The 2013-14 Budget:

Overview of the Governor's Budget

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LAO

EXECUTIVE SUMMARY

Governor's Proposal

Presents Budget With $1 Billion Projected Reserve. On January 10, 2013, the Governor released his 2013-14 budget package. Similar to our November 2012 forecast, this latest package reflects a significant improvement in the state's finances, due to the economic recovery, prior budgetary restraint, and voters' approval of temporary tax increases. Specifically, the Governor proposes $138.6 billion in General Fund and special fund spending in 2013-14, up 4.5 percent from 2012-13. The administration forecasts that the state's General Fund budgetary balance will be $1 billion at the end of 2013-14 under the Governor's plan.

Includes Education, Health, and Debt Repayment Proposals. The budget contains major proposals in education, including a new formula for financing schools and additional General Fund resources for the public university systems. The package also presents options for expanding Medi-Cal under the federal health care reform law. In addition, the Governor's multiyear budget plan includes proposals to eliminate most of the so-called "wall of debt," a group of selected budgetary obligations now totaling around $30 billion that were incurred in recent years.

LAO Comments

Transition From Multibillion Dollar Annual Deficits to "Baseline" Budgets. Over the past several years, each January Governor's budget has included billions of dollars in proposed solutions—expenditure reductions, revenue increases, borrowing, and other actions—in order to close budget shortfalls. Now, however, the state has reached a point where its underlying expenditures and revenues are roughly in balance. With the exception of education funding, the remainder of state General Fund spending reflects a baseline budget. This means that state-supported program and service levels established in 2012-13 generally continue "as is" in 2013-14. Under our and the administration's fiscal forecasts, this situation would likely continue into 2014-15.

Governor's Focus on Fiscal Restraint and Paying Off Debts Appropriate. The Governor's emphasis on fiscal discipline and paying off the state's accumulated budgetary debts is commendable, especially in light of the risks and pressures that the state still faces. We note that there are still considerable risks to revenue estimates given uncertainty surrounding federal fiscal policy and the volatility inherent in our revenue system. In addition, under the Governor's multiyear plan, the state would still have no sizable reserve at the end of 2016-17 and would not have begun the process of addressing huge unfunded liabilities associated with the teachers' retirement system and state retiree health benefits. As such, the state faces daunting budget choices even in a much-improved fiscal environment.

Issues Highlighted by Governor Merit Legislative Consideration. While there will still be important decisions to make on the administration's budget plan, the Legislature is being asked by the Governor to consider a variety of significant policy issues. Probably the most important are the K-12 school finance formula and the Medi-Cal expansion under federal health care reform.

In addition, the Governor has proposed a new model for funding and providing adult education services, changes in the way the state funds community college enrollment, and caps on the number of state-subsidized college units. His budget presentation also discusses potential changes to state infrastructure financing. We believe these issues are worthy of serious legislative consideration and have, in the past, offered alternatives for addressing many of them.

OVERVIEW

The Governor's Budget Proposal

On January 10, 2013, the Governor released his 2013-14 budget package. That spending plan proposes $138.6 billion in General Fund and special fund expenditures, as shown in Figure 1. Contrary to recent years in which the state faced multibillion-dollar deficits, this latest package reflects a significant improvement in the state's finances. This report offers an overview of the Governor's budget proposal, including our reactions to the plan.

How the Administration Arrived at Its Budget Forecast

Projected 2012-13 Surplus Would Erase Deficit From Prior Year. For 2012-13, the administration estimates that General Fund revenues will be $95.4 billion and expenditures will be $93 billion, as shown in Figure 2. This $2.4 billion operating surplus will erase the $2.2 billion deficit that remained after 2011-12 and leave the General Fund with a small reserve as it enters 2013-14. (Throughout this report, amounts for the General Fund include revenues from the Education Protection Account, created by Proposition 30 [2012]).

Proposed Budget Would End 2013-14 With $1 Billion Reserve. The Governor's budget package projects General Fund revenues of $98.5 billion in 2013-14. The budget assumes $97.7 billion in General Fund expenditures, producing an $851 million operating surplus in 2013-14. The budget package estimates that the General Fund will end 2013-14 with a $1 billion reserve. (The Governor plans again to suspend the transfer to a separate reserve, the Budget Stabilization Account [BSA] created by Proposition 58 in 2004.)

Differences From LAO's November 2012 Forecast. Our November 2012 publication,

Figure 1

Budget Expenditures

(Dollars in Millions)

Fund Type	2011-12 Revised	2012-13 Revised	2013-14 Proposed	Change From 2012-13 Amount	Change From 2012-13 Percent
General Fund[a]	$86,404	$92,994	$97,650	$4,656	5.0%
Special funds	33,853	39,648	40,928	1,279	3.2
Budget Totals	**$120,257**	**$132,642**	**$138,578**	**$5,936**	**4.5%**
Selected bond funds	$6,104	$12,295	$7,248	-$5,046	-41.0%
Federal funds	73,063	85,830	78,841	-6,989	-8.1

[a] Includes Education Protection Account created by Proposition 30 (2012).

Figure 2

Governor's Budget General Fund Condition

Includes Education Protection Account (In Millions)

	2011-12 Revised	2012-13 Revised	2013-14 Proposed
Prior-year fund balance	-$2,282	-$1,615	$785
Revenues and transfers	87,071	95,394	98,501
Total resources available	$84,789	$93,779	$99,286
Expenditures	$86,404	$92,994	$97,650
Ending fund balance	-$1,615	$785	$1,636
Encumbrances	$618	$618	$618
Reserve	**-$2,233**	**$167**	**$1,018**

The 2013-14 Budget: California's Fiscal Outlook, estimated that the Legislature and Governor would need to address a $1.9 billion budget problem by June 2013. The Governor's budget, on the other hand, produces a $1 billion reserve at the end of 2013-14. The $2.9 billion difference between our office's estimate and that of the administration is mostly explained by the following factors:

- ***Higher Tax Revenues ($1.1 Billion).*** Across the three fiscal years (2011-12, 2012-13, and 2013-14), the administration's forecast includes about $1.1 billion in higher revenues. Specifically, this total includes higher revenues from the personal income tax (PIT) ($1.4 billion) and the sales and use tax (SUT) ($0.2 billion), and lower revenues from the corporation tax (CT) (-$0.6 billion).

- ***Higher Estimates of Savings ($1 Billion).*** The administration's January forecast includes about $700 million in higher savings associated with the dissolution of redevelopment agencies (RDAs) and $300 million in higher savings from using cap-and-trade revenues to offset programs traditionally supported by the General Fund.

- ***Revenues From Health Taxes and Fees ($0.7 Billion).*** The administration has proposed extending the hospital quality assurance fee ($310 million) and reauthorizing the gross premiums tax on Medi-Cal managed care plans ($364 million).

- ***Lower Repayments of Special Fund Loans ($0.5 Billion).*** Our November forecast assumed the repayment of about $1.3 billion in special fund loans from the General Fund. The administration's forecast includes about $500 million in lower net repayments of such loans. In some cases, the administration proposes to delay repayment dates and in other cases, it plans to repay loans earlier.

Key Components of the Budget Plan

The Governor's 2013-14 budget contains major new proposals for schools and community colleges and continues the implementation of the federal Patient Protection and Affordable Care Act (ACA). In addition, the budget proposes General Fund spending increases for the public university systems and revises previously projected savings associated with the dissolution of RDAs and cap-and-trade auction revenues. Figure 3 outlines the major new proposals contained in the Governor's budget.

Includes Major Proposition 98 Proposals. The Governor's budget contains major new Proposition 98 proposals for schools and community colleges. Most notably, the budget replaces much of the current system of K-12 finance with a new funding formula. The new formula allows more local control because it has virtually no state requirements for programmatic spending. The spending plan also includes substantial funding to pay down existing K-14 payment deferrals, reducing the need for school districts and community colleges to borrow to meet their cash needs.

Uses Proposition 39 Funding for Projects at Schools and Community Colleges. By changing the method used by multistate businesses in determining their state taxable income, Proposition 39 (2012) increases corporate tax revenues. The Governor's budget includes all such revenue in the calculation of the Proposition 98 minimum guarantee. In addition, Proposition 39 requires that half of the new revenues fund energy efficiency programs through 2017-18. The budget proposes to use that funding for projects at schools and community colleges.

Increases Funding for UC and CSU. The budget package proposes a 5 percent base increase ($125 million each) in 2013-14 for University of California (UC) and California State University (CSU). This funding is in addition to the $125 million that last year's budget provided to each of the systems for 2013-14 in exchange for not increasing tuition levels in 2012-13. The Governor also has a multiyear plan that would provide 5 percent base increases in 2014-15 and 4 percent in the subsequent two years. As a result of these increases, the Governor expects tuition levels to remain flat through 2016-17. In addition, the budget proposes to shift debt-service costs for general obligation bonds into UC's and CSU's budgets.

Implementing the ACA. The ACA provides states with the option to expand Medi-Cal coverage to certain adults with incomes up to 138 percent of the federal poverty level who are not currently eligible. The budget package suggests two alternatives for this optional expansion—one in which the state would administer an expanded version of its current Medi-Cal Program and another in which counties administer the expansion while meeting state eligibility requirements. The ACA also includes several provisions that will likely result in additional enrollment among the currently eligible Medi-Cal population. The budget provides a $350 million General Fund "placeholder" for these additional costs for the currently eligible population.

The Administration's Multiyear Forecast

Forecasts Balanced Budgets. The administration's multiyear budget projection reflects both its updated revenue and expenditure projections, as well as projections of various proposals made by the Governor in his 2013-14 budget plan. The administration projects that future General Fund revenues will exceed

Figure 3

Major Proposals in the Governor's Budget

General Fund (In Millions)	
Proposed Savings	
Repay fewer special fund loans[a]	$1,042
Reauthorize the gross premiums tax on Medi-Cal managed care plans	364
Extend the hospital quality assurance fee	310
Transfer funds from court construction account to the General Fund	200
Use prior appropriations over revised Proposition 98 guarantee level for QEIA	172
Suspend newly identified state mandates	104
Use highway account revenues to pay transportation debt service	67
Proposed Augmentations	
Provide augmentation for UC and CSU	250
Expand CalWORKs employment services	143
Other Policy Proposals	
Begin to implement K-12 funding formula[b]	—
Restructure adult education program[b]	—
Use Proposition 39 funds for energy efficiency projects at K-14 schools	—
Base community college funding on census of students at end of term[b]	—
Cap number of state subsidized college units per student	—
Expand Medi-Cal via a state- or county-based model	—

[a] Relative to administration's multiyear forecast as of June 2012. The LAO's November 2012 forecast projected special fund loan repayments to be about $500 million lower than the June 2012 multiyear forecast.

[b] Funded within Proposition 98 and has no net effect on General Fund expenditures.

QEIA = Quality Education Investment Act.

expenditures annually—thereby producing annual operating surpluses of at least $47 million (in 2014-15) and as much as $994 million (in 2016-17). By the end of 2016-17, the administration projects the accumulation of a $2.5 billion General Fund reserve. Transfers to the other state reserve, the BSA, are assumed to be suspended by the Governor throughout the forecast period.

Projects Smaller Future Surpluses Than LAO's Forecast. Our November forecast also reflected a significant improvement in state finances, albeit with much larger surpluses beyond 2013-14. Specifically, our forecast produced an over $1 billion operating surplus in 2014-15, growing thereafter to a $7.5 billion surplus in 2016-17. The differing formats of the forecasts make comparisons difficult. Some of the difference can be explained by the administration having its own estimates of future revenues and expenditures, including estimates of caseload growth for many state programs. For example, in 2016-17 the administration projects $700 million less in local property taxes (which offset state funding to schools) and higher health and human services costs of perhaps a few hundred million dollars.

A significant portion of the disparity, however, appears to relate to fiscal and policy proposals in the Governor's plan, which were not included in our forecast of current state laws and policies. In particular, the Governor's university funding proposals result in higher expenditures in 2016-17 in the administration's multiyear forecast. Among the differences are the Governor's proposals to eliminate most of the wall of debt, a group of selected budgetary obligations now totaling around $30 billion that were incurred in recent years. Our forecast projected less spending to repay these obligations through 2016-17, given the lack of formal legislative action to date to adopt several elements of the Governor's wall of debt plan. Higher proposed spending to repay wall of debt obligations causes part of the difference in projected operating surpluses. In 2016-17, for example, the Governor proposes several billion dollars more spending to pay outstanding obligations to schools and local government, end a longstanding lag in state contributions to employee pensions, and retire special fund loans.

LAO Comments

Transition From Multibillion Dollar Annual Deficits to Baseline Budgets. Over the past several years, each January the Governor's budget has included billions of dollars in proposed solutions—expenditure reductions, revenue increases, borrowing, and other actions—in order to close massive budget shortfalls. Now, however, the state has reached a point where its underlying expenditures and revenues are roughly in balance. For instance, the administration is proposing a limited set of actions (such as delaying repayment of some special fund loans and authorizing two health-related taxes) in order to keep the budget in balance, build a modest reserve, and fund a limited number of augmentations (the most prominent being for the state universities). With the exception of education funding, the remainder of state General Fund spending reflects a baseline budget. This means that state-supported program and service levels established in 2012-13 would generally continue as is in 2013-14 under the Governor's plan. Under our and the administration's fiscal forecasts, this situation would likely continue into 2014-15.

Governor's Focus on Fiscal Restraint and Paying Off Debts Is Appropriate. In his budget presentation, the Governor stressed fiscal discipline, including the importance of paying off the state's accumulated budgetary debts. We think this emphasis is commendable, especially in light of the risks and pressures that the state still faces. As we noted in the *Fiscal Outlook,* there are still considerable risks to revenue estimates given:

(1) uncertainty at the federal level over "fiscal cliff" issues related to the debt limit and sequestration, and (2) normal volatility in our state revenue structure. In addition, despite the Governor's commitment to paying down much of the wall of debt, the state would still have no sizable reserve at the end of 2016-17 under his multiyear plan and would not have begun addressing huge unfunded liabilities associated with the teachers' retirement system and state retiree health benefits. As such, the state potentially faces some daunting choices even in this much-improved fiscal environment.

Governor Poses Important Policy Choices for the Legislature. While there will still be important fiscal decisions to make on the administration's budget plan, the Legislature is being asked by the Governor to consider a variety of significant policy issues. Probably the two most important ones are: (1) a new K-12 funding formula, and (2) two options for implementing Medi-Cal expansion under federal health care reform. In addition, the Governor has proposed a new model for funding and providing adult education services, changes in the way the state funds community college enrollment, and caps on the number of state-subsidized college units. He also has suggested various changes to the state's role in funding infrastructure. We believe these issues are worthy of serious legislative consideration. On many of these issues, we have identified similar problems as the Governor, while offering alternative ways to address those problems. Given that the Legislature will not be required to deal with addressing huge budgetary shortfalls, we believe addressing the challenges posed by the Governor would be well worth the time and effort.

ECONOMICS AND REVENUES

Administration's Economic Forecast

Forecast Assumes Continuing Economic Recovery. Similar to recent economic forecasts from the administration and our office, the *2013-14 Governor's Budget* economic forecast assumes continuation of the current moderate economic recovery in the U.S. and California. Figure 4 (see next page) summarizes the administration's economic forecast for calendar years 2012 through 2015, and Figure 5 (see page 11) compares the administration's forecast to recent forecasts from our office, the University of California, Los Angeles (UCLA) Anderson School of Management, and IHS Global Insight—a major economic forecasting firm (which does not provide California-specific forecasts). All of the recent California forecasts assume continuing, moderate job growth and improvements in the state's housing sector over the next few years.

Administration Forecast Completed Prior to New Year's Day Federal Tax Legislation. The administration completed its current economic forecast in early December, consistent with its traditional schedule. Of the forecasts shown in Figure 5, only the U.S. forecast by IHS Global Insight was completed after final congressional passage on January 1, 2013 of the American Taxpayer Relief Act (ATRA). The act averted certain aspects of the fiscal cliff, a variety of previously scheduled federal tax increases and spending reductions. Although Congress and the President agreed to halt scheduled income tax rate increases on all but the highest rate brackets and delay scheduled spending cuts in domestic and defense programs, ATRA allowed increased income taxes to go into effect for many upper-income Americans, as well as higher payroll taxes for most workers.

Near-Term Economic Prospects Slightly Weaker Under Some Recent Forecasts. Previous forecasts by both the administration and our office assumed that Congress and the President would take actions to avert the fiscal cliff, but ATRA results in a set of federal actions that differ from those assumed in prior forecasts. For example, contrary to the assumptions embedded in recent state economic forecasts, ATRA allowed an immediate end to the temporary payroll tax cut (likely resulting in near-term decreases in economic activity) but extended for 2013 provisions that allow businesses to offset the immediate costs of certain new equipment and software ("bonus depreciation," which likely results in near-term increases in economic activity).

The loss of take-home pay resulting from higher payroll taxes is included in the calculation of personal income. The IHS Global Insight forecasts 2.8 percent growth in U.S. personal income in 2013—1 percentage point below the administration's forecast—due largely to this forecast's incorporation of the end of the payroll tax cut. Overall U.S. economic growth (as expressed by the increase in real gross domestic product) is just slightly lower in IHS Global Insight's forecast. While that forecast acknowledges an economic drag resulting from higher payroll taxes and increased income taxes on upper-income Americans, this drag is largely offset in the near term by more rapid growth in some sectors of the economy, the bonus depreciation tax policy, and a decline in recently elevated personal savings rates, which should allow consumers to maintain much of their recent spending patterns despite reduced take-home pay.

Figure 4

Administration's January 2013 Economic Forecast

United States	2012	2013	2014
Percent change in:			
Real gross domestic product	2.1%	1.8%	2.8%
Personal income	3.5	3.8	4.8
Wage and salary employment	1.4	1.5	1.6
Consumer price index	2.1	1.9	2.0
Unemployment rate	8.1	7.8	7.4
Housing starts (millions)	0.8	1.0	1.3
Percent change from prior year	25.3	27.9	31.4
Federal funds rate	0.1	0.1	0.1

California	2012	2013	2014
Percent change in:			
Personal income	5.1%[a]	4.3%[a]	5.5%
Wage and salary employment	2.0	2.1	2.4
Unemployment rate	10.6	9.6	8.7
Housing permits (thousands)	57	81	123
Percent change from prior year	21.7	42.7	51.6
Single-unit permits (thousands)	27	37	63
Multiunit permits (thousands)	30	44	60

[a] The administration's economic forecast appropriately reflects various one-time effects of Facebook's 2012 initial public offering (IPO) of stock. This assumes that the official federal survey accurately captures these effects. Other economic forecasts, including our office's prior forecasts, omit these one-time effects. If the IPO had been excluded from this administration forecast, growth in California personal income would have been 4.7 percent in 2012 and 4.5 percent in 2013. Most of the IPO effects on personal income were heavily concentrated in the fourth quarter of 2012, which affects Proposition 98 and state appropriations limit calculations for 2013-14 and 2014-15.

LAO Comments

Federal Policy Is the Key Forecast Risk Now. The administration's forecast is similar to our office's November 2012 forecast. The federal actions included in ATRA likely mean slightly weaker prospects for the overall U.S. and state economies in 2013, due mainly to the end of the payroll tax cut, as compared with both the administration's recent forecast and our own forecast of two months ago. The major remaining uncertainties in the near term are the series of upcoming federal decisions concerning

(1) the statutory cap on U.S. public debt known as the debt ceiling; (2) the delayed 8 percent to 10 percent cuts to many federal spending programs known as sequestration, which are now scheduled to begin on March 1, 2013; and (3) the expiration at the end of March of the current "continuing resolution" that funds federal government operations. The debt ceiling raises the biggest concerns for the economy in the near term. While U.S. government debt reached its cap of $16.4 trillion on December 31, 2012, the federal government now is implementing a series of financial maneuvers that allow it to pay its legal obligations despite an inability to issue additional debt. Without a debt ceiling increase or similar action, these maneuvers will be exhausted, and the federal government will have to delay payments on some of its obligations beginning at some point around late February or early March 2013.

Prolonged Federal Impasse Could Damage the Economic Recovery. A prolonged impasse by federal leaders concerning the debt ceiling and sequestration decisions could dampen consumer, business, and investor confidence in the coming weeks, thereby damaging the modest economic recovery. The 2011 debt ceiling debate coincided with a notable slowing of economic growth, as measured by several key economic statistics: employment, gross domestic product, motor vehicle sales, and business investment, among others. If a similar impasse were to occur in the coming weeks, economic growth in 2013 could be noticeably weaker than the administration's projections. A stock market slump, if it were to occur, would pose a particular threat to the state budget, given the state's progressive PIT rates and reliance on capital gains of high-income taxpayers.

The recent state economic forecasts all assume that the federal government will adopt some

Figure 5

Comparing Administration's Economic Forecast With Recent Forecasts[a]

	2013				2014			
	LAO November 2012	UCLA December 2012	DOF January 2013	IHS Global Insight January 2013	LAO November 2012	UCLA December 2012	DOF January 2013	IHS Global Insight January 2013
United States								
Percent change in:								
Real gross domestic product	1.8%	1.7%	1.8%	1.7%	3.0%	2.8%	2.8%	2.7%
Personal income	3.9	3.7	3.8	2.8[a]	4.9	4.9	4.8	5.0
Wage and salary employment	1.3	1.4	1.5	1.4	1.8	1.7	1.6	1.7
California								
Percent change in:								
Personal income	4.7%	3.3%	4.3%	NA	5.5%	5.2%	5.5%	NA
Wage and salary employment	2.3	1.4	2.1	NA	2.5	2.2	2.4	NA
Unemployment rate	9.6	9.7	9.6	NA	8.7	8.4	8.7	NA
Housing permits (thousands)	83	75	81	NA	113	130	123	NA

[a] The forecasts make various assumptions about federal tax and spending policies in 2013 and beyond. The IHS Global Insight forecast—developed after passage of January 2013 federal tax legislation—incorporates the expiration of the payroll tax reductions at the end of 2012, which affects 2013 personal income growth in particular.

NA = Not applicable.

spending decreases, as well as additional tax increases, gradually over the long term. Nevertheless, the implementation of sudden spending cuts at the levels envisioned in the current sequestration law could reduce economic activity somewhat below forecasted levels in the near term. In particular, segments and regions of the economy with high concentrations of federally funded activity, such as the San Diego region (with significant military and federally funded research activities), could be negatively affected.

California-Specific Economic Risks. In addition to federal policy risks, all of the recent economic forecasts shown in Figure 5 assume continuing improvement in California's housing markets and construction industry. While recent housing trends have been notably positive, with rising home prices and increased sales, these trends could be easily upset in the near term by a sharp decline in consumer and investor confidence resulting from a prolonged debt ceiling debate. In addition, there remains some uncertainty concerning how individuals and businesses will react to several recent state-level policy changes, including the temporary PIT and SUT increases approved in Proposition 30 and the state's greenhouse gas reduction policies (including cap-and-trade auctions).

Risks From Middle East Conflicts. Among the other risks to the economic forecast are continuing conflicts in the Middle East, such as the civil war in Syria and recently heightened tensions involving Israel and Iran. While weak energy demand growth has caused major declines in oil prices recently, which have benefited consumers and businesses, sudden price spikes can result from instability in the Middle East. Such price spikes, if they were to occur, could weaken the modest economic recovery.

Administration's Revenue Forecast

Figure 6 summarizes the administration's revenue forecast through 2016-17 and lists major differences between this new forecast and both the *2012-13 Budget Act* forecast from June 2012 and our office's November 2012 forecast. Figure 7 (see page 14) provides more detail concerning these comparisons related to 2012-13 and 2013-14 revenues.

Personal Income Tax

The Governor's budget forecasts that PIT revenues booked to the General Fund and Education Protection Account for 2012-13 will total $60.6 billion, an increase of $6.8 billion (13 percent) over the updated 2011-12 PIT forecast. Around one-fourth of this year-over-year growth results from the full phase-in of rate increases for upper-income taxpayers under Proposition 30. For 2013-14, the budget forecasts that PIT revenues will climb to $61.7 billion, an increase of 1.8 percent. Assumed accelerations of income from 2013 to 2012—as some taxpayers sought to avoid higher federal taxes related to the fiscal cliff—affect year-over-year growth during this period. In general, these accelerations increase PIT revenues in the forecast for tax year 2012 and, in turn, decrease the projected growth rate for tax year 2013.

Administration Has Increased Its PIT Estimates. The administration has increased its prior projections for state PIT revenues. Compared to the June 2012 forecast, the new projections increase PIT revenues by $379 million for 2012-13. (This increase occurs despite an approximately $600 million decrease in the administration's May 2012 projection of PIT revenues resulting from the Facebook initial public offering.) In addition, the new forecast shows higher 2013-14 PIT revenues of $1.5 billion compared to the administration's June 2012 multiyear budget forecast.

The new projections include revised PIT estimates for previous fiscal years. For example, similar to what we discussed in November 2012, the budget adjusts the entering 2011-12 fund balance upward due primarily to higher PIT revenues for 2010-11 and prior years. (The budget also includes new nonrevenue adjustments to the entering fund balance.) In addition, PIT revenues booked to 2011-12 are now projected to be $878 million higher than in the June 2012 forecast. Some of these differences relate to the state's increasingly complex accrual policies, which shift revenues collected from one fiscal year to another in the state's budget calculations. (Historically, for example, this Governor's budget forecast would be the last official update of 2011-12 revenues. Under the new accrual policies, which we discussed in our November *Fiscal Outlook* publication, final information on 2011-12 revenues seemingly will not be available until at least the middle of 2014—around 700 days after the end of the fiscal year—with comparable lags for each succeeding year's revenues.)

Higher Capital Gains Forecast, Among Other Changes. Based in part on the Department of Finance (DOF) analysis of new tax agency data released in late November 2012, the administration has revised its forecast of California residents' net capital gains in tax year 2011 upward from $52 billion in the 2012-13 budget forecast to $68 billion now. This, in turn, seems to contribute to higher capital gains projections for future years. At the same time, the administration has

Figure 6

Administration's Multiyear Revenue Forecast

General Fund and Education Protection Account Combined (In Millions)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Personal income tax	$53,836	$60,647	$61,747	$67,550	$71,981	$75,344
Sales and use tax	18,652	20,714	23,264	24,920	26,733	27,261
Corporation tax	7,949	7,580	9,130	9,655	10,169	10,592
Subtotal, "Big Three" taxes	($80,437)	($88,941)	($94,141)	($102,125)	($108,883)	($113,197)
Insurance tax	$2,165	$2,022	$2,198	$2,413	$2,480	$2,550
Other revenues	2,959	2,631	2,185	1,878	1,876	1,919
Net transfers and loans	1,509	1,800	-23	-563	-1,956	-325
Total Revenues and Transfers	**$87,071**	**$95,394**	**$98,501**	**$105,853**	**$111,283**	**$117,341**
Differences—Governor's Forecast Minus *2012-13 Budget Act* Forecast						
Estate tax	—	-$45	-$290	-$725	-$1,180	NA
Taxes and other revenues	$516	-660	1,394	-170	1,266	NA
Net transfers and loans[a]	-275	212	1,280	43	-572	NA
Totals	$241	-$493	$2,384	-$852	-$486	—
Differences—Governor's Forecast Minus LAO November 2012 Forecast						
Taxes and other revenues	$863	-$385	$632	$1,462	$1,281	$568
Transfer of Proposition 39 revenue to new fund[b]	—	—	475	500	513	525
Other transfers and loans (net)[a]	-275	169	651	-441	-1,528	-212
Totals	$589	-$216	$1,758	$1,521	$265	$881

[a] A positive number generally indicates that the Governor's budget forecast assumes fewer General Fund loan repayments to special funds. A negative number generally indicates that the Governor's budget forecast assumes more General Fund loan repayments to special funds. Differences in transfers other than loans also are reflected in this line.

[b] Amounts listed are the transfers of Proposition 39 (2012) revenue to the Clean Energy Job Creation Fund that were assumed in the LAO November 2012 forecast. This transfer of revenues is omitted from the Governor's budget proposal.

NA = Not applicable.

lowered its overall forecast of Californians' wage income in 2011 and 2012, particularly estimates of wage growth for upper-income taxpayers. While we do not expect to release a complete updated revenue forecast until May 2013, our preliminary observations are that DOF's overall adjustments for 2011 and 2012 seem reasonable based on currently available data. At this time, we find their 2012-13 and 2013-14 PIT forecasts—those most relevant for the upcoming budget process—to be reasonable.

2013 Will Be an Unusual Year of PIT Collections. While the administration's near-term PIT projections seem reasonable at this time, we observe that the next few months will produce PIT collection data that will be particularly challenging to interpret. This unusual period already has begun, with overall December 2012 PIT collections running $2.2 billion (41 percent) above those of December 2011, or $1.3 billion (22 percent) above DOF's forecast for the month in the *2012-13 Budget Act*. A significant portion of these increases may relate to decisions by individuals and businesses to accelerate receipts of capital gains, dividends, and wages from 2013 to 2012, in order to avoid higher federal tax rates related to the fiscal cliff. December and early January withholding data show that wage and bonus income subject to such withholding has increased substantially compared to last year. Similar to both our and the administration's revenue forecasts in recent months, the updated administration forecast assumes that California tax filers accelerated 20 percent of the capital gains they otherwise would realize in 2013 to 2012, along with 10 percent of dividends and 1 percent of wages. To the extent that PIT payments continue to exceed DOF projections through the rest of January, it may mean that these accelerations are occurring at a greater level than assumed. This, in turn, may mean increased 2012 tax revenue (benefiting the 2011-12 and 2012-13 fiscal years) and decreased 2013 tax revenue (affecting 2012-13 and 2013-14), compared to current projections.

Figure 7

Comparisons With Prior Revenue Forecasts

General Fund and Education Protection Account Combined (In Millions)

	2012-13			2013-14		
	Budget Act June 2012	LAO November 2012	Governor[a] January 2013	DOF Multiyear Forecast June 2012	LAO November 2012	Governor[a] January 2013
Personal income tax[b]	$60,268	$59,860	$60,647	$60,234	$61,712	$61,747
Sales and use tax[b]	20,605	20,839	20,714	23,006	22,721	23,264
Corporation tax[c]	8,488	8,535	7,580	8,931	9,119	9,130
Subtotal, "Big Three" taxes	$89,361	$89,234	$88,941	$92,171	$93,551	$94,141
Insurance tax	$2,089	$2,050	$2,022	$2,110	$2,212	$2,198
Estate tax	45	—	—	290	—	—
Other revenues	2,804	2,695	2,631	2,849	2,129	2,185
Net transfers and loans	1,588	1,631	1,800	-1,303	-1,149	-23[d]
Total Revenues and Transfers	**$95,887**	**$95,610**	**$95,394**	**$96,117**	**$96,743**	**$98,501**
Difference—Governor's Forecast Minus Budget Act Forecast			**-$493**			**$2,384**
Difference—Governor's Forecast Minus LAO Forecast			**-$216**			**$1,758**

[a] Reflects Governor's budget proposals, which contribute to differences from prior forecasts concerning net transfers and loans in particular.

[b] Includes additional revenues from Proposition 30 (2012).

[c] November 2012 and January 2013 forecasts include additional revenues from Proposition 39 (2012).

[d] Governor's January 2013 forecast reflects administration's plans to repay fewer special fund loans in 2013-14 and not to transfer a portion of Proposition 39 revenues from the General Fund to a new fund created by the measure.

It will be difficult to assess these January variances in the near term due to a variety of other issues. Proposition 30, as approved in November 2012, retroactively raised PIT rates for upper-income filers to the beginning of 2012. Most such taxpayers likely will have to make additional payments between December 2012 and April 2013, but we are unlikely to have a good idea of when these payments have come to the state's coffers until at least April. Another complicating factor is the anticipated multiweek delay in the tax filing season due to the recent decisions by Congress and the President to adjust significant elements of the federal tax code. In addition, the state faces routine difficulties in interpreting incoming PIT collections, volatile as they are due to ups and downs in the stock market. Potential stock market volatility coinciding with the upcoming federal debt ceiling deliberations also could affect PIT collections in the coming few months. For all of these reasons, we advise interpreting tax agency collection data between now and April with extreme caution. (Only "agency cash" reports released monthly by DOF are relevant for budgetary forecasting and tracking. "Controller's cash" reports are not useful for those purposes.)

Given the standard lags in receiving final tax data and the state's accrual policies, it likely will be a year or two before reliable conclusions concerning 2012 and 2013 tax collections are known. By May, however, both we and the administration will have more data—based on updated economic statistics and spring tax collections—to make more informed assessments of 2012-13 and 2013-14 PIT revenues.

Sales and Use Tax

In its new forecast, DOF projects General Fund SUT revenues to increase to $23.3 billion in 2013-14. (This is 12.3 percent above the updated estimate for 2012-13, with about one-third of this growth resulting from the full-year effect of the temporary one-quarter cent SUT increase under Proposition 30. That temporary tax increase begins this month, halfway through the 2012-13 fiscal year.)

Small Changes in Administration Estimates. The administration's updated forecast of 2011-12 SUT revenues is $269 million lower than reflected in the 2012-13 budget package, while its new projection for 2012-13 SUT revenues is $109 million higher. Compared to the June 2012 multiyear DOF forecast, 2013-14 SUT revenues are now projected to be $258 million higher.

Mild Risk to the Forecast Due to Expiration of Payroll Tax Cut. At this time, we observe some mild risks for the administration's SUT forecast. Its forecast does not reflect the potential drag on taxable retail sales resulting from the end of the temporary 2 percentage point reduction in federal payroll taxes. Because of this expiration, after-tax incomes for most Californians should be lower than the levels the administration assumed when projecting SUT revenue for 2012-13 and 2013-14. It is possible that this factor alone could result in a few hundred million dollars less in SUT revenue—compared to the administration forecast—in 2012-13 and 2013-14 combined. As with the PIT, consumer and business concerns related to the upcoming federal deliberations also could cause SUT revenue to lag projections.

Corporation Tax

Large Reductions in Non-Proposition 39 CT Revenue Forecast. As discussed in our November *Fiscal Outlook* publication, CT collections have been very weak recently, and there are major difficulties with forecasting this tax at the present time. Similar to our office's November forecast, the administration now is lowering its *2012-13 Budget Act* forecasts for CT revenues to reflect the recent dramatic weakness in CT collections. The administration now is projecting $7.6 billion, as compared to $8.5 billion in the budget act. This $7.6 billion includes about $440 million of increased CT revenues due to passage of Proposition 39 in November 2012. Accordingly,

if Proposition 39 had not passed, CT revenues for 2012-13 would be declining to $7.1 billion, a 16 percent drop compared to the budget act projections from June 2012. While we cannot fully explain the reasons for this precipitous drop, it is likely due in part to major tax policy changes made in recent years. The administration's 2013-14 forecast includes $900 million of Proposition 39 revenues, the growth of which accounts for part of the $1.6 billion increase in CT for that fiscal year.

Additional Risks to the Forecast. Through December 2012, 2012-13 CT collections for the fiscal year to date were running 35 percent below collections from the prior year and 32 percent below DOF's year-to-date projections (from the June 2012 forecast). The state clearly has had difficulty in forecasting the effects of recent CT policy and other changes. Recent collection trends suggest that CT projections may need to be dropped further in the coming months.

Estate Tax

Estate Tax Estimates Lowered to Zero Due to Congressional Action. Figures 6 and 7 display the administration's prior estimates for California estate taxes. Consistent with our recent forecasts, the administration now has revised its estimates for these taxes down to zero due to the federal decision to permanently end the federal tax credit to which California's estate tax has been linked for decades. California's estate tax law was approved by voters with passage of Proposition 6 in 1982. Proposition 6 prohibits a change to the relevant portions of the law unless it is approved by the state's voters. For this reason, the administration is correct to assume that current law prohibits collections of California state taxes on estates of those who die in the future.

Special Fund Loan Repayment Transfers

A Part of the So-Called Wall of Debt. The state has lent balances of its special funds to the General Fund in order to help address budget shortfalls over the last decade. The General Fund now has around $4 billion of outstanding budgetary loans from the state's special funds. The state has considerable flexibility about when to repay these loans, and to date, the Legislature has granted the administration considerable discretion about when such repayments will occur. The Governor has stated his preference to pay down these budgetary obligations as part of his multiyear plan to reduce the so-called wall of debt. (The Legislature, however, has not taken a formal action to date to indicate its agreement with this and other aspects of the Governor's wall of debt proposals.)

Delays Proposed for Previously Planned 2013-14 Loan Payments. In the administration's 2012-13 multiyear budget forecast of June 2012, it estimated that the state would pay off $183 million of special fund loans in 2012-13 and $1.6 billion of such loans in 2013-14. Considering both currently scheduled loan repayment dates, as well as our understanding of when some departments would need to access the borrowed funds for special fund purposes, our November forecast assumed that $1.3 billion of these loans would be repaid in 2012-13 and 2013-14 combined. The Governor's budget plan proposes instead that $752 million of loan repayments occur, including $186 million in 2012-13 and $566 million in 2013-14. Compared to the assumed list of loan repayments in our November *Fiscal Outlook* publication, the administration proposes to delay repayments on prior loans from various special funds, including:

- State Highway Account ($150 million).
- The judicial branch's Immediate and Critical Needs Account ($90 million).
- Hospital Building Fund ($75 million).

The budget plan also proposes to make repayments to several other funds that were not included in our November list of assumed loan repayments.

All Loans Proposed to Be Paid Off by End of 2016-17. The administration's multiyear budget plan proposes that all of the remaining loans from special funds be paid off by the end of 2016-17. In the administration's plan, $795 million of loans would be paid off in 2014-15, $2.2 billion in 2015-16, and $557 million in 2016-17. (Our November forecast assumed that around $1.2 billion of special fund loans would remain outstanding as of the end of 2016-17, given that there has been no formal legislative action to adopt the Governor's wall of debt repayment plan.)

Recommend Legislature Take Charge of a Repayment Plan. The Legislature has considerable flexibility to direct the method and manner of special fund loan repayments. We recommend that it do so beginning this year. We also recommend that legislators hold hearings in 2013 concerning each one of the special funds proposed to be repaid in the Governor's 2013-14 budget plan, as shown in Figure 8. These hearings would provide an important opportunity—with the special funds in line to be repaid hundreds of millions of dollars—to explore the operations of special fund programs.

Figure 8

Special Fund Loan Repayments Proposed by the Governor for 2013-14

(In Thousands)

Department	Special Fund	Proposed Repayment Amount
Justice	National Mortgage Special Deposit Fund	$100,000
Resources Recycling and Recovery	California Beverage Container Recycling Fund	94,400
Public Utilities Commission	California High Cost Fund-B Administrative Committee Fund	75,000
Public Utilities Commission	California Advanced Services Fund	75,000
Transportation	State Highway Account, State Transportation Fund	50,000
Resources Recycling and Recovery	Glass Processing Fee Account	39,000
Resources Recycling and Recovery	PET Processing Fee Account, California Beverage Container Recycling Fund	27,000
Public Utilities Commission	Public Utilities Commission Utilities Reimbursement Account	25,000
Energy Commission	Renewable Resource Trust Fund	20,000
General Services	Public School Planning, Design, and Construction Review Revolving Fund	15,000
Food and Agriculture	Department of Agriculture Account, Department of Food and Agriculture Fund	15,000
Consumer Affairs	Real Estate Appraisers Regulation Fund	8,100
Peace Officer Standards and Training	Peace Officers' Training Fund	4,000
Justice	False Claims Act Fund	3,000
Consumer Affairs	State Dentistry Fund	2,700
Consumer Affairs	Professional Engineer & Land Surveyor Fund	2,500
Consumer Affairs	Bureau of Home Furnishings & Thermal Insulation Fund	1,500
Consumer Affairs	Behavioral Science Examiners Fund	1,400
Financial Institutions	Credit Union Fund	1,350
Cal-EPA	Rural CUPA Reimbursement Account	1,300
Justice	Missing Person DNA Data Base Fund	1,000
Transportation	Historic Property Maintenance Fund	1,000
Toxic Substances Control	Site Remediation Account	1,000
Emergency Management Agency	Victim-Witness Assistance Fund	900
ABC Appeals Board	Alcoholic Beverage Control Appeals Fund	500
Alcohol and Drug Programs	Driving-Under-the-Influence Program Licensing Trust Fund	400
Consumer Affairs	Speech-Language Pathology & Audiology & Hearing Aid Dispensers Fund	300
Total		**$566,350**

ABC = Alcoholic Beverage Control; CUPA = Certified Unified Program Agency; DNA = deoxyribonucleic acid; PET = polyethylene terephthalate.

In these hearings, legislators could ask special fund departments and program stakeholders these types of questions:

- What level of reserves will the special fund have after the proposed loan repayment is executed?

- What level of reserves does the fund need to cope with routine seasonal cash flow fluctuations and/or periodic annual declines in revenue? (This answer is likely to vary among special funds.)

- When was the last time that the fund's fees were adjusted? Is a temporary or permanent fee decrease appropriate, given the proposed loan repayment?

- What special fund activities are operating well and which are operating below expectations? Is targeted additional special fund spending needed after the loan repayments? Will such spending be sustainable, given current fee levels?

- Do the special fund's activities duplicate those in other state departments or at the local or federal level? Should any of these activities be ended? Are new activities needed to address important new state priorities?

In addition to asking these questions about special funds proposed for immediate repayment, the Legislature also could consider whether any other special funds—the ones proposed by the Governor to be repaid in later years—should instead be repaid now.

EXPENDITURE ISSUES

Proposition 98

Proposition 98 funds K-12 education, the California Community Colleges (CCC), preschool, and various other state education programs. The Governor's budget increases total Proposition 98 funding by $2.7 billion—a 5 percent increase from the revised current-year level. As shown in Figure 9, the General Fund share of Proposition 98 increases by 9 percent whereas the share from local property tax revenues is projected to drop by 4 percent. (The drop is due to the tapering off of the transfer of one-time liquid assets from former RDAs.) Also shown in the figure, the year-over-year increase in Proposition 98 funding is notably greater for community colleges (10 percent) than for K-12 education (4 percent). About half of the additional increase for the community colleges is related to the Governor's proposal to restructure adult education.

Adjustments to Proposition 98 Minimum Guarantee

Estimate of 2012-13 Minimum Guarantee Changes Slightly, Grows Notably in 2013-14. For 2012-13, the administration's estimate of the Proposition 98 minimum guarantee is $53.5 billion—down $54 million from the budget act estimate. Proposition 98-related spending, however, is estimated to be $163 million above the minimum guarantee. To bring spending down to the minimum guarantee, the Governor proposes to reclassify $163 million in 2012-13 appropriations as funds for meeting a statutory obligation associated with the Quality Education Investment Act (QEIA). For 2013-14, the Governor proposes to fund at the administration's estimate of the minimum guarantee—$56.2 billion. The $2.7 billion year-to-year increase in the guarantee is

driven by the state's healthy year-to-year increase in General Fund revenues. Part of this increase is due specifically to growth in Proposition 39 revenues, as discussed below.

Includes All Proposition 39 Revenues in Proposition 98 Calculation. Proposition 39, passed by the voters in November 2012, requires most multistate businesses to determine their California taxable income using a single sales factor method, which has the effect of increasing state corporate tax revenue. The administration projects that Proposition 39 will increase state revenue by $440 million in 2012-13 and $900 million in 2013-14. The Governor's budget plan includes all revenue raised by Proposition 39 in Proposition 98 calculations, which has the effect of increasing the minimum guarantee by $426 million in 2012-13 and an additional $94 million (for a total increase of $520 million) in 2013-14.

Rebenching Adjustment for Ongoing Redevelopment Revenues Is Locked In. Over the past two decades, the state has made numerous shifts in the allocation of property taxes among cities, counties, special districts, schools, and community colleges. These shifts change the amount of property tax revenues allocated to schools and community colleges and—absent any adjustments to the Proposition 98 calculation—can unintentionally increase or decrease the minimum guarantee. To ensure that these property tax shifts have no effect on the total amount of funding schools and community colleges receive, the state "rebenches" the Proposition 98 minimum guarantee. The *2012-13 Budget Act* rebenches the guarantee to account for the shift of redevelopment-related revenues. This adjustment allows the state to achieve dollar-for-dollar Proposition 98 General Fund savings for the transfers of both ongoing residual property tax receipts and one-time redevelopment-related liquid assets. In 2013-14, the Governor updates the rebenching adjustment to reflect the revised estimates of one-time redevelopment-related liquid assets but

Figure 9

Proposition 98 Funding[a]

(Dollars in Millions)

	2011-12 Actual	2012-13 Revised	2013-14 Proposed	Change From 2012-13	
				Amount	Percent
Preschool	$368	$481	$481	—	—
K-12 Education					
General Fund	$29,368	$33,406	$36,084	$2,679	8%
Local property tax revenue	11,963	13,777	13,160	-618	-4
Subtotals	($41,331)	($47,183)	($49,244)	($2,061)	(4%)
California Community Colleges					
General Fund	$3,279	$3,543	$4,226	$683	19%
Local property tax revenue	1,974	2,256	2,171	-85	-4
Subtotals	($5,253)	($5,799)	($6,397)	($597)	(10%)
Other Agencies	$83	$78	$79	$1	1%
Totals	**$47,035**	**$53,541**	**$56,200**	**$2,659**	**5%**
General Fund	$33,097	$37,507	$40,870	$3,362	9%
Local property tax revenue	13,937	16,034	15,331	-703	-4

[a] General Fund amounts include Education Protection Account funds.

does not update the adjustment to account for revised estimates of ongoing residual property tax revenues.

Major Proposition 98 Proposals

As shown in Figure 10, the Governor's budget dedicates the increase in Proposition 98 funding to several education initiatives. For both schools and community colleges, these proposals include one-time payments to reduce deferrals as well as ongoing programmatic funding increases. In addition, the budget provides a 1.65 percent cost-of-living adjustment for a few K-12 categorical programs. The budget also funds a 0.10 percent increase in K-12 average daily attendance but assumes no increase in funded enrollment levels at the community colleges. The Governor's major proposals are described in more detail below. As discussed later in this report, the *Governor's Budget Summary* also expresses interest in rethinking school facility funding as an alternative to authorizing a new state general obligation bond. (In addition to the proposals described in this report, the Governor makes proposals relating to various aspects of charter school funding and facilities, special education funding and program consolidation, and funding for online high school and community college courses.)

Dedicates $1.9 Billion to Paying Down Deferrals. During the past several years, the state relied heavily on deferring Proposition 98 payments as a way to achieve budgetary savings. In 2008-09, for example, the state delayed $3.2 billion in Proposition 98 payments to achieve one-time General Fund savings. By 2011-12, a total of $10.4 billion in Proposition 98 payments were paid late. The *2012-13 Budget Act* dedicates $2.2 billion to retire a portion of the state's outstanding deferrals. The Governor's 2013-14 plan continues to reduce the number of late payments by setting aside $1.9 billion for this purpose. The 2013-14 proposal would reduce the state's outstanding deferrals from $8.2 billion to $6.3 billion. This reduction in deferrals would diminish the need for school districts and community colleges to borrow to support operations while awaiting the state's late payments.

Provides $1.6 Billion to Begin Implementing New K-12 Funding Formula. The Governor proposes to significantly restructure the way the state allocates K-12 funding. Similar to last year's

Figure 10
Governor's Major Proposition 98 Budget Changes
(In Millions)

Technical Changes	
Make technical adjustments	$148
Fund K-12 categorical growth	49
Fund K-12 revenue limit growth	3
Adjust for prior-year deferral payments	-2,225
Subtotal	(-$2,025)
Policy Changes	
Pay down deferrals	$1,944
Transition to new K-12 funding formula	1,630
Allocate money for energy efficiency projects	450
Provide funding for CCC adult education	300
Provide general-purpose funds for CCC	197
Add two programs to K-12 mandate block grant[a]	100
Provide cost-of-living adjustment for certain K-12 programs[b]	63
Fund new CCC online project	17
Swap one-time funds	-17
Subtotal	($4,684)
Total Changes	**$2,659**

[a] Adds Graduation Requirements and Behavioral Intervention Plans.
[b] Applies to special education, child nutrition, and California American Indian education centers.

proposal, the Governor's plan would consolidate K-12 revenue limits and almost all of the state's roughly 60 categorical programs into one streamlined funding formula with essentially no associated programmatic spending requirements. The formula would provide a base funding grant per student. The formula also would provide supplemental funding intended for districts to serve English learners and students from low-income families as well as provide lower class sizes in grades kindergarten through third and offer career technical education classes in high school. The budget proposal allocates $1.6 billion to begin increasing district rates to a target base rate, with the supplemental grants adjusted in tandem with base increases. Based on the administration's estimates, the formula would be fully implemented by 2019-20.

Proposes $450 Million for School and Community College Energy Efficiency Projects. For a five-year period (2013-14 through 2017-18), Proposition 39 requires that half of the annual revenue raised from the measure—up to $550 million—be transferred to a new Clean Energy Job Creation Fund to support projects intended to improve energy efficiency and expand the use of alternative energy. The Governor proposes to allocate all Proposition 39 energy-related funding over the next five years exclusively to school districts and community college districts ($450 million in 2013-14 and $550 million annually for the next four years). For 2013-14, the Governor's budget proposes to provide school districts $400.5 million and community college districts $49.5 million for energy efficiency projects. (Under the administration's approach, this spending would count toward meeting the Proposition 98 minimum guarantee.) The administration proposes to allocate this funding to districts on a per-student basis, with school districts and community college districts receiving $67 and $45 per student, respectively. Under the proposal, the California Department of Education (CDE) and the CCC Chancellor's Office could consult with the California Energy Commission (CEC) and the California Public Utilities Commission (CPUC) to develop guidelines for districts in prioritizing the use of the funds. Upon project completion, school districts and community college districts would report their project expenditure information to CDE and the Chancellor's Office, respectively.

Proposes Major Changes for Adult Education. Under the Governor's restructuring plan, state support for adult education would be narrowed to core instructional programs, including adult elementary and secondary education, vocational training, English as a second language, and citizenship. The administration also indicates interest in more clearly delineating among CCC adult education (noncredit instruction) and collegiate coursework (credit instruction) to ensure funding is better aligned to the type of instruction offered. Perhaps the most notable part of the Governor's restructuring plan is his proposal to fund all adult education through the CCC system. Specifically, the Governor proposes to eliminate school districts' adult education categorical program and consolidate all associated funding (about $600 million Proposition 98 General Fund) into the proposed new K-12 funding formula. The Governor's budget then provides a base Proposition 98 General Fund augmentation of $300 million to create a new adult education categorical program within CCC's budget. According to the DOF, these funds would be distributed to CCC districts using a formula based on the number of students served in the prior fiscal year. While CCC would be responsible for administering adult education, the Governor's plan would allow community colleges to contract with school districts (through their adult schools) to provide instruction to students.

Provides Almost $200 Million in Discretionary CCC Funds. The Governor's budget also provides a base increase of $197 million in Proposition 98 General Fund support for the CCC system. Unlike other state funds in the CCC budget, the Governor's proposal would allow the Chancellor's Office to make its own decision about how the funds would be distributed and for what purpose. For example, the Chancellor's Office could choose to allocate the monies to districts for enrollment growth or a general faculty salary increase. Alternatively, the Chancellor's Office could designate the funds for various special purposes, such as to improve student achievement through a competitive grant program.

Addresses Two Large School Mandates. The Governor's budget includes a $100 million augmentation to the school mandates block grant to reflect the addition of two large mandates: Graduation Requirements and Behavioral Intervention Plans (BIP). (The proposal does not identify how much funding is for each mandate but instead combines them into a single augmentation.) Notably, the Governor's proposal only provides funding for the two mandates through the block grant—it does not include any funding for districts that choose to submit claims for reimbursement. For BIP, the Governor also plans to introduce budget trailer bill language to more closely align state requirements with federal requirements, which is intended to eliminate most of the state's costs for reimbursing this mandate through the claims process going forward.

Proposes Retiring Many K-14 Obligations by End of 2016-17. The Governor's budget package includes a multiyear plan to address many of the state's outstanding K-14 wall of debt obligations. In 2013-14, 2014-15, and 2015-16, the Governor proposes to use half of the year-to-year growth in the Proposition 98 minimum guarantee to pay down the state's outstanding school and community college deferrals. A smaller payment would be required in 2016-17 to fully retire all deferrals. In 2016-17, the plan also would use $2.1 billion in settle-up payments to reduce the K-14 mandate backlog. (Roughly $1.9 billion in outstanding mandate claims would remain unpaid.) In addition, the Governor proposes to retire all of the state's obligations associated with the Emergency Repair Program and QEIA by 2016-17.

Positive Aspects of Governor's Proposition 98 Budget Plan

We believe the Governor's Proposition 98 budget plan has three particularly positive features, discussed below.

Balance of One-Time and Ongoing Spending Reasonable. Of the Proposition 98 resources available for 2013-14, the Governor dedicates $1.9 billion for one-time purposes (paying down school and community college deferrals) and uses the remainder for ongoing programmatic increases. Although no one "right" mix of spending exists, we think the Governor's generally balanced approach is reasonable. Using such an approach would allow the state to eliminate all school and community college deferrals by 2016-17—prior to the expiration of Proposition 30's PIT increases after the 2018 calendar year. Under the Governor's plan, however, an outstanding mandate backlog of $1.9 billion would remain. We recommend the Legislature also develop a plan to eliminate this backlog.

Proposal to Streamline School Finance System Has Many Positive Features. The Governor's proposal to restructure the way the state allocates K-12 funding also has many strong components. Most importantly, it would replace a complicated, top-down system with one that is more transparent, better linked with student costs, and locally driven. It also would transition gradually to the new system, ensuring that the vast majority of

districts receive funding increases in 2013-14 and the coming years, while simultaneously making progress towards a more rational distribution of funds. Though the Governor's overall school finance plan has considerable merit, we believe the Legislature could strengthen it by making a few modifications. Specifically, we recommend against the Governor's plan to exclude two large programs that have particularly antiquated funding formulas (Targeted Instructional Improvement Grant and Home-to-School Transportation) from the new formula. Additionally, the Legislature likely will want to work with the administration to explore ways to ensure that districts are using supplemental funds to benefit disadvantaged students as well as ensure districts have strong incentives to do routine maintenance on their facilities (given the state's large investment in these facilities over the last decade).

Proposal to Restructure BIP Mandate Has Several Benefits. Because revisions to federal law now provide certain behavioral-related protections for students with disabilities, we believe most, if not all, current state BIP requirements do not provide significant additional benefit for students. Thus, we believe the Governor's proposal to repeal most of the state's BIP requirements would not have adverse effects. Rather, the proposal likely would provide considerable state and local benefits. Most notably, repealing the state requirements would eliminate the administrative work associated with claiming mandate reimbursements, free up time for more student-oriented activities, and offer schools more discretion over how best to meet the needs of students with behavioral issues. Repealing the state BIP requirements also would allow the state to redirect Proposition 98 funding from reimbursing mandate costs to potentially higher Proposition 98 priorities, such as implementing a better overall K-12 funding system.

Some Concerns With Four of Governor's Proposition 98 Proposals

Though we think the Governor's Proposition 98 plan has notable positive features, we have some concerns with four of his proposals, as discussed below.

Adult Education Restructuring Needed but Governor's Plan Has Some Shortcomings. As we discuss in our recent report, *Restructuring California's Adult Education System* (December 2012), the existing adult education system has a number of major problems. Thus, the Governor should be commended for identifying adult education reform as a high state priority. We also agree with the Governor on the need to focus adult education on core instructional programs such as English as a second language and vocational education. We have some concerns, however, with his plan to consolidate adult education within the CCC system. Community colleges vary significantly in terms of the extent to which they consider adult education to be part of their educational mission. As such, some CCC districts might not be prepared to assume responsibility for adult education programs. Given the considerable variation across the state in terms of the availability of adult education instruction, we also are concerned with the Governor's plan to allocate funds to community colleges based solely on existing service levels. Given these and other concerns, we lay out an alternative approach in our recent report that would leverage the comparative advantages of both community colleges and adult schools and allocate new funds for adult education based on relative local needs.

Proposal to Add Mandates to Block Grant Raises Several Questions. Another concern is related to the administration's proposal to add Graduation Requirements and BIP to the mandates block grant. In particular, the Governor's proposal raises several questions about how to address

the exceptionally large costs of these mandates. The Governor's approach appears to assume that most districts will continue to participate in the mandates block grant rather than file claims separately. One potential problem with this plan is that it could be undermined if many districts decide to discontinue participation in the block grant and instead submit claims for reimbursement. Because annual claims for the Graduation Requirements and BIP mandates could be higher than $300 million, this risk seems notable. At the same time, the annual costs for these mandates ultimately could be significantly lower than $300 million since (1) the state recently enacted legislation to require that some of these costs be offset with other state funds, and (2) the Governor is proposing the statutory changes for BIP discussed earlier that could eliminate most of this mandate's reimbursable costs. In determining how to respond to the Governor's mandates proposal, the Legislature will need to consider these and other factors.

No Assurance Governor's Proposal for CCC Base Funds Would Be Spent on State's Priorities. We have relatively more serious concerns with the Governor's proposal to provide a nearly $200 million unallocated base increase to CCC. Over the past few years, the Legislature has enacted several pieces of legislation specifying a number of priorities it desires to fund once new CCC resources become available. These include a common assessment instrument to place incoming CCC students into appropriate coursework, additional academic counselors to help students identify and make progress toward their educational goals, and systemwide electronic student transcripts to improve campus record-keeping and efficiencies. In addition to these recently enacted priorities, the state has a number of outstanding CCC liabilities, including over $300 million that is owed to community colleges for past mandate claims. In allowing the CCC system to make its own spending decisions for the proposed base increase, the Legislature would lose assurance that the state's highest CCC priorities would be addressed.

Redevelopment Rebenching Approach Could Increase State Costs in Long Run. We also are concerned that the Governor's proposal not to update the ongoing redevelopment rebenching adjustment could result in substantial additional General Fund costs (or foregone savings) in future years. In years when the Proposition 98 minimum guarantee is determined by "Test 1," rebenching for local property tax shifts allows the state to achieve dollar-for-dollar General Fund savings. (The state automatically achieves these savings in a Test 2 or Test 3 year.) In 2012-13, the last year in which the Governor is proposing to make an adjustment for the transfer of ongoing redevelopment-related revenues to schools, the state is estimated to receive savings. Over the next several years, however, schools are expected to receive substantially more revenues as RDA debts are repaid. Without updating the rebenching adjustment, the state could enter a Test 1 year and be unable to achieve dollar-for-dollar savings for all revenues transferred. We recommend the Legislature modify the Test 1 factor, as needed, to account for the increase in revenues transferred to schools. This approach would maximize General Fund savings and ensure Proposition 98 funding reflects more accurately the sizeable shift of local property tax receipts to schools that is expected to occur over the next several years.

Serious Concerns With Governor's Proposition 39 Proposal

As discussed in more detail below, we have several serious concerns with the Governor's Proposition 39 proposal.

Treatment of Proposition 39 Revenues Highly Questionable. The Governor applies all revenue raised by Proposition 39—including the revenue required to be spent on energy-related projects—toward the Proposition 98 calculation. This is a serious departure from our longstanding view of how revenues are to be treated for the purposes of Proposition 98. It also is directly contrary to what the voters were told in the official voter guide as to how the revenues would be treated. Based on our view, revenues are to be excluded from the Proposition 98 calculation if the Legislature cannot use them for general purposes—typically due to restrictions created by a voter-approved initiative or constitutional amendment. The voter guide reflected this longstanding interpretation by indicating that funds required to be used for energy-related projects would be excluded from the Proposition 98 calculation. Given these concerns, we recommend the Legislature exclude from the Proposition 98 calculation all Proposition 39 revenues required to be used on energy-related projects. This would reduce the minimum guarantee by roughly $260 million. We also recommend the Legislature count the $450 million in allocations for energy efficiency projects as non-Proposition 98 expenditures (though the state still could choose to spend a portion on schools and community colleges). Relative to the Governor's proposal, these two recommendations combined would result in roughly $190 million in additional operational Proposition 98 support for schools and community colleges (with total state costs increasing by the same amount).

Exclusive Focus on School and College Facilities Unlikely to Maximize Energy and Job Benefits. Proposition 39 requires that the Clean Energy Job Creation Fund maximize energy and job benefits by, among other things, supporting energy efficiency retrofits and alternative energy projects in public schools, colleges, universities, and other public facilities. Proposition 39 specifically states that projects must be selected based on the number of in-state jobs they would create and their energy benefits. By dedicating all the energy-related funding over the five-year period only to school and community colleges and excluding other eligible projects that potentially could achieve a greater level of benefits, the Governor's proposal very likely would not maximize state energy and job benefits. We believe that a more effective approach would be to first evaluate the relative energy savings and job benefits among *all* potential projects.

Plan to Distribute Funding Among Districts Also Not Based on Need. The Governor's approach to distributing Proposition 39 funding does not link funding with potential benefits. Instead, the Governor proposes to provide every school district and community college district with funding on a per-student basis. This presumes the potential for energy savings is equal among all districts and does not focus on those school and community college energy projects likely to provide the greatest energy and job benefits. Most notably, the Governor's approach does not take into account that the need for energy efficiency projects varies by district, with the need depending on the size, age, and climate zone of the facilities in each district.

Proposal Lacks Other Key Components Required by Proposition 39. Proposition 39 requires that monies from the Clean Energy Job Creation Fund be appropriated only to agencies with established expertise in managing energy projects and programs. Proposition 39 also requires that funding be coordinated with the CEC and CPUC to avoid duplication and maximize leverage of existing energy efficiency and clean energy efforts. The Governor's proposal does not appear to adhere to these provisions. Specifically, because the funding is to be appropriated to CDE and the Chancellor's Office, the Governor's proposal might not meet the Proposition 39 provision requiring

funds be provided only to agencies with established energy-project expertise. Additionally, the Governor indicates that CDE and the Chancellor's Office have the option to consult with CEC and CPUC—despite Proposition 39 requiring more formal CEC and CPUC involvement.

Higher Education

California's publicly funded higher education system consists of the UC, CSU, CCC, Hastings College of the Law (Hastings), and the California Student Aid Commission. As shown in Figure 11, the Governor's budget provides $11.9 billion in General Fund support for higher education in 2013-14. This is $1.4 billion (13 percent) more than the revised current-year level. The bulk of the new funding is for base increases at the universities, a general purpose increase for the community colleges, adult education restructuring, and increased participation in Cal Grant financial aid programs. (Certain aspects of the CCC budget, including adult education restructuring, are described earlier in the Proposition 98 section of this report.) A portion of the total ongoing General Fund increase is linked with provisions of the 2012-13 budget package that appropriated $125 million each to UC and CSU in 2013-14 if they did not raise student tuition levels in 2012-13.

Governor Raises Major Concerns About Higher Education in California

The *Governor's Budget Summary* highlights several major concerns with the state's higher education system. One of the administration's concerns is the rising cost of higher education. The Governor notes that UC and CSU increased their spending from 2007-08 to 2012-13 while many other public agencies were making notable spending reductions. A large share of these additional university costs were borne by students and families over this period (though the Governor notes that California public postsecondary institutions still have some of the lowest tuition and fee levels in the country). The Governor also expresses concern with poor student outcomes, noting that graduation rates are relatively low and CCC transfer rates are very low. Another concern the Governor highlights is excess-unit taking, which unnecessarily increases higher education costs. The Governor notes that some students take units far in excess of graduation requirements and, in turn, other students have more restricted access to courses. In responding to these concerns, the Governor concludes that UC, CSU, and CCC "need to move aggressively to implement reforms to provide high-quality instruction at lower cost" by making more efficient use of faculty resources.

Figure 11
Higher Education General Fund Support[a]

(Dollars in Millions)

	2011-12 Actual	2012-13 Revised	2013-14 Proposed	Change From 2012-13	
				Amount	Percent
University of California	$2,504	$2,567	$2,846	$279	11%
California State University	2,228	2,492	2,809	317	13
California Community Colleges	3,612	3,802	4,503	701	18
Hastings College of the Law	8	9	10	—	3
California Student Aid Commission	1,533	1,624	1,722	98	6
Grand Totals	**$9,885**	**$10,494**	**$11,890**	**$1,396**	**13%**

[a] For UC, CSU, and Hastings College of the Law, amounts include general obligation bond debt service in each year. For CCC, amounts include general obligation bond debt service and funding for the CCC Chancellor's Office. For the California Student Aid Commission, amounts include federal Temporary Assistance for Needy Families and the Student Loan Operating Fund support that directly offset General Fund costs.

Major Higher Education Proposals

Proposes Multiyear Plan to Increase State Support of Higher Education. As part of his overall approach to address higher education issues, the Governor proposes a multiyear higher education budget plan. The main funding component of the multiyear plan is 4 percent to 5 percent annual base General Fund increases for each of the higher education segments over the next four years (2013-14 through 2016-17). For 2013-14, the Governor provides base increases of $125 million each for UC and CSU, nearly $200 million for CCC, and slightly less than $400,000 for Hastings. The Governor links these base increases with the segments' success in achieving certain objectives, including improving graduation rates at all segments, increasing the CCC transfer rate, and improving credit and basic skills course completion. To help achieve these objectives, the Governor expects the segments to implement certain strategies, including increasing the availability of courses, using technology to deliver quality education to greater numbers of students in high-demand courses, improving course management and planning, using faculty more effectively, and increasing use of summer sessions.

Proposes No Tuition and Fee Increases Over Extended Period. The Governor expects the universities to maintain current tuition and fee levels for the next four years. Given no increases went into effect in 2012-13, tuition and fee levels would remain flat for a six-year period (2011-12 through 2016-17).

No Enrollment Targets for Universities. Unlike historical budget practice, the Governor includes no enrollment targets for UC and CSU in the multiyear plan. The Governor indicates the universities would have full discretion in determining how many students to serve. The Governor proposes to continue to fund community college districts based on enrollment (though he proposes to change the way enrollment is calculated, as discussed below).

Proposes CCC Funding Incentive Initiative. The Governor also proposes to change the basis on which community college districts are funded for credit instruction. Currently, the amount of funding a district receives depends largely on the number of students enrolled at "census"—a point defined in CCC regulations as one-fifth into a given academic term (typically the third or fourth week of the semester). Beginning in 2013-14, the Governor proposes to add a second CCC census date at the *end* of each term. Over a five-year period, there would be a gradual shift in the relative weight of these census dates for purposes of calculating district enrollment. By 2017-18, community colleges would be funded exclusively on the number of enrolled students at the end of each term. According to DOF, any reduction in a district's enrollment monies resulting from this policy change would be automatically transferred to that district's categorical programs providing student support services (such as tutoring and counseling). According to the Governor, the purpose of the proposed change is to promote student success by providing community colleges with incentives to ensure appropriate student placement and good course management.

Proposes to Cap Number of Units State Subsidizes. In addition, the Governor proposes placing a limit on the number of units the state would subsidize per student. Under the proposal, students taking units in excess of the cap generally would be required to pay the full cost of instruction. For 2013-14 and 2014-15, the Governor proposes a cap of 150 percent of the standard units needed to complete most degrees at UC and CSU (270 quarter-units at UC and 180 semester-units at CSU). Thereafter, the Governor proposes a cap of 125 percent of the standard required units at UC and CSU—about one extra year of coursework. For the

community colleges, the Governor proposes a cap of 90 semester-units beginning in 2013-14. This cap also equates to about one extra year of coursework beyond that required for transfer. According to the Governor, the unit cap is intended to create an incentive for students to shorten their time-to-degree, reduce costs for students and the state, and increase access to more courses for other students.

Other Notable Higher Education Proposals. In addition to the proposals highlighted above, the Governor's budget shifts about $400 million to begin funding general obligation bond debt-service payments within the universities' budgets. (We discuss this proposal in more detail in a later section of this report.) The Governor also has two proposals relating to employee benefits at CSU. The Governor proposes to lock in state appropriations for CSU retirement costs based on 2012-13 payroll costs, with CSU bearing any additional retirement costs above this payroll level moving forward. The Governor also seeks to provide CSU the statutory authority to negotiate the share that current employees pay for health care benefits. Additionally, the Governor sets aside some funding in each segment to expand the number of online courses and fund other related technology projects—$17 million for CCC and $10 million each for CSU and UC. Though the Governor's budget contains no policy proposals for the state's student financial aid programs, it does reflect higher Cal Grant costs as a result of increased participation. Specifically, the administration estimates 2012-13 costs are $61 million higher than budget act estimates, with 2013-14 costs increasing an additional $100 million from the revised 2012-13 level.

Governor's Higher Education Plan on Right Track but Could Be Improved

Below, we first discuss our assessment of the Governor's overall vision and plan for higher education and then turn to an assessment of some of his more specific higher education proposals.

Overarching Objectives Deserve Serious Consideration. We believe the administration has identified several important areas of focus for California's higher education system in the coming years. In particular, we generally agree with the Governor on the need for structural reforms that will increase the productivity of the higher education system and result in lower cost per degree for students and the state. We also think the Governor's emphasis on student success and student incentives reflects important state priorities and could help focus both the higher education segments' and students' efforts.

Changes to Governor's Plan Needed to Ensure Objectives Are Met. If these overarching objectives are to be achieved, however, we believe that parts of the Governor's specific multiyear budget plan need to be further developed and refined. Though the Governor enumerates several performance expectations for the universities (for example, improving graduation and transfer rates), his plan includes no clear way to hold the segments accountable for meeting these expectations. That is, the proposal neither contains specific outcome targets nor requires the universities to report on progress toward meeting those targets. Absent specific targets and state monitoring, the Governor and Legislature would have difficulty holding the segments accountable for achieving these goals and addressing the state's priorities. This type of accountability is of particular concern given the existing mismatch between what the Governor has identified as state priorities and what the segments have identified as segmental priorities within their own budget plans. For example, the universities' own budget plans dedicate a significant portion of growth funding to faculty compensation increases. Such a budget approach could perpetuate the

traditional, high-cost higher education delivery model for which the Governor expresses concern while leaving student success and incentive initiatives unaddressed.

More Thought Needed on Funding Allocations to Segments. Despite the Governor's concern that the state's public higher education system is inefficient, costly, and not producing acceptable outcomes, the central part of his multiyear plan is unallocated base increases. Yet, it is unclear exactly why additional state funding is needed to make the segments more efficient, reduce costs, and produce better outcomes. Moreover, the Governor's plan for base increases generally attempts to treat the segments equally. In the case of UC and CSU, the Governor even proposes the identical dollar amount (despite the two segments relying to different degrees on state support). The higher education segments, however, probably should not be treated identically (either in percentage or dollar terms). It is likely that a more rational, less arbitrary allocation could prove more effective. For example, if one segment could achieve greater improvement in outcomes per dollar invested, the Legislature could consider allocating a greater share of the augmentations to that segment.

Locking in Tuition and Fee Levels for Extended Period Raises Concerns. Following several years of steep tuition increases, the Governor's desire to hold tuition and fees flat for 2013-14 is understandable. We have some concerns, however, with his proposal also to hold tuition and fees flat for an extended period. Extended tuition freezes help students who are currently in school but often lead to larger increases and greater tuition volatility for future students. Currently, tuition paid by students (after state grant aid) covers about 30 percent of education-related costs at both universities and about 5 percent at CCC. A long-term policy to maintain this share of cost or gradually change it to a specified level likely would result in more modest and predictable tuition changes for students and their families.

Governor's Census-Date Proposal Misses Opportunity for More Meaningful Changes to CCC Funding Model. We share the Governor's concern that CCC's current funding mechanism creates incentives for colleges to enroll students but provides no strong incentives to help students fulfill their broader academic objectives. We also agree with the administration that the CCC funding model would benefit from being more outcome-oriented. We are concerned, however, that the Governor's census-date proposal could create potential unintended consequences in the classroom, such as grade inflation or reductions in course rigor. The Governor's proposal also has weak justification for redirecting any reduction in a district's apportionment funds relating from the census-date change to that district's categorical programs. In effect, the Governor presupposes that students do not complete their courses because of inadequate support services, but many other factors can affect completion rates that would suggest a notably different reallocation of resources. (For example, added student support services would do nothing to address a poorly designed or taught course.) Given these concerns, we suggest the Legislature consider changes to the funding model that would place greater emphasis on more meaningful outcome measures, such as rewarding colleges for student learning gains and *program* completions (such as obtaining a degree or skills certificate) rather than *course* completions. We also suggest the Legislature rethink how best to use any funds freed up under a new outcome-oriented funding model.

Unit Caps Merit Consideration. We think the Governor's unit-caps proposal would provide incentives for colleges to streamline academic programs and improve academic counseling while also providing incentives for students to develop

focused academic plans and reduce excess-unit taking. Setting a specific unit cap, however, will require consideration of the reasons students accrue excess units, including unavailability of courses, inconsistent transfer requirements, and requirements of particular majors. The initial limit (150 percent of standard requirements) likely would not have a significant impact at the universities (as the administration indicates, most university students do not exceed this limit). The eventual limit to be imposed at the universities after two years (125 percent of standard requirements) appears to be more in line with the goal of encouraging efficient completion, though remains quite generous. As we have recommended in the past, we also believe a unit cap for the community colleges, along the lines of the one the Governor proposes, is reasonable.

Dissolution of Redevelopment Agencies

Projected RDA Dissolution Savings Reduced by One-Third. The budget assumes General Fund savings from the dissolution of RDAs of $2.1 billion in 2012-13 and $1.1 billion in 2013-14. These amounts are about one-third (a total of $1.6 billion) lower than assumed in the 2012-13 budget. Distributions of residual property taxes—former RDA property tax revenues not needed to pay agency debts—to schools are nearly $1.4 billion less than previously assumed, while distributions of former RDA liquid assets to schools are about $200 million less. Figure 12 provides additional detail on the assumed state education savings related to redevelopment dissolution and compares these figures to past estimates.

Estimates Now Appear Reasonable but Still Face Significant Uncertainty. The redevelopment savings assumed in the budget appear reasonable based on recently available information—including the amount of residual property taxes distributed to schools in January 2013 and the results of DOF's December review of some former RDA assets. However, these savings are subject to considerable uncertainty and could vary by several hundred million dollars annually, with a greater chance of the savings falling below the level assumed in the Governor's budget plan. Three primary factors contribute to this uncertainty:

- First, several key steps in the redevelopment dissolution process have yet to occur. As a result, there is little reliable information on a large category of former RDA assets.

- Second, the willingness of RDA successor agencies—the entities overseeing the dissolution of RDAs—to comply with state direction regarding redevelopment dissolution has been uneven. For example,

Figure 12

Comparing Redevelopment Dissolution Savings In Governor's Budget to Past Estimates

(In Millions)

	Residual Property Taxes	Liquid Assets	Totals
2013-14 Governor's Budget			
2012-13	$784	$1,302	**$2,086**
2013-14	559	558	**1,117**
Difference From 2012-13 Enacted Budget			
2012-13	-892	-177	**-1,069**
2013-14	-452	-42	**-494**
Difference From LAO Fiscal Outlook (November 2012)			
2012-13	107	612	**719**
2013-14	66	-91	**-25**

some successor agencies have not met anticipated timelines for performing certain procedures, while others have disputed DOF findings regarding the availability of assets for distribution to schools and other local governments.

- Finally, the outcomes of current and expected future litigation regarding redevelopment dissolution could affect state savings.

Federal Patient Protection and Affordable Care Act

The ACA, also referred to as federal health care reform, is far-reaching legislation that makes significant changes to health care coverage and delivery in California. The ACA is designed to create a health coverage purchasing continuum that makes it easier for persons to access, purchase, and maintain health care coverage. As individuals' incomes rise and fall; as they become employed, change employers or become unemployed; and as they age, they are to have access to different sources of coverage along the coverage continuum. Creating this continuum requires the modification of existing government programs and integration of these programs with new programs created by ACA. Some of the key ACA provisions include:

- ***Creates Penalties for Certain Individuals Without Health Insurance Coverage.*** Beginning January 1, 2014, the ACA requires most U.S. citizens and legal residents to have health insurance coverage or incur a penalty. This requirement is commonly known as the individual mandate.

- ***Establishes Health Benefits Exchanges.*** The ACA provides for each state to establish a health benefits exchange (Exchange). (If a state chooses not to establish an Exchange, the federal government will establish and administer an Exchange on the state's behalf.) The Exchange will function as a central marketplace for individuals, families, and small businesses to purchase health coverage.

- ***Creates Optional Medicaid Expansion.*** Beginning January 1, 2014, California has the option under the ACA to expand coverage under its Medicaid program (known as Medi-Cal) to include most adults under age 65 with incomes at or below 138 percent of the federal poverty level (FPL) who are not currently eligible for Medi-Cal—hereafter referred to as the expansion population. Beginning in January 2014, the federal matching rate for coverage of the expansion population will be 100 percent for the first three years. The matching rate will gradually decline between 2017 and 2020, at which point the state will bear 10 percent of the additional cost of health care services for the expansion population.

- ***Makes Changes to Outreach, Enrollment Processes, and Eligibility Standards.*** Beginning January 1, 2014, the ACA generally simplifies the standards used to determine eligibility for the Medi-Cal Program. In addition, the ACA includes provisions aimed at streamlining the enrollment processes and coordinating with other public entities that will offer subsidized health insurance coverage to low– and moderate–income persons. There will also be enhanced outreach activities aimed at enrolling uninsured individuals in health insurance coverage, including Medi–Cal.

The Legislature has already passed legislation to implement significant elements of the ACA. For example, Chapter 655, Statutes of 2010 (AB 1602, Perez), and Chapter 659, Statutes of 2010 (SB 900, Alquist), established the California Health Benefits Exchange. However, significant ACA implementation issues requiring legislative policy decisions and statutory direction remain to be addressed over the next several months, as discussed below. These issues include the major issue of whether or not to opt in to the optional Medicaid expansion under the ACA.

Governor Outlines Two Alternatives For Implementing Optional Medi-Cal Expansion

The administration has stated its commitment to adopting the optional Medicaid expansion authorized under the ACA. The Governor's budget summary document presents two distinct approaches—a state-based expansion and a county-based expansion. However, the administration neither indicates which approach it prefers nor provides an estimate of the fiscal impact on the state for either approach. Accordingly, the budget does not reflect any costs or savings related to the optional Medi-Cal expansion.

State-Based Expansion Approach. Under the state-based expansion approach, the state would build upon the existing state-administered Medi-Cal Program and managed care delivery system. Aside from long-term care, covered benefits for the expansion population would be similar to benefits available to the currently eligible population.

County-Based Expansion Approach. Under this alternative approach, the counties would have operational and fiscal responsibility for implementing the Medi-Cal expansion. Operational responsibilities include some functions performed by the state and Medi-Cal managed care plans to administer the program for the currently eligible population.

- Establishing networks of providers to deliver health care services.
- Setting payment rates to providers.
- Processing claims billed by providers.

Counties could build upon their existing medical programs for indigents and Low Income Health Programs (LIHPs) to operate the expansion. The county-based expansion would meet statewide eligibility standards and cover a minimum benefits package similar to coverage requirements for health plans offered on the Exchange. Counties would also have the option of covering additional benefits (other than long-term care) for the expansion population. The administration indicates this approach would likely require federal approval.

LAO Comments on Medi-Cal Expansion Proposal

More Information Is Needed. By discussing both approaches to the Medi-Cal expansion in broad terms, the Governor leaves important details to be clarified later. For example, there are many questions about how a county-based expansion would operate, including:

- ***Optional or Mandatory?*** Would operating the expansion be mandatory or optional for counties?
- ***Degree of Flexibility?*** What flexibility would counties have in establishing and/ or expanding local delivery systems? For example, would counties be able to contract with existing Medi-Cal managed care plans to provide services for the expansion population?

County-Based Option Raises Policy and Implementation Issues. The county-based option raises important policy considerations for the Legislature. For example, the ACA envisions

and, in some instances, requires administrative streamlining and simplification of health care programs for low- and moderate-income populations. Adopting the county-based option would potentially complicate these efforts. Under the state-based option, state-administered Medi-Cal would serve as the health care coverage program for nearly all qualified persons with income below 138 percent FPL—thereby simplifying program administration. In contrast, the county-based option would potentially continue fragmentation of state and local health care programs. Low-income childless adults would be enrolled in county-administered programs, while families with children and persons with disabilities would be enrolled in the state-administered Medi-Cal Program.

The county-based option also raises questions about how the expansion would be implemented in all counties by January 1, 2014. Under a state Medi-Cal waiver, most counties currently administer LIHPs, which offer coverage to at least a portion of the expansion population. However, the LIHPs differ from the state-administered Medi-Cal Program in several ways, such as offering different provider networks and covered benefits. In addition, there are a few counties that do not currently operate LIHPs. Therefore, a significant amount of time might be needed for certain counties to enhance their existing health coverage programs, or create new programs, in order to meet federal and/or state requirements for coverage provided to the expansion population.

Budget Suggests Making Major Changes to State-County Relationship

Under current law, counties are responsible for providing health care services to low-income individuals without health care coverage—a group commonly referred to as the medically indigent. The budget summary document notes that counties will realize savings associated with medically indigent adults becoming eligible for Medi-Cal under the expansion. The budget summary further asserts that state implementation of the ACA will require it to assess how much of these county savings "should be redirected to pay for the shift in health care costs to the state." While the budget summary does not specify how this redirection would occur, it refers to possible changes in the state-county fiscal relationship. Under the state-based expansion approach, the budget summary suggests an increase in county programmatic and financial responsibility for child care and other social service programs. Similarly, under the county-based expansion approach, the financial responsibility for a share of Medi-Cal costs for the expansion population would belong with the counties.

LAO Comments on Changing State-County Relationship

Effects of ACA on State and County Finances Are Subject to Significant Uncertainty. Any estimate of the net effects of ACA implementation on state and local finances is subject to substantial uncertainty at this time. Several major factors contribute to this uncertainty, including: (1) the size of the newly eligible Medi-Cal population, (2) the extent to which this newly eligible population will enroll in the program, (3) the pace at which they will enroll, and (4) the average per-person costs. In addition, a significant number of low-income Californians will remain uninsured after the expansion is adopted—including the undocumented population—and it is unclear what indigent health costs will remain after ACA is fully implemented. These residual costs will vary substantially from county to county depending on, among other things, the county's demographics and existing health care delivery system. Other aspects of the ACA, such as reduced federal funding for hospitals that serve a disproportionate

amount of Medicaid and uninsured populations, also may have significant fiscal effects on counties that operate public hospitals.

State Constitution Complicates Efforts to Change State-County Relationship. Given the provisions of the State Constitution (1) requiring the state to reimburse local governments for new programs and increased shares of costs for programs and (2) limiting state authority to change many local government revenues, developing an implementation plan that redirects county funds will be complex. Changes of the magnitude suggested by the Governor may require voter-approved amendments to the State Constitution, as was the case with the 2011 program realignment.

Time Needed to Assess Changes in State-County Relationship. As suggested by the Governor, the significant effect of ACA implementation on state and county finances requires a careful reassessment of the current state-county fiscal relationship. In light of the many uncertainties regarding ACA implementation and the complexity inherent in modifying county fiscal and program responsibilities, the Legislature may find it appropriate to delay making permanent changes in county duties and resources until after the effects of ACA implementation are clearer.

Governor's Budget Includes Some ACA Implementation Costs But Does Not Address All of the ACA's State Fiscal Effects

The Governor's budget plan incorporates some of the costs of ACA implementation. However, it does not include the fiscal effects of other aspects of ACA implementation such as modifying or eliminating certain state programs.

Placeholder for Costs Associated With Increased Enrollment of Currently Eligible Population. The Medi-Cal budget includes a $350 million General Fund placeholder for costs associated with increased enrollment among individuals who are currently eligible for Medi-Cal, but not enrolled in the program, until a more refined estimate can be developed. The ACA contains several provisions that will likely increase enrollment among individuals who are currently eligible for Medi-Cal, including simplified eligibility and enrollment procedures, enhanced outreach activities, and the individual mandate to obtain health coverage. The state will be responsible for 50 percent of the costs associated with the increased enrollment among individuals who are currently eligible. At the time this overview was prepared, it is unclear whether there are any additional ACA-related costs that are included in the administration's placeholder estimate besides costs associated with increased enrollment among the currently eligible.

Placeholder Cost Estimate May Be Too High. The estimated costs associated with the increase in enrollment among individuals currently eligible for Medi-Cal is subject to significant uncertainty. Under a moderate-cost scenario that we think is most likely, we estimate that the health care costs associated with this population would be approximately $100 million in 2013-14—significantly less than the $350 million included in the Governor's budget. Using different but still plausible assumptions, we estimate state costs could potentially be as low as $30 million or as high as $250 million in 2013-14. Therefore, even under a set of assumptions that would result in relatively high state costs, our estimates are lower than the placeholder in the Governor's budget.

Fiscal Estimates Are Incomplete. There are several potential costs and savings related to ACA implementation that are not included in the Governor's budget. As discussed above, the budget does not assume any state savings or costs associated with the optional Medi-Cal expansion. In addition, the budget does not assume savings

from reduced enrollment in other state health programs—such as the Family Planning, Access, Care, and Treatment Program and the Breast and Cervical Cancer Treatment Program—that may result from the additional health coverage options made available under the ACA. The Legislature will need to account for these and other ACA-related fiscal effects in the 2013-14 spending plan.

Key ACA Policy Decisions Remain

In addition to decisions related to the optional Medi-Cal expansion discussed above, the state has several other major ACA-related policy decisions that have yet to be made—many of which have potential fiscal effects in 2013-14. Some of the key decisions facing the Legislature include:

- Selecting the benefits that would be provided to the Medi-Cal expansion population if a state-based approach were adopted.
- Determining how to implement the new Medi–Cal eligibility standards as required by the ACA.
- Evaluating whether to modify or eliminate existing state health programs that provide services to persons who would become newly eligible for Medi–Cal or other health coverage in 2014.
- Whether or not to establish a Basic Health Program, a "Bridge Program" between Medi-Cal and the Exchange (as proposed by the Governor), or some other program intended to make coverage more affordable for populations with incomes too high to qualify for Medi-Cal.

These and other important ACA policy decisions may be informed by additional federal guidance that is expected in the coming months. As the Legislature considers these policy decisions, it will also need to consider any related fiscal effects as it constructs the state's 2013-14 budget.

California Department of Corrections and Rehabilitation

Budget Reflects Population Trends and Recent Administrative Actions

Budget Proposal. The Governor's budget provides $9 billion for the California Department of Corrections and Rehabilitation (CDCR) in 2013-14. This is an increase of $33 million (less than one percent) above the 2012-13 level. The budget reflects recent population projections showing that the average inmate population will decline by about 3,600 inmates to 129,000 in the budget year, and the parolee population will decline by about 5,700 parolees to 43,000. These population reductions are due to a 2011 policy to shift—or "realign"—responsibility for housing and supervising various lower-level adult offenders from the state to the counties. Despite the projected decrease, the inmate population is expected to exceed a federal court-imposed cap on the prison population by about 7,000 inmates at the end of 2012-13.

Recent Administration Actions. On January 7, 2013, the administration submitted a filing to the federal court requesting that it withdraw or modify the existing order requiring the prison population cap. (In response to a court order, the administration also submitted a plan for additional ways to reduce the prison population, such as early release of certain inmates. The Governor, however, has indicated that he does not support this plan.) In addition, the Governor recently terminated an emergency proclamation, originally issued by Governor Schwarzenegger in 2006, that allowed CDCR to involuntarily transfer inmates to out-of-state contract prisons. The state currently houses about 8,900 inmates in out-of-state facilities.

The Governor's proposed budget for CDCR assumes the current inmate and parolee population trends and that the state does not meet the existing court-ordered prison cap. The budget is also consistent with the termination of the emergency proclamation, reflecting reduced expenditures for out-of-state contract beds. The reduced use of out-of-state beds, however, increases the number of inmates housed in in-state prisons, contributing to the amount by which the state will exceed the court-ordered population cap. The administration plans to completely eliminate the use of such out-of-state beds by July 2016.

Court Ruling on Population Limit May Not Be Final Prior to 2013-14. It could take months or longer for the federal court to decide whether to end or modify the prison population limit currently in place, as has been requested by the Governor. For example, it took more than a year for the U.S. Supreme Court to uphold the first ruling by a federal court to institute the prison cap in California. Consequently, there may be little action for the Legislature to take with regard to meeting the existing prison cap until the courts decide this issue. If, however, the federal courts do ultimately require the state to reduce its prison population to meet the existing or a modified cap, the Legislature may want to ensure that any population reduction plan that is implemented is consistent with legislative priorities. Any plan to reduce the inmate population further would have budgetary impacts (costs and savings), the exact amount depending on the specific changes included in the plan.

Other Issues

The *Governor's Budget Summary* discusses several major issues with important long-term implications for state and local finances. Below, we briefly discuss the Governor's comments concerning infrastructure, the Unemployment Insurance (UI) Fund, and the local government mandate process. We agree with the Governor that the state needs to take action in each of these areas of state government operations.

Infrastructure

Governor Suggest Changes Needed for Infrastructure Spending Practices. The *Governor's Budget Summary* indicates that the administration is considering some changes to the state's infrastructure spending practices. The administration appears interested in identifying alternatives that limit future bond authorizations backed by the General Fund—currently the state's main source of infrastructure funding. Some alternatives mentioned in the Governor's proposal include reconsidering the state's role in funding local government infrastructure, identifying new funding sources, and creating new mechanisms to prioritize and limit capital spending.

Possible Effects on Education and Transportation, Among Other Areas. The administration discusses potential infrastructure changes in several policy areas. In transportation, the Governor plans to convene a working group to identify state spending priorities, consider long-term, pay-as-you-go funding options, and evaluate the division of responsibilities between state and local government. In higher education, the Governor once again proposes to shift the universities' general obligation bond debt-service payments into their base budgets. The administration asserts that this would limit the segments' capital spending by highlighting the trade-offs between spending on infrastructure versus operations. The Governor also suggests that now is an appropriate time to consider the state's role in funding K-12 facilities and outlines the administration's principles for any future state funding. Lastly, the administration intends to release a five-year infrastructure plan later this year, which will outline the administration's

infrastructure priorities for the next five years. (If released, this would be the first statewide plan since the introduction of the Governor's budget in 2008-09.) Consistent with the alternatives discussed above, the administration states that the plan will rely less on future voter-authorized general obligation bonds than the state has over the past decade.

Legislature Faces Key Infrastructure Decisions. Over the next few years, the Legislature faces key decisions regarding state infrastructure spending. Several infrastructure programs, such as K-12 and higher education, have exhausted their existing bond authority and lack state funding for any new projects. The Legislature and Governor also must determine how to proceed with the $11 billion water bond now scheduled for the November 2014 statewide ballot. Additionally, state departments, as well as local governments that rely on state funds for infrastructure, continue to identify infrastructure needs with costs exceeding available resources. If the state elects to maintain its current policies relating to infrastructure, meeting these infrastructure demands likely would require the Legislature to shift a larger share of the state's budget to infrastructure.

Options for Legislative Consideration. Given the state's finite resources and other non-infrastructure priorities, the Legislature could consider other options for managing its infrastructure. In many program areas, these alternatives would be similar to the ideas presented by the Governor: prioritizing the state's infrastructure investments, reevaluating the scope of infrastructure receiving state support, and identifying user fees or charges that could provide additional funding. Developing a comprehensive plan that incorporates these alternatives, however, is a complex task that requires a well-defined process for planning and financing projects. We discuss options for developing such a process in our August 2011 report, *A Ten-Year Perspective: California Infrastructure Spending.*

Accordingly, a five-year infrastructure plan and a renewed focus from the administration on infrastructure planning would be positive steps. The five-year plan or other infrastructure proposals from the Governor could provide a starting point for discussions on future funding of the state's infrastructure. What is critical in the near term is that the Legislature establish a coordinated process for reviewing the Governor's plan and articulating its priorities.

Unemployment Insurance Fund Insolvency

Federal Loans Total About $10 Billion. The UI Fund has been insolvent since 2009, primarily reflecting recession-related growth in unemployment benefit payments that exceeded the available fund balance. The state has borrowed from the federal government since 2009 to continue paying unemployment benefits, and the outstanding loan from the federal government is projected to be $10.2 billion at the end of 2013. The Governor's budget does not propose a solution to the ongoing UI Fund deficit, but instead specifies that the Secretary for Labor and Workforce Development will initiate a series of meetings by February 1, 2013 to discuss solutions to repay the federal loan and stabilize the financial condition of the UI Fund. The budget also assumes a $291 million General Fund interest payment on the federal loan for 2013-14.

Effects of the Continuing Insolvency. For each year that the state carries a federal loan balance, UI taxes paid by employers are incrementally increased. The proceeds from these increased tax revenues are used to pay down the principal on the state's federal loan. Absent corrective action, the administration projects that the federal loan will

not be fully repaid until sometime after 2020. Until then, state interest payments on the federal loan remain a significant annual liability.

Recommend Various Actions to Address Program's Financial Health. We have previously found that California's UI program has a structural mismatch between its revenues and benefit costs that predates the recent recession and cannot be sustained for the long term. In our October 2010 report, *California's Other Budget Deficit: The Unemployment Insurance Fund Insolvency*, we recommended a balanced approach of tax increases, benefit reductions, and eligibility changes to address the long-term financial health of the UI program. These policy options are still viable, and could be phased in over several years if the goal were to minimize the potential adverse economic effects of such proposals on UI beneficiaries and employers.

Local Government Mandates

Source of Friction Between State and Local Governments. For many years, the state mandate reimbursement process has been a source of friction between the state, schools, and other local governments. Last year, the state adopted a block grant program to improve the education mandate process. This year, the administration indicates that it will explore ways to improve the mandate process for other local governments, with a focus on reducing state requirements and maximizing local flexibility.

Options for Improving Local Government Mandate Reimbursement Process. Improving the mandate reimbursement process makes sense. The current process is lengthy, complex, and not oriented toward promoting good outcomes. The Legislature may wish to explore greater use by the administration of the procedures authorized in Chapter 329, Statutes of 2007 (AB 1222, Laird), such as reimbursing local governments for their reasonable costs to implement a mandate instead of requiring detailed cost documentation.

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