although the average projected annual increase in HHS spending from 2016-17 through 2020-21 is 8.1 percent, there is substantial variation in spending growth rates by program. For example, over these years, General Fund spending growth for Medi-Cal averages 10.9 percent per year, while the Supplemental Security Income/State Supplementary Program (SSI/SSP) is projected to grow more modestly, with average annual growth of 3 percent. General Fund spending for the CalWORKs program is projected to decline after 2017-18, in part reflecting both projected caseload declines as well as the infusion of non-General Fund funding sources to support the program.

Below, we discuss spending trends in the major HHS programs.

Medi-Cal

Overall Spending Trends. We estimate that 2016-17 General Fund spending for Medi-Cal local assistance will be $17.9 billion—0.7 percent (or $130 million) higher than what was assumed in the *2016-17 Budget Act*. This mainly reflects higher General Fund spending on Medicare Part A and B premiums for beneficiaries dually enrolled in Medi-Cal and Medicare as a result of updated projections of 2017 premiums from the federal government. General Fund support increases 4.5 percent to $18.7 billion in 2017-18 and increases an additional 15.9 percent to $21.7 billion in 2018-19. General Fund costs are projected to increase in 2017-18 largely as a result of underlying program growth in caseload and per-enrollee costs as well as increased costs associated with the newly eligible population under the ACA (the so-called "optional expansion population") as the state cost share for this population increases. (Under the ACA, the state's cost share for the optional expansion population is 5 percent beginning in 2017, increasing to 10 percent by 2020 and beyond.) In addition to underlying program growth and the optional expansion, costs are projected to increase in 2018-19 as a result of the passage of Proposition 55. We assume Proposition 55 will result in $2 billion in additional funding from the General Fund for Medi-Cal in 2018-19. (We note that the actual amount of revenue Medi-Cal receives in 2018-19 as a result of Proposition 55 will vary between zero dollars and $2 billion depending on decisions by the administration.) Absent the additional funding resulting from Proposition 55, Medi-Cal's budget in 2018-19 would otherwise have grown by 5.2 percent relative to 2017-18. General Fund cost growth in 2019-20 and 2020-21 is projected to be 14.3 percent and 9.2 percent, respectively (assuming Proposition 55 continues to result in $2 billion in additional funding annually from the General Fund for Medi-Cal). This largely reflects the sunset of the current MCO tax, the state's increased share of cost for the optional expansion population, and an end to increased federal funding for the Children's Health Insurance Program (CHIP).

Caseload Continues to Grow. In June 2016—the most recent month for which enrollment counts may be considered nearly complete—total Medi-Cal caseload was around 13.6 million. This includes nearly 3.4 million individuals who became newly eligible for Medi-Cal under the optional ACA expansion. Total enrollment in June 2016 represents a net increase of roughly 800,000 (or 6 percent) from total enrollment in June 2015.

Caseload Growth Projected to Continue. We assume enrollment among families, children, and the optional expansion population will grow annually at a rate of about 1 percent throughout the outlook period. This translates into growth of about 100,000 enrollees per year across these populations. We also assume enrollment among seniors and persons with disabilities will grow at their historical annual rates of about 3 percent and 2 percent, respectively, throughout the outlook period. This translates into growth of roughly 50,000 enrollees per year among seniors and person with disabilities.

Projected Growth in Managed Care and Fee-for-Service (FFS) Expenditures. The underlying sources of growth in Medi-Cal are changes in caseload and per-enrollee costs. The latter is dependent on growth in health care prices paid by the program in managed care and FFS. We estimate that under our economic growth scenario *overall* expenditures in managed care will grow by about 5 percent annually through 2020-21. Our outlook also assumes overall FFS expenditures will grow by about 4 percent annually throughout the outlook period. These projections are subject to considerable uncertainty, particularly if future movements in managed care capitated rates or FFS costs differ substantially from recent historical trends.

State Share of Cost for ACA Optional Expansion Begins in 2017. From 2014 through 2016, the federal government pays 100 percent of the costs for the optional expansion population. Under current law, the federal share will decline from 2017 to 2020, with the state eventually paying 10 percent of the cost of health care services for the optional expansion population. Our outlook assumes General Fund costs associated with this population of roughly $900 million in 2017-18 growing to over $1.6 billion in 2020-21.

CHIP Federal Funding. CHIP is a joint federal-state program that provides health coverage to children in low-income families but with incomes too high to qualify for Medicaid. In California, both CHIP and Medicaid coverage are provided through Medi-Cal. The ACA authorizes an increase in the federal share of cost for CHIP from 65 percent to 88 percent. The higher federal share of cost will be available from October 1, 2015 through September 30, 2019. On a full-year basis, this results in General Fund savings of over $600 million. However, federal funding for CHIP has only been appropriated through September 30, 2017. Our outlook assumes Congress will appropriate additional funding for CHIP beyond September 30, 2017 and that the enhanced federal cost share authorized by ACA will continue through September 30, 2019. After September 30, 2019, our outlook assumes the enhanced federal cost share will no longer be available, consistent with what is authorized under the ACA, and the federal share of cost will revert to the historical level of 65 percent.

MCO Tax Assumed to End After July 1, 2019. Chapter 2 of the 2015-16 Second Extraordinary Session (SB2X 2, Hernandez) imposes a revised MCO tax on most managed care plans for three years ending July 1, 2019. We assume the MCO tax is not extended by the Legislature beyond this time and therefore ends after July 1, 2019. In 2017-18 and 2018-19, we assume the MCO tax results in annual General Fund savings of about $1.7 billion in Medi-Cal. (The net General Fund savings from the MCO tax are about $1.3 billion in each year after accounting for the General Fund impact of other tax provisions associated with the MCO tax.) We assume the General Fund savings in Medi-Cal phase down to about $450 million in 2019-20 as a result of Medi-Cal being budgeted on a cash basis, before being phased out entirely in 2020-21.

Coordinated Care Initiative (CCI) Assumed to Continue. The CCI is a seven-county demonstration project consisting of three main components: (1) the optional enrollment of "dual eligibles" into managed care plans that integrate their Medi-Cal and Medicare benefits (known as "Cal MediConnect"); (2) mandatory enrollment of dual eligibles into managed care for their Medi-Cal benefits; and (3) making Medi-Cal-funded long-term services and supports, including IHSS, available exclusively through managed care. Current law requires CCI to demonstrate net General Fund savings—as estimated by the Department of Finance—to remain operative each fiscal year. We assume CCI remains operative throughout the outlook period.

Outlook Accounts for Passage of Proposition 52. Our outlook accounts for the passage of Proposition 52, which extends the hospital quality assurance fee permanently. While recent federal regulations governing Medicaid managed care have the potential to require changes to the fee to obtain federal approval, we assume the fee will be approved by the federal government and that the General Fund savings generated by the fee will not be impacted by any necessary changes. We assume the fee will result in General Fund savings of $850 million in 2017-18, growing to over $1 billion by 2020-21.

In-Home Supportive Services

General Fund expenditures for IHSS are estimated to be $3.5 billion in 2016-17, increasing to about $3.7 billion in 2017-18. This increase is primarily due to projected caseload and hours-per-consumer growth, which we assume will continue throughout the outlook period. We project that IHSS expenditures will reach nearly $5 billion by 2020-21. To a large degree, this growth reflects the implementation of statutorily scheduled statewide minimum wage increases that will significantly increase the average cost per consumer, particularly beginning in 2018-19. In addition, implementing a new paid sick leave policy for IHSS providers beginning in 2018-19 will likely increase IHSS costs, but the full fiscal impact of this policy is uncertain. These cost pressures are projected to be partially offset by: (1) increases to the county maintenance-of-effort (MOE) that reduce the state share of IHSS costs, and (2) the end of General Fund support for the restoration of IHSS service hours previously reduced by 7 percent (this General Fund support is set to expire with the sunset of the current MCO tax at the end of 2018-19). These factors are discussed in more detail below.

Rising Statewide Minimum Wage Will Increase Hourly Cost of Care. The newly enacted statewide minimum wage increases—set to gradually raise the state's minimum wage to $15 per hour by 2022—will generally increase wages for IHSS providers. Since the current average wage for IHSS providers is about $11 per hour (above the current statewide minimum wage), we project that the major costs of the scheduled minimum wage increases will begin when wages increase to $12 per hour and above, beginning in 2019. When the statewide minimum wage increases are fully implemented in 2022, we estimate the costs of the minimum wage increases to total about $1.5 billion General Fund per year, growing with growth in caseload and hours per consumer.

Costs, Implementation of Paid Sick Leave for IHSS Providers Uncertain. Beginning on July 1, 2018, IHSS providers will be eligible—pursuant to 2016 legislation—to earn up to 8 hours annually of paid sick leave, ramping up to 24 hours annually when the minimum wage is increased to $15 per hour (scheduled for January 1, 2022). The implementation details of paid sick leave are uncertain and could require significant administrative effort. We anticipate there could be some administrative costs related to paid sick leave in 2017-18 in order to prepare for the launch of paid sick leave in 2018-19.

County Costs of IHSS Continue to Depend on CCI. As we discussed in the Medi-Cal section of this report, we assume CCI continues to be implemented throughout the outlook period. Therefore, we also assume that the county MOE for IHSS will continue, increasing by 3.5 percent per year plus a share of any wages and benefits negotiated at the county level. Should the CCI be discontinued and the MOE unwound, counties' contributions to IHSS would return to the share of cost levels in place prior to CCI—about 35 percent of the nonfederal share of IHSS program costs. This increase in county contributions to IHSS costs could decrease our projected state share of cost for the IHSS program by hundreds of millions of dollars annually in the out-years.

Restoration of the IHSS Service Hours Previously Reduced by 7 Percent Tied to MCO Tax Existence. Beginning in 2016-17, the General Fund will support the restoration of the IHSS service hours previously reduced by 7 percent so long as the MCO tax is in place. Since the MCO tax is set to expire at the end of 2018-19 under current law and continuation of the tax beyond the sunset date is uncertain, our outlook projections assume that this General Fund support for the restoration of service hours will not be included beginning in 2019-20. We estimate that discontinuing General Fund support would result in General Fund savings of about $300 million annually, growing with growth in caseload and hours per consumer. For further discussion of the MCO tax, please reference the "Medi-Cal" section of this report.

Developmental Services

We estimate that General Fund spending for the Department of Developmental Services (DDS) will total $4.0 billion in 2016-17. We project that General Fund expenditures will increase by $118 million in 2017-18 and reach a total of $4.4 billion by 2018-19. By 2020-21, we project General Fund expenditures to reach $5.6 billion. These projected expenditure increases are mostly due to cost increases for community services resulting from (1) a growing caseload (we project 4 percent annual growth) and (2) increased costs per consumer. The increased costs per consumer in the community are higher due in part to changes in service utilization as well as impacts of statutorily scheduled minimum wage increases throughout the outlook period. (We note that, due to incomplete data, our estimated minimum wage impacts are highly uncertain.) Overall, estimated expenditure increases are partially offset by reductions in the cost for developmental centers (DCs) as a result of individuals transitioning out of the DCs due to anticipated closures. We assume DC closures will occur consistent with DDS' projected timelines, with Sonoma DC scheduled to close by the end of 2018 and Fairview DC and the general treatment area at Porterville DC scheduled to close by the end of 2021.

Potential Fiscal Pressures. There are a few potentially significant fiscal pressures that could drive further spending not assumed in our outlook. First, we assume that DDS will maintain federal Medicaid funding for individuals in Intermediate Care Facility living units at Porterville and Fairview DCs found by the Department of Public Health to be out of compliance with federal certification requirements. Effective July 1, 2016, the state successfully negotiated settlement agreements with the federal government related to these decertified units to continue federal funding through December 2016 with the possibility of one-year extensions through 2019, if certain requirements are met. While we assume that the state will be able to successfully extend the termination dates of the agreements—and therefore federal funding—annually through 2019, we note that there is a possibility of a loss of federal funds during this time if the terms of the agreements are not met. In such circumstances, the General Fund would likely be called upon to backfill the lost federal funding. Second, we find that compliance by March 2019 with new federal requirements related to Medicaid-funded community-based services could drive additional state spending not included in our outlook. We have not accounted for these potential costs due to the high level of uncertainty regarding the timing and order of magnitude of these costs.

SSI/SSP

State expenditures for SSI/SSP are estimated to be $2.9 billion in 2016-17 and are projected to remain at about the same level in 2017-18. We estimate that caseload growth will increase state costs by about $20 million annually through the outlook period. We have also assumed that the state provides each year over the forecast period a COLA on the state-funded SSP portion of the SSI/SSP grant. Such a COLA was enacted as part of the 2016-17 budget package. We estimate an ongoing COLA would increase SSI/SSP General Fund costs by $60 million to $90 million annually, resulting in total spending on SSI/SSP reaching approximately $3.2 billion by 2020-21.

Housing and Disability Income Advocacy Program Could Increase Caseload, State Costs. The 2016-17 budget provided $43.5 million of one-time General Fund support—to be spent over three years—for the Housing and Disability Income Advocacy Program. Under this program, counties may receive additional funding to help individuals apply for disability-related income support, which includes SSI/SSP. If this program leads to more approved SSI/SSP applications, then caseload—and therefore state costs—could increase.

CalWORKs

We estimate that General Fund spending in the CalWORKs program will be $709 million in 2016-17, roughly consistent with the *2016-17 Budget Act*. This 2016-17 estimate, however, masks two adjustments that offset one another: first, increased General Fund costs of $90 million to backfill a reduction in certain realignment funds previously estimated to be available to support the program and, second, a roughly equal amount of General Fund savings due to lower-than-expected caseload. From this 2016-17 funding amount, we project that General Fund spending in CalWORKs will increase by roughly $340 million (48 percent) to a little over $1 billion in 2017-18 (and then decrease in following years) reflecting the net effect of (1) savings due to declining caseload, (2) net costs related to the implementation of prior policy changes, and (3) changes in the availability of other funding sources. We discuss each of these factors in greater detail below.

Savings From Declining Caseload. In recent years, improvements in the state's economic situation have been accompanied by moderate reductions in the CalWORKs caseload. Under our economic growth scenario, which features the continuation of relatively positive economic conditions, we project that the CalWORKs caseload will continue to gradually decline, but at a slower rate than in recent years. We estimate that declining caseload will result in General Fund savings in 2017-18 of about $150 million relative to 2016-17, with progressively smaller amounts of additional savings in later years.

Net Costs From Implementation of Prior Policy Changes. CalWORKs program spending in the near term will be influenced by several recent policy changes that are not yet fully implemented. Taken together, we estimate that these changes will increase General Fund spending in 2017-18 by a net amount of about $120 million relative to 2016-17. These changes include:

- ***Costs From Repeal of Maximum Family Grant (MFG) Policy.*** The MFG policy specifies, with limited exceptions, that a family may not receive an increase to its CalWORKs grant to reflect the birth of a child if the family continuously received assistance in the ten months prior to the child's birth. The 2016-17 budget package repeals the MFG policy effective January 2017, increasing the grants received by some families. The 2016-17 budget includes $109 million from all funds to pay for increased cash assistance from repealing the MFG policy during the latter half of 2016-17. We estimate that total General Fund spending in CalWORKs will rise by roughly $110 million in 2017-18 to reflect a full year of the policy's repeal.

- ***Costs From 1.43 Percent Grant Increase.*** Pursuant to a statutory mechanism, maximum CalWORKs grant amounts were increased by 1.43 percent in October 2016. The 2016-17 budget includes $36 million from all funds to pay for this grant increase in 2016-17. We estimate that total General Fund spending in CalWORKs will rise by roughly $10 million in 2017-18 to reflect a full year of implementation.

- ***Costs From Child Care Rate Increases.*** The 2016-17 budget package increased reimbursement rates for Stage 1 child care providers effective January 2017 and included $20 million from all funds to pay for these higher rates during the latter half of 2016-17. We estimate that total General Fund spending in CalWORKs will rise by roughly $20 million in 2017-18 to reflect a full year of implementation.

- ***Savings From Higher Minimum Wage.*** The state's minimum wage increased to $10 per hour in January 2016 and is statutorily scheduled to increase to $10.50 per hour in January 2017 and $11 per hour in January 2018, with additional increases in later years. Increases to the minimum wage are expected to result in increased earnings for some families enrolled in CalWORKs. Families enrolled in CalWORKs with higher earnings receive lower cash grants and some families will have earnings that exceed eligibility thresholds and cause them to leave the program, resulting in savings. The 2016-17 budget assumes savings of $26 million (all funds) from an increased minimum wage during 2016-17. We estimate additional General Fund savings from a higher minimum wage of roughly $20 million in 2017-18.

Changes in Availability of Other Funding Sources. In addition to General Fund support, the CalWORKs program is supported by federal TANF block grant funds, realignment funds, and county funds. Changes in the amount of funding available from these sources affect how much General Fund support is required in CalWORKs. We estimate that General Fund support for CalWORKs in 2017-18 will increase relative to 2016-17 by roughly $370 million to reflect two main changes in funding available from these other sources.

First, the 2016-17 budget includes about $400 million in one-time TANF funds that are carried over from not being spent in prior years. We assume that General Fund spending in CalWORKs will increase in 2017-18 to backfill these one-time funds available in 2016-17. We note that the state allocates TANF block grant funds to other programs in the state budget and has flexibility to backfill the one-time TANF funds in some of these other programs. Specifically, the state could replace a portion of the TANF block grant funds allocated to CSAC with General Fund instead of replacing one-time TANF funds with General Fund in CalWORKs. For simplicity, our outlook assumes the backfill for one-time TANF funds will occur in CalWORKs and that the amount of TANF funds allocated to CSAC remains constant at the level assumed in the *2016-17 Budget Act* in later years in the outlook. Whether the backfill for one-time TANF funds takes place in CalWORKs or in CSAC, the effect on the state's General Fund bottom line is the same.

Second, state law dedicates the growth in certain realignment funds to pay for grant increases, including certain increases that are currently supported in part by the General Fund, such as the repeal of the MFG policy and the 1.43 percent grant increase described above. As realignment funds dedicated to fund grant increases grow each year, General Fund support for repealing the MFG policy and 1.43 percent grant increase is offset. We estimate that growth in dedicated realignment funds will reduce General Fund spending by about $30 million in 2017-18 relative to our 2016-17 estimates. We further estimate, based on our economic growth scenario, that growth in dedicated realignment funds will not be sufficient to *fully* offset the General Fund costs of repealing the MFG policy and providing the 1.43 percent grant increase before the end of 2020-21.

Trends in Total Spending From All Funds. Figure 18 (see next page) displays projected total CalWORKs spending from all funding sources, consistent with our economic growth outlook scenario and our assumptions about available TANF block grant and realignment funding described above. As shown in the figure, we estimate that total spending will be roughly $5.3 billion in 2016-17—about $90 million less

Figure 18

Projected Total CalWORKs Program Funding[a]

(In Millions)

	2016-17	2017-18	2018-19	2019-20	2020-21
Federal TANF block grant funds	$2,584	$2,194	$2,194	$2,194	$2,194
Realignment funds dedicated to grant increases[b]	281	308	366	424	462
Other realignment/county funds[c]	1,774	1,772	1,771	1,770	1,770
General Fund	709	1,050	896	748	636
Totals	**$5,348**	**$5,324**	**$5,227**	**$5,136**	**$5,062**

[a] Excludes Kin-GAP and TANF funds transferred to the California Student Aid Commission.

[b] Dedicated funds provided from the 1991 realignment Child Poverty and Family Supplemental Support Subaccount.

[c] Includes funding from the 1991 realignment Family Support Subaccount, the 1991 realignment CalWORKs MOE Subaccount, and a 2.5 percent county share of cash assistance costs.

TANF = Temporary Assistance for Needy Families; Kin-GAP = Kinship Guardianship Assistance Program; and MOE = maintenance-of-effort.

than assumed in the *2016-17 Budget Act* because of lower-than-expected actual caseload as described previously. Total spending from all funds is projected to decrease slightly by about $20 million in 2017-18, with further decreases (in both total spending and General Fund support) in later years, largely reflecting declining caseloads and increases to the state's minimum wage.

Child Welfare Services

State Costs for the Continuum of Care Reform (CCR) Expected to Increase in 2017-18, Before Declining in Subsequent Years. Legislation passed in 2015 and 2016, collectively known as CCR, makes significant changes to the way the state cares for children in foster care. The CCR aims to reduce the state's reliance on relatively costly group home placements while expanding foster children's access to mental health and other supportive services. The CCR increases overall county costs in the short run by requiring higher service levels and program standards. These higher costs will be offset—at least partially in the short run—by growing county savings that result from a gradual reduction in the number and duration of group home placements.

The 2011 realignment transferred fiscal responsibility for child welfare services from the state to the counties. The State Constitution requires the state to provide funding for any statewide policy changes, such as CCR, that have the effect of increasing overall county costs. Accordingly, the Legislature appropriated nearly $120 million General Fund in 2016-17 for county welfare departments to implement CCR. We project General Fund costs for CCR implementation to increase to about $180 million in 2017-18. In time, counties' CCR-related savings are expected to exceed their CCR-related costs, and General Fund support would no longer be required. The amount and timing of CCR-related county savings are uncertain, however, and will affect how much, if any, General Fund is needed for CCR beyond 2017-18.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for the state judicial branch and the California Department of Corrections and Rehabilitation (CDCR).

Judicial Branch

General Fund spending for the support of the judicial branch in 2016-17 is estimated to be $1.8 billion. Our forecast assumes that judicial branch spending will be, on net, roughly the same level in 2017-18. While certain one-time funding increases for the courts will expire at the end of the current year, we assume that such savings will be offset by spending increases in 2017-18. First, we assume inflation adjustments for the compensation of court employees of roughly $50 million each year over the forecast period. Second, as we discuss in more detail below, we estimate that the implementation of Proposition 63 and Proposition 66 will increase annual court costs. Our forecast assumes that General Fund spending on the courts will reach almost $1.9 billion by the end of the outlook period.

Implementation of Proposition 63 and Proposition 66. In November 2016, voters approved two propositions that will likely increase judicial branch costs over the forecast period. First, Proposition 63 creates a new court process to ensure that individuals convicted of offenses that prohibit them from owning firearms do not continue to have them. Second, Proposition 66 implements various changes to court procedures for legal challenges to death sentences, such as imposing time limits on those challenges and revising rules to increase the number of available attorneys for those challenges. Our forecast assumes that the full implementation of Proposition 63 and Proposition 66 will increase judicial branch costs over the forecast period in the high tens of millions of dollars annually. We note that the actual fiscal effects of the propositions on the judicial branch will depend heavily on how the courts choose to implement certain provisions.

Corrections and Rehabilitation

General Fund spending for support of CDCR operations in 2016-17 is estimated to be $10 billion. Our forecast assumes that CDCR spending will decline in 2017-18 by just over 1 percent to about $9.8 billion. This primarily reflects the effect of (1) the expiration of certain one-time funding increases at the end of the current year and (2) the implementation of Proposition 57 and Proposition 66 (as discussed in more detail below). Our forecast for 2018-19 assumes that General Fund spending for the support of CDCR will decline again slightly but then increase annually thereafter to about $9.9 billion by the end of the forecast period, due to modest annual growth in the inmate population. (Funding for increased CDCR employee compensation costs is included under "Remaining programs" in Figure 12 at the beginning of this chapter, not the CDCR line.)

Implementation of Proposition 57 and Proposition 66. Proposition 57, recently approved by voters, (1) makes certain nonviolent offenders eligible for parole consideration—in some cases earlier than otherwise, (2) expands CDCR's authority to reduce inmates' sentences through credits, and (3) mandates that judges determine whether youths are subject to adult sentences in criminal court. Our forecast assumes that the prison population will decline in the short term resulting from the implementation of Proposition 57. (Absent the passage of Proposition 57, the state's prison population would likely have increased modestly over the forecast period, primarily due to an estimated increase in the number of offenders with relatively long sentences.) We assume that the measure will reduce the prison population and associated costs primarily due to some nonviolent offenders serving shorter prison terms. However, by the end of the forecast period, we project that the prison population will slightly exceed current levels, due to the underlying growth trend.

In addition to changing the court procedures for legal challenges to death sentences, Proposition 66 (as discussed earlier) also allows the state to house condemned inmates in any prison, rather than only at specified prisons. If the state changes the way it houses condemned inmates, the measure could result in state prison savings. We assume that such changes are implemented—resulting in savings reaching the tens of millions of dollars annually over the forecast period.

EMPLOYEE COMPENSATION AND RETIREMENT COSTS

As discussed below, our outlook assumes continuation of recent employee compensation practices, pension funding policies, and current pension system investment return assumptions. State spending may increase significantly above our growth scenario assumption if any of the following occur: (1) investment returns are lower than the state's pension boards assume; (2) the state's pension boards change their investment or other actuarial assumptions; (3) the state agrees to larger pay increases for state employees in order to implement the Governor's retiree health prefunding plan; or (4) other factors arise that increase state employee compensation and retirement costs.

State Employee Pay and Benefits

Significant Costs Expected From Collective Bargaining. Much of the state's employee compensation costs are determined by what is included in labor agreements—referred to as memoranda of understanding (MOUs)—between the state and its 21 rank-and-file state employee bargaining units. The Legislature must ratify MOUs before they go into effect. The administration typically extends similar compensation increases to managers and supervisors.

The Legislature may be asked to ratify new agreements for 15 bargaining units whose MOUs have expired or are scheduled to expire in 2017-18. The employees associated with these 15 bargaining units—including managers and supervisors—represent about three-fifths of the state's General Fund payroll cost and nearly 70 percent of the state workforce. Similar to recently ratified agreements with most of the bargaining units that already have MOUs for 2017-18, our outlook assumes that in these 15 future agreements the state will (1) provide annual pay increases near the rate of inflation, (2) pay one-half of the "normal cost" by 2018-19 to start prefunding retiree health benefits, and (3) maintain the state's current share of employee health premiums. Including pay and benefit increases that have already been agreed to and the assumed compensation increases described above, General Fund costs in 2017-18 would be about $400 million above 2016-17 levels. By 2020-21, the cumulative increase in General Fund state employee costs under this scenario would be more than $1 billion above 2016-17 spending levels. To the extent that future MOUs provide smaller or larger compensation increases, these amounts would vary.

Rising Health Benefit Costs. In 2015-16, the state paid about $4 billion for active and retired state employee health benefits: about $2 billion for active employees (about half from the General Fund) and about $2 billion for retirees (nearly all paid initially from the General Fund, with roughly half of the costs recovered from other funds). By 2020-21, we estimate that these costs will exceed $5 billion. These growing costs result from increased payments for health services and a growing retiree base.

CalPERS Pension Costs Rising . . . In recent years, the state's contribution rates to the California Public Employees' Retirement System (CalPERS) pension plans have increased due to investment losses during the recession and CalPERS' decisions to change certain actuarial assumptions. Our growth scenario assumes that CalPERS maintains its current assumption of a 7.5 percent discount rate. We estimate that the state's contributions to CalPERS will increase each year, with General Fund payments climbing above 2016-17 levels by about $200 million in 2017-18 and very roughly $1 billion by 2020-21.

. . . But Could Rise Above Our Assumptions. CalPERS indicates that it expects average investment returns to be lower over the next decade than the 7.5 percent it currently assumes. To the extent that investment returns are lower than this assumption, the state's annual costs will increase to pay higher unfunded liabilities. Alternatively, the CalPERS board could decide to lower its assumed rate of return—requiring the state to contribute more money each year to both the normal cost and the unfunded liability. Increases in the normal cost also could increase employee costs to prefund their pension benefits—creating pressure to increase their pay beyond what we currently assume.

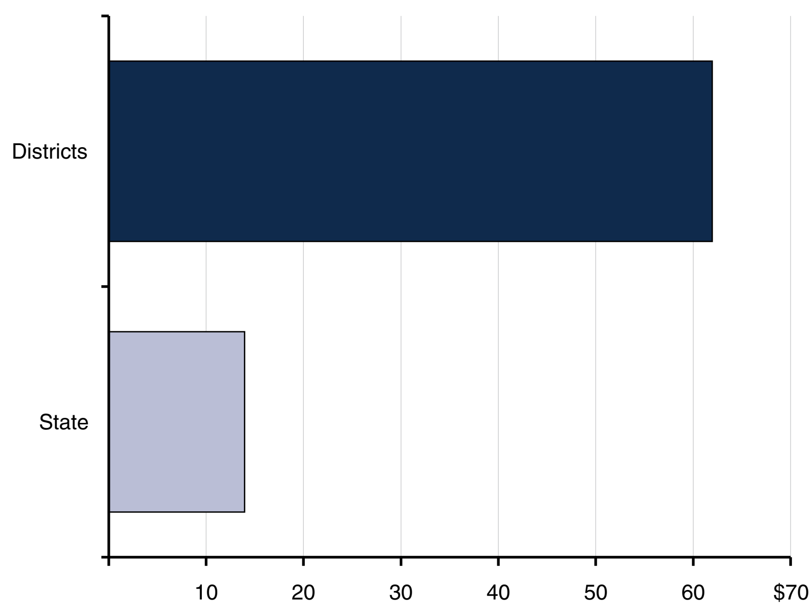
CalSTRS

State Contribution Made Up of Three Components. In 2016-17, the state's contribution to the California State Teachers' Retirement System (CalSTRS) totals 8.6 percent of statewide teacher compensation, as measured on a two-year lag. The contribution is a combination of three components. First, the state contributes a base amount of about 2 percent to CalSTRS' main pension program. Second, Chapter 26 of 2014 (AB 1469, Committee on Budget) provides for a state supplement to pay down a share of CalSTRS' $76 billion unfunded liability. Figure 19 shows how the funding plan assigns responsibility for CalSTRS' unfunded liabilities as of the most recent actuarial valuation. In 2016-17, the state's supplemental rate is 4.3 percent. Finally, the state contributes about

Figure 19

Responsibility for CalSTRS' $76 Billion Unfunded Liability

As of June 30, 2015 (In Billions)



Note: Figure does not show $0.3 billion portion of unfunded liability that is not assigned to either the state or districts under the funding plan.

2.3 percent of compensation to a program that protects retirees' pension benefits from the effects of inflation, known as the Supplemental Benefits Maintenance Account.

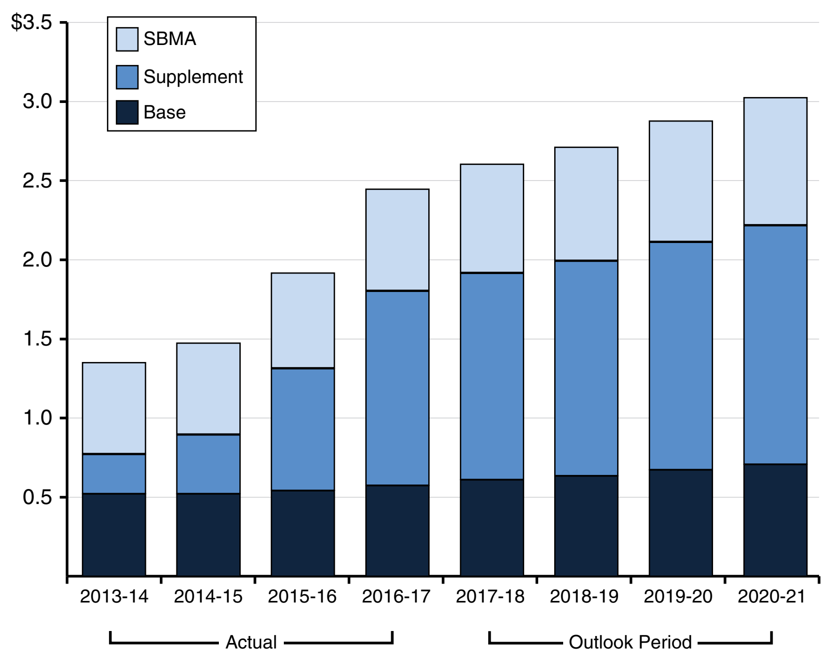
Previous LAO Outlooks Had Projected Near-Term State Savings. In our November 2015 *Fiscal Outlook* report, we described how the state's share of CalSTRS' unfunded liabilities had decreased since the Legislature passed the funding legislation in 2014. Accordingly, state contributions were expected to decline by several hundred million dollars beginning in 2017-18. This projection reflected the CalSTRS policy at that time, which would have set the state's supplemental rate to the rate necessary to pay down the state's share by the mid-2040s.

Recent Board Decision Pays Down State Share Faster. In June 2016, the CalSTRS board voted to maintain the state's supplemental rate at 4.3 percent until the state's share of CalSTRS' unfunded liabilities is eliminated. Based on recent estimates from CalSTRS, we assume that the state's share would not be eliminated until after our outlook period. Accordingly, we assume that the state's contribution rate will be 8.6 percent through 2020-21. As shown in Figure 20, we estimate that state contributions to CalSTRS would total $2.6 billion in 2017-18 and would rise steadily with growth in payroll to $3 billion in 2020-21.

Figure 20

State Contributions to CalSTRS Continue to Rise Under LAO Outlook

(In Billions)



SBMA = Supplemental Benefits Maintenance Account.

UNEMPLOYMENT INSURANCE

Interest Payments on Federal Loans. Reserves in the state's unemployment insurance (UI) trust fund were exhausted in 2009, requiring the state to borrow from the federal government to continue payment of UI benefits. The state is required to make annual interest payments on these federal loans. California's outstanding loan balance is estimated to be roughly $4 billion at the end of 2016, with a 2016-17 General Fund interest payment of $111 million. Based on projected unemployment rates in our economic growth outlook scenario, the remaining federal loans are estimated to be repaid by the end of 2018, with a final estimated General Fund interest payment of roughly $50 million in 2017-18.

DEBT SERVICE ON INFRASTRUCTURE BONDS

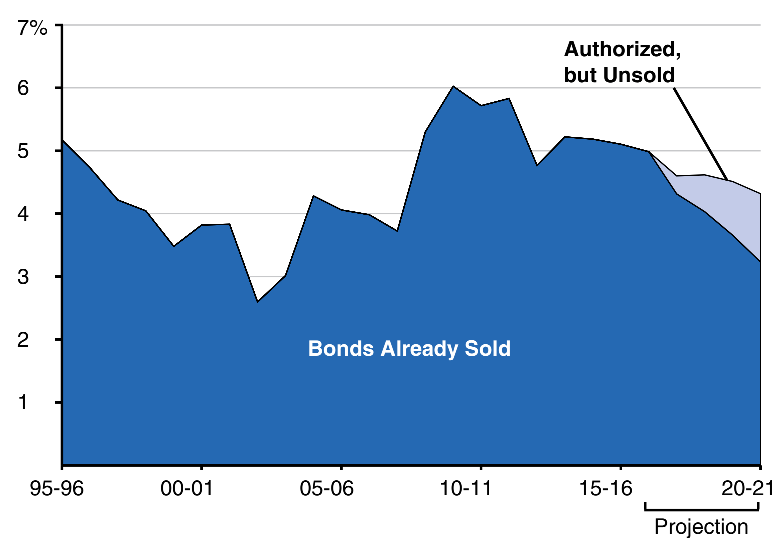
Debt Service Ratio (DSR) Has Fluctuated Historically. The DSR—the ratio of annual General Fund spending on debt service costs to annual General Fund revenues and transfers—is often used as one indicator of the state's debt burden. As shown in Figure 21, the DSR has varied considerably in past decades between about 3 percent and 6 percent. In the late 2000s, the DSR grew to about 6 percent as large bond measures were approved and state revenues dropped due to the recession. More recently, however, the DSR has declined to about 5 percent. The modest decline in the DSR occurred for a variety of reasons, including rebounding General Fund revenues, refinancing of existing debt, and state policies shifting some state debt costs from the General Fund to special funds—such as in transportation.

DSR Expected to Fall Below 5 Percent. We estimate that the DSR will fall below 5 percent over the next several years. This is because we project that under the growth scenario General Fund revenues will increase somewhat faster than debt service costs. We assume that the state gradually sells bonds that have been approved by voters or the Legislature. These bonds include some of the remaining unsold infrastructure bonds that voters approved in 2006, 2008, and 2014 as well as a portion of the school bond approved in November 2016 (Proposition 51). Our projections do not include any additional debt service costs for new bonds that may be authorized by the voters or the Legislature during the forecast period.

Figure 21

Debt Service Ratio Expected to Decline Somewhat

Percent of General Fund Revenues and Transfers Spent on Debt Service



Chapter 4:

The General Fund After 2017-18

In this chapter, we present two estimates of the budget's condition through 2020-21. These estimates are sensitive to two types of uncertainty: economic uncertainty and other budget uncertainty. Different economic outcomes can result in billions of dollars of difference in our bottom line estimates for the state's budget condition. Other uncertainties, particularly changes in state or federal policy or implementation, could similarly change the budget's bottom line condition—in either direction—by hundreds of millions or even billions of dollars.

ECONOMIC UNCERTAINTY

To reflect the economic uncertainty inherent in our budget outlook, we analyze the budget's condition under two scenarios of the economy's performance over the next five years: (1) an economic growth scenario and (2) a mild recession scenario. Under the growth scenario, we assume moderate, but steady, growth in employment, personal income, and the stock market as the economy continues to grow throughout the entire outlook period. Under the recession scenario, we assume the state experiences a mild economic downturn, with a big stock market decline, beginning near the middle of calendar year 2018. For reference, this downturn is roughly comparable to the dot.com bust of the early 2000s. (Following a review of our recession modeling, we have reduced somewhat the recession-period revenue loss, compared to last year's *Fiscal Outlook*.) Both scenarios account for passage of Proposition 55, which extended higher income tax rates on high-income earners, as well as the fiscal effects resulting from measures approved by voters at the November 2016 election.

Revenues

Revenues Over Outlook Differ Dramatically Between Two Scenarios. Figure 22 (see next page) displays our revenue outlook under both the growth and recession scenarios. Under our economic growth scenario, between 2016-17 and 2020-21, we assume there is 4.6 percent growth in the state's "Big Three" tax revenues: the personal income tax (PIT), sales and use tax, and corporate tax. Growth in the PIT drives the majority of this overall increase over the period. In the recession scenario, over the entire outlook period, we assume revenues are roughly $40 billion lower than they are under the growth scenario. Much of this decline is attributable to a decline in PIT revenues in 2018-19, 2019-20, and 2020-21.

Spending

Expenditures Grow 4.5 Percent in Growth Scenario. Figure 23 (see page 51) compares our estimates of expenditures under the growth scenario and the recession scenario. Under our economic growth scenario, we assume 4.5 percent growth in overall General Fund expenditures between 2016-17 and 2020-21. This rate reflects, in particular, significant growth in health and human service (HHS) program spending. Under the growth scenario, we assume spending on major HHS programs reaches $45.2 billion in 2020-21, an 8.1 percent average annual increase from 2016-17. The bulk of this increase is related to expenditures in Medi-Cal, the state's health insurance program for low-income Californians. Between 2016-17 and 2020-21, we assume expenditures in this program grow from nearly $18 billion to over $27 billion in the growth scenario.

Automatic Reductions in Formula-Driven Programs in Recession Scenario. Relative to the growth scenario, expenditures are lower in formula-driven spending in the recession scenario. In particular, this includes the formulas for determining schools and community college funding (Proposition 98) and debt payments (Proposition 2). Together, expenditures related to these two programs are roughly $20 billion lower relative to the growth scenario over the outlook period. These changes are primarily driven by our assumptions about lower revenues, including those related to capital gains, in the recession scenario.

Moderate Increase in Costs for Some Programs in Recession Scenario. In our assumptions about spending under the recession scenario, we estimate expenditures are moderately higher for certain caseload-driven HHS programs. We do not estimate changes in spending under the recession scenario associated with other programs.

Figure 22

Revenue Outlook Under Growth and Recession Scenarios

General Fund (Dollars in Billions)

	Estimates		Outlook				Average Annual Growth[a]
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	
Economic Growth Scenario							
Personal income tax	$79.0	$85.1	$91.0	$95.8	$100.5	$104.7	5.3%
Sales and use tax	24.8	24.7	25.0	26.0	26.7	27.3	2.5
Corporation tax	10.0	9.9	10.2	10.5	10.9	11.2	3.2
Subtotals, "Big Three" Revenues	($113.8)	($119.7)	($126.1)	($132.3)	($138.1)	($143.2)	(4.6%)
Other revenues	$4.8	$4.2	$4.1	$4.3	$4.8	$4.9	4.3%
BSA transfer	-1.8	-3.3	-2.0	-1.8	-1.6	-1.6	—
Other transfers	-1.2	-0.6	-0.1	0.1	0.2	0.2	—
Totals, Revenues and Transfers	**$115.6**	**$120.0**	**$128.1**	**$134.8**	**$141.0**	**$146.7**	**5.1%**
Mild Recession Scenario							
Personal income tax	$79.0	$85.1	$89.1	$88.4	$89.0	$93.6	2.4%
Sales and use tax	24.8	24.7	25.0	24.6	25.1	26.1	1.4
Corporation tax	10.0	9.9	10.2	7.9	10.0	10.2	0.8
Subtotals, "Big Three" Revenues	($113.8)	($119.7)	($124.3)	($120.9)	($124.0)	($129.9)	(2.1%)
Other revenues	$4.8	$4.2	$4.1	$4.3	$4.7	$4.9	4.0%
BSA transfer	-1.8	-3.3	-1.9	-0.9	-1.0	-1.0	—
Other transfers	-1.2	-0.6	-0.1	-0.1	-0.2	0.2	—
Totals, Revenues and Transfers	**$115.6**	**$120.0**	**$126.4**	**$124.1**	**$127.6**	**$133.9**	**2.8%**

[a] From 2016-17 to 2020-21.

BSA = Budget Stabilization Account.

For example, we do not make changes to programs with largely discretionary budgets set by the Legislature annually. In the presence of a tightening budget condition, however, the Legislature would likely make different choices about these parts of the budget, among others.

Reserves

The state has two budget reserves: the Special Fund for Economic Uncertainties (SFEU) and the Budget Stabilization Account (BSA). Both reserves help insulate the budget from situations where revenues underperform budget assumptions. The Legislature can appropriate funds in the SFEU for any purpose, while the use of funds in the BSA is more restricted. Below, we present our estimates of total reserves under the growth and recession scenarios. For the purposes of this section, "operating surpluses" or "operating deficits" equal the increases or decreases in total budget reserves in each fiscal year.

Operating Surpluses Assuming Continued Economic Growth. Figure 24 (see next page) displays operating surpluses under the economic growth scenario. If our assumptions held and current laws and policies remained in place, the

Figure 23

General Fund Expenditure Estimates Under Growth and Recession Scenarios

(Dollars in Billions)

	Estimates		Outlook				Average Annual Growth[a]
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	
Economic Growth Scenario							
Education Programs							
Proposition 98[b]	$49.1	$51.0	$52.4	$54.2	$56.3	$57.9	3.2%
Non-Proposition 98	8.6	8.7	9.0	9.4	9.7	10.0	3.6
Health and Human Services	31.2	33.0	34.5	38.0	41.6	45.2	8.1
Criminal Justice	11.3	11.7	11.6	11.6	11.7	11.7	-0.1
Infrastructure Debt Service[c]	5.3	5.4	5.5	5.8	6.0	5.8	2.0
Other Programs[d]	9.4	12.2	13.2	13.3	14.0	14.8	5.0
Totals	**$114.9**	**$122.0**	**$126.1**	**$132.3**	**$139.3**	**$145.5**	**4.5%**
Percent Change		6.2%	3.4%	4.9%	5.3%	4.5%	
Mild Recession Scenario							
Education Programs							
Proposition 98[b]	$49.1	$51.0	$51.7	$49.1	$49.5	$52.5	0.7%
Non-Proposition 98	8.6	8.7	9.0	9.4	9.7	10.0	3.6
Health and Human Services	31.2	33.0	34.5	38.2	42.2	46.0	8.6
Criminal Justice	11.3	11.7	11.6	11.6	11.7	11.7	-0.1
Infrastructure Debt Service[c]	5.3	5.4	5.5	5.8	6.0	5.8	2.0
Other Programs[d]	9.4	12.2	13.1	12.5	13.3	14.2	3.9
Totals	**$114.9**	**$122.0**	**$125.3**	**$126.5**	**$132.4**	**$140.3**	**3.6%**
Percent Change		6.2%	2.7%	1.0%	4.6%	6.0%	

[a] From 2016-17 to 2020-21.

[b] Reflects the General Fund component of the Proposition 98 minimum guarantee. Average annual growth in the minimum guarantee—the General Fund and Local Property Tax revenue combined—is 3.8 percent in the growth scenario and 2.1 percent in the recession scenario.

[c] Debt service on general obligation and lease revenue bonds generally used for infrastructure. Does not include: (1) lease revenue debt service for community colleges, which is included under Proposition 98, or (2) UC's and CSU's debt service, which is included in non-Proposition 98 education spending.

[d] Includes employee compensation and retirement cost increases as well as small departments not included in the above categories.

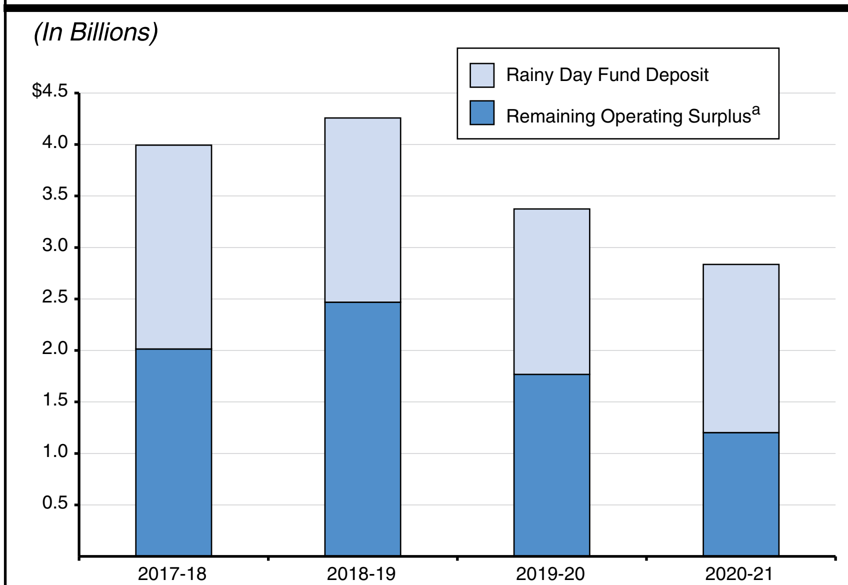
Note: Program groups are defined to include departments listed in Figure 12.

General Fund would be in surplus through 2020-21. BSA deposits would range between $1.6 billion and nearly $2 billion over the period, with the BSA balance available for future budget emergencies. The remaining operating surpluses would be available for new budget commitments—spending increases or tax reductions—or building larger reserves. (The figure assumes no sales tax reductions under two existing state laws due to growing SFEU balances.)

In Recession Scenario, Reserves Cover Operating Deficits Through 2020-21. Figure 25 shows operating surpluses and deficits and total reserve balances under the recession scenario. Under these assumptions, by the end of 2017-18 the state has $10.4 billion in total reserves. Under this scenario, the state would exhaust that reserve balance by the end of 2020-21, ending with a small portion of that year's operating deficit—just $154 million—that is not covered by reserves. This means, under these assumptions, the state could weather a mild recession without cutting spending or raising taxes through 2020-21. If deficits continued in 2021-22, the state would face

Figure 24

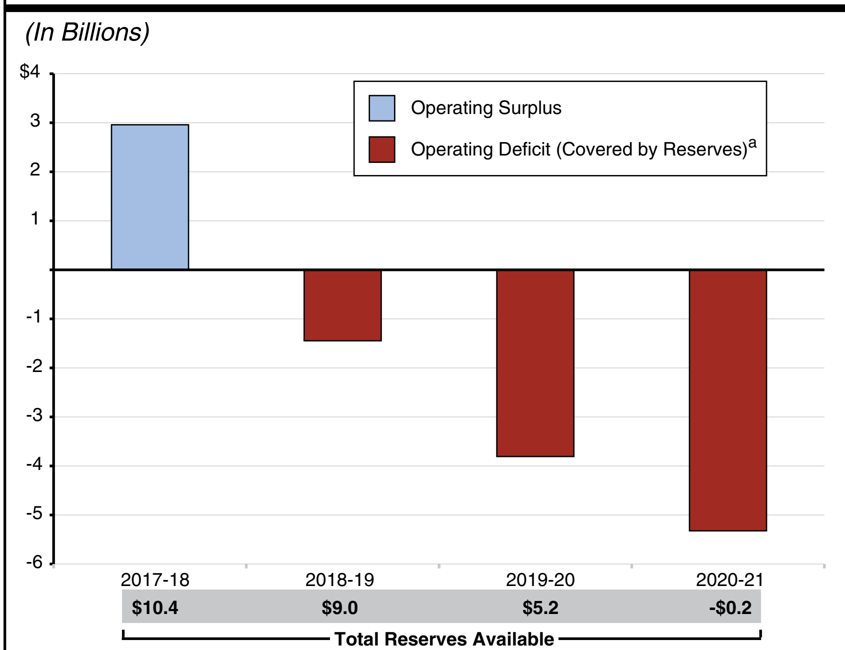
General Fund Surpluses and Reserve Deposits Under Economic Growth Scenario



[a] Amount that can be allocated in budget or used to build additional reserves.

Figure 25

Reserve Balances Cover Operating Deficits in Mild Recession Scenario



[a] A small portion ($154 million) of the operating deficit in 2020-21 is not covered by reserves.

decisions about how to solve a budget problem at that time.

Budget Situation Worse With New, Ongoing Commitments. Both the growth and recession scenarios assume the state makes no additional commitments in any year over the period. If the state did make such commitments, the budget outlook would be worse than displayed in the recession scenario and less optimistic than the growth scenario. Ongoing commitments compound each year, such that their out-year effect is much larger than their annual amount. For example, if the state committed $1 billion in new ongoing annual spending in 2017-18, total reserves would be lower by around $4 billion in 2020-21.

BUDGET UNCERTAINTIES

In addition to economic uncertainty described above, other factors, notably those related to policy decisions, could leave the budget in better or worse condition in the out-years. We describe some of these uncertainties below.

Decisions by the Legislature. Both the growth and recession scenarios assume there is no change in state policies. For example, we assume the tax on managed care organizations (MCO) will expire, consistent with current law, in 2019. Currently, some General Fund costs and savings are tied to the MCO tax. Our outlook assumes the MCO tax will expire, resulting in: (1) General Fund costs of about $1.7 billion for Medi-Cal (to backfill the loss of MCO tax revenues), (2) General Fund savings of about $300 million for In-Home Supportive Services (IHSS), and (3) roughly $400 million more in corporation and insurance taxes. If the Legislature extended the tax, the out-year budget condition would improve under both scenarios by about $1 billion annually. Similarly, our outlook assumes recent budgetary practices in programs with largely discretionary budgets set by the Legislature—including expenditure increases for employee compensation and the universities—continue. If the Legislature did not provide these increases, the budget condition would improve.

Decisions by Other State Entities. The California Public Employees Retirement System (CalPERS) has indicated it expects average investment returns over the next decade to be lower than the 7.5 percent it currently assumes. If the CalPERS board reduced its assumed rate of return to match its assumptions, the state would have to pay much more each year to both the normal cost and unfunded liability. This could increase state costs annually by hundreds of millions or even billions of dollars—during and/or after our outlook period. In addition, in both the growth and recession scenarios, our outlook assumes $2 billion in additional General Fund annual appropriations for Medi-Cal under the provisions of Proposition 55, beginning in 2018-19. However, decisions by the Director of Finance about how to implement this part of Proposition 55 could result in some or all of that $2 billion not being provided, thereby lowering state costs.

Decisions by the Federal Government. Our outlook assumes no major changes in federal policy over the outlook period. Various decisions by the federal government, however, could influence future state General Fund costs, in particular for some HHS programs. For example, recent federal regulations governing Medicaid managed care may require changes to the state Hospital Quality Assurance Fee. Similarly, there is uncertainty about whether the federal government will provide federal financial participation for newly enacted paid sick leave for IHSS providers. The federal government also could change provisions of the Affordable Care Act. These decisions—and others—could cost or save the state billions of dollars over the outlook period.

State Minimum Wage Costs. Our multiyear budget outlook includes hundreds of millions of dollars in additional costs related to the state minimum wage increase. For several programs, however, these costs are highly uncertain. Actual state budgetary costs related to the minimum wage could be hundreds of millions of dollars higher or lower than our assumptions. In addition, for both scenarios, the outlook assumes minimum wage increases go into effect as scheduled under current law. However, under certain economic and budgetary conditions, the law allows the Governor to delay the scheduled minimum wage increases. If the state pursued these delays under the recession scenario, the budget's condition would improve somewhat.

LAO COMMENTS

Budget Estimates Are Highly Uncertain. After 2017-18, General Fund revenues could be billions of dollars higher than those in the growth scenario or billions of dollars lower in a recession that is more severe than the one we display. Budget shortfalls would occur sooner, in particular, if a recession began before the middle of 2018. Shortfalls could be greater if the recession were more severe than the mild downturn we illustrate here or if the state made additional budget commitments. On the other hand, the budget could be in even better condition if the economy expanded faster, state spending was lower, or the stock market performed better than we assume in our growth scenario.

State Is Increasingly Prepared to Weather a Mild Economic Recession. Our recession scenario shows that the state budget is much better prepared to weather a mild economic downturn with minimal disruptions to programs. However, the reserve balances displayed in this chapter assume the state makes no new budget commitments—whether spending increases or tax reductions. If the state were to make significant ongoing budget commitments in 2017-18 or later, reserve balances would be insufficient to cover operating deficits in a mild recession and the state could face much more difficult choices—such as reducing spending or increasing taxes—to balance the state budget. Similarly, difficult choices would arise if the next recession is more severe than the mild one we have modeled in this report.

Plan for Size of Next Economic Downturn. As it crafts future budgets, the Legislature each year will allocate discretionary funds among reserves, one-time spending, and ongoing budget commitments based on its priorities. In deciding what level of reserves to hold, the Legislature may want to consider the size of a potential future recession for which it would like to plan. In the presence of a more severe recession, the state would face larger budget deficits. As such, weathering a more severe recession would require more preparation now, while the economy is still growing.

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