The 2015-16 Budget:

Overview of the Governor's Budget

MAC TAYLOR • LEGISLATIVE ANALYST • JANUARY 13, 2015

LAO

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EXECUTIVE SUMMARY

This publication is our office's initial response to the *2015-16 Governor's Budget* proposal, which was presented to the Legislature on January 9, 2015.

Higher Revenue Projections and Spending Increases. The administration projects that General Fund tax revenues will end 2014-15 more than $2 billion above its projections in last June's state budget package. Further, the administration projects that the General Fund's three major taxes collectively will increase by over $5.6 billion in 2015-16—to a level that is more than $1 billion above administration estimates from last June for the 2015-16 fiscal year. These higher revenue projections result in a multibillion-dollar influx of new funds for schools and community colleges under the Proposition 98 minimum funding guarantee. The administration's budget estimates also assume that General Fund spending for Medi-Cal, the state's primary health care program for low-income people, is up by hundreds of millions of dollars in 2014-15, compared to last year's budget assumptions, and by about $800 million above that level in 2015-16. The budget identifies other increased health and human services costs and potential budgetary risks.

Governor's Priorities Generally Prudent Ones. In the near term, the Governor's reluctance to propose significant new program commitments outside of Proposition 98 could help avoid a return to the boom and bust budgeting of the past. His proposal to pay off state government's retiree health liabilities over the next few decades would, if fully funded, address the last of state government's large unaddressed liabilities. Over the long run, eliminating those liabilities would significantly lower state costs, affording future generations more flexibility in public budgeting. The Governor, however, proposes no additional funds to implement the plan. Proposition 2 provides a stream of dedicated funding for debt payments that is available to address these retiree health liabilities.

Even Higher Revenues Likely for 2014-15. Recent strong economic data and a surge in state income tax collections in December lead us to conclude that the state likely will collect more tax revenue in 2014-15 than the administration now estimates. Barring a sustained stock market drop, an additional 2014-15 revenue gain of $1 billion to $2 billion seems likely. Even bigger gains of a few billion dollars more are possible. Additional revenues in 2014-15 will go largely or entirely to schools and community colleges and could result in a few billion dollars of higher ongoing state payments to schools. Whether tax revenues grow further, stagnate, or, in the worst case, decline in 2015-16 will depend in large part on trends in volatile capital gains and business income. History tells us that the current strength of state revenues, bolstered by a soaring stock market last year, may not continue for long. As the Governor argues, the budget remains vulnerable to downturns that may re-emerge with little warning. Building budget reserves and paying down state debts remain important goals.

OVERVIEW

The Governor's Budget Proposal

On January 9, 2015, the Governor presented his 2015-16 budget proposal to the Legislature. As shown in Figure 1, the budget package proposes spending $158.8 billion, an increase of 1 percent over revised levels for 2014-15. While the figure shows 1.4 percent General Fund spending growth, that number understates growth in program spending because of a variety of one-time factors. This total consists of $113.3 billion from the General Fund and $45.5 billion from special funds. In addition, the administration proposes to spend $5.9 billion from bond funds and $100.4 billion from federal funds. (For a summary of estimated and proposed state spending by major program area, see the appendix.)

The *2015-16 Governor's Budget* marks the first budget proposal since Proposition 2—the budget reserve and debt payment measure—was approved by voters in November 2014. Proposition 2 is highly complex and significantly alters how the state saves money in its budget reserves and pays down existing debts.

General Fund Condition

The General Fund receives most state taxes and is the state's main operating account. The Legislature must balance resources and expenditures from the fund each year. Figure 2 displays the administration's estimate of the condition of the General Fund.

Figure 1

Governor's Budget Expenditures

(Dollars in Millions)

Fund Type	2013-14 Revised	2014-15 Revised	2015-16 Proposed	Change From 2014-15 Amount	Change From 2014-15 Percent
General Fund[a]	$99,838	$111,720	$113,298	$1,578	1.4%
Special funds	38,311	45,559	45,520	-38	-0.1
Budget Totals	**$138,149**	**$157,278**	**$158,818**	**$1,540**	**1.0%**
Selected bond funds	$4,494	$5,252	$5,885	$633	12.1%
Federal funds	72,583	96,505	100,376	3,871	4.0

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

Figure 2

The Administration's General Fund Condition Statement

Includes Education Protection Account (In Millions)

	2013-14 Revised	2014-15 Revised	2015-16 Revised
Prior-year fund balance	$2,264	$5,100	$1,423
Revenues and transfers	102,675	108,042	113,380
Expenditures	99,838	111,720	113,298
Difference between revenues and expenditures	$2,837	-$3,678	$82
Ending fund balance	$5,100	$1,423	$1,505
Encumbrances	971	971	971
SFEU balance	4,130	452	534
Reserves			
SFEU balance	$4,130	$452	$534
Pre-Proposition 2 BSA balance	—	1,606	1,606
Proposition 2 BSA balance	—	—	1,220
Total Reserves	**$4,130**	**$2,058**	**$3,361**

SFEU = Special Fund for Economic Uncertainties and BSA = Budget Stabilization Account.

Despite Large Revisions, 2014-15 Ends With Nearly Unchanged SFEU Balance. In the Governor's budget proposal, the administration routinely updates estimates of revenues and spending for the last two enacted budgets, as well as the estimate of the entering fund balance for the prior year (in this case 2013-14). Over 2013-14 and 2014-15 combined, the administration projects higher revenues ($3 billion) and higher net spending ($2.9 billion) compared with figures assumed in the June 2014 budget package. (For 2014-15, overall General Fund spending for education rises $2.5 billion above last June's assumptions largely due to higher Proposition 98 requirements, and health and human services spending rises by a net amount of over $800 million.) In addition, the Governor's budget reflects a $165 million downward adjustment to the entering fund balance for 2013-14. These revisions result in an ending balance in the 2014-15 Special Fund for Economic Uncertainties (SFEU)—the state's traditional budget reserve—which is just $3 million higher than assumed in the June 2014 budget package.

Budget Proposes Total Reserves of $3.4 Billion for End of 2015-16. Under the administration's revenue projections and spending proposals, the General Fund would end 2015-16 with $3.4 billion in reserves. This total is the combination of $1.6 billion deposited in the Budget Stabilization Account (BSA) before Proposition 2, a $1.2 billion projected deposit in the BSA for 2015-16, and a $534 million year-end reserve in the SFEU. As we discussed in our November 2014 publication, *The 2015-16 Budget: California's Fiscal Outlook*, there is a strong argument that the Legislature could appropriate pre-Proposition 2 BSA balances with a simple majority vote, whereas the Governor would have to declare a budget emergency before the Legislature could access BSA funds deposited after passage of Proposition 2.

Major Features of the Governor's Proposal

Figure 3 presents the major features of the Governor's proposal.

Deposits $1.2 Billion in the BSA. Figure 4 (see page 6) displays the Proposition 2 rules and calculations relevant for the 2015-16 budget process. (Proposition 2 also created a reserve for school and community college funding under Proposition 98, but a deposit into that reserve seems unlikely in the next few years.) As shown in the figure, Proposition 2 annually captures an amount equal to 1.5 percent of General Fund revenues plus capital gains taxes that exceed a long-term historical average. Under the administration's revenue and Proposition 98 estimates, Proposition 2 captures a total of $2.4 billion. Proposition 2 requires that this total be split between debt payments and the BSA. Accordingly, the Governor's budget makes a $1.2 billion deposit in the BSA in 2015-16.

Pays Down $1.2 Billion in Debts Under Proposition 2. Proposition 2 requires that the remaining $1.2 billion be used to pay down existing state debts. The administration proposes to pay down $965 million in special fund loans and $256 million in prior-year Proposition 98 costs known as "settle up." These actions reduce the outstanding amount of special fund loans and Proposition 98 settle up to $2.1 billion and $1.3 billion, respectively. The administration's multiyear forecast proposes to dedicate Proposition 2 debt payments exclusively for these two purposes through 2018-19, thereby providing no Proposition 2 funding to address the state's large retirement liabilities—those liabilities resulting from unfunded pension and retiree health benefits—during that period.

Budget Suggests Collective Bargaining on Retiree Health Liabilities. The state prefunds pension benefits for state employees by investing contributions during those employees' working years and using these resources to pay monthly pension payments in retirement. Unlike pension benefits, the state does not prefund health and dental benefits for its retired workers. Rather, the state pays for the cost of retiree health benefits when those workers retire, a much more expensive system known as "pay-as-you-go." As of the end of 2013-14, the state recorded a $71.8 billion unfunded liability for retiree health benefits earned to date by current and past state and California State University (CSU) employees.

Figure 3

Major Features of the Governor's Budget Proposal

Budget Reserves

- Ends 2015-16 with $3.4 billion in total reserves.
  – Includes $2.8 billion in the Budget Stabilization Account and $534 million in the state's traditional budget reserve.

Paying Down State Debts

- Pays down $1.2 billion in non-retirement budget debts, to meet Proposition 2 requirements.
  – Includes about $1 billion in special fund loans and $256 million in Proposition 98 "settle up."
- Eliminates all remaining school and community college deferrals ($992 million).
- Pays down $1.5 billion of mandate backlog for schools and community colleges.
- Provides final $273 million payment for school facility repair program.
- Provides $533 million to cities and counties for mandates under 2014-15 budget "trigger."
- Plans to discuss $72 billion unfunded liability for retiree health benefits with state employee groups.

Education

- Provides additional $4 billion for K-12 Local Control Funding Formula.
- Provides additional $876 million for workforce education and training.
  – Includes funding for adult education consortia, career technical education, apprenticeships, and noncredit instruction.
- Increases community college funding by $524 million for enrollment growth, COLA, student support, and other campus priorities.
- Increases base funding by $119 million each for the California State University and the University of California.
- Augments Cal Grant funding by $69 million in 2014-15 and an additional $129 million in 2015-16 for increased participation.

Health and Human Services

- Assumes Medi-Cal caseload of 12.2 million.
- Restructures managed care organization tax to comply with federal law and to raise additional revenues in order to restore IHSS hours eliminated as a result of the 7 percent reduction.
- Reserves $300 million for costs associated with new Hepatitis C medication.
- Funds previously approved CalWORKs grant increase with redirected realignment revenues and $73 million from the General Fund.

Resources/Environment

- Appropriates remaining funds from Proposition 1E (2006) flood prevention bond ($1.1 billion).
- Allocates $532.5 million of the Proposition 1 water bond passed by the voters in 2014.
- Assumes $1 billion of cap-and-trade auction revenues.
- Spends $115 million ($93.5 million General Fund) for drought response.

Infrastructure

- Addresses some deferred maintenance issues in specified departments using about $500 million from the General Fund.

In his budget proposal, the Governor suggests bargaining with public employee unions in the coming years to begin addressing this problem. The *2015-16 Governor's Budget Summary* calls for active and future state workers to split the cost of prefunding benefits earned in the future—similar to the standard adopted by the Legislature for pensions in 2012. The Governor's budget plan—including the administration's multiyear budget forecast—provides no funding for any of these efforts through 2018-19 (the multiyear forecast's final year).

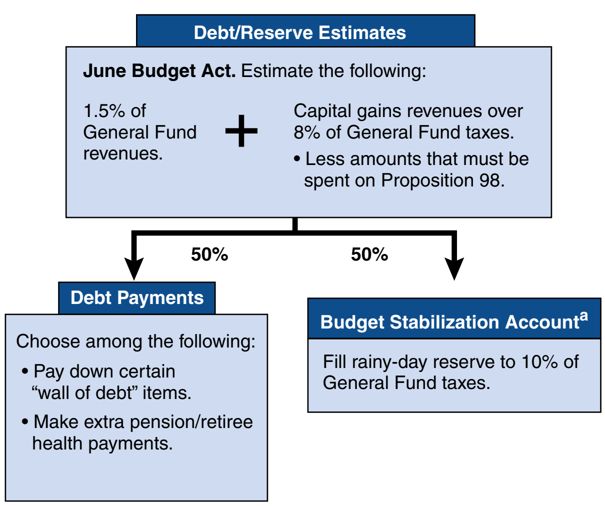
Significant New Funding for Education. The bulk of new spending under the Governor's budget is for education. The largest single education augmentation is $4 billion to continue implementing the Local Control Funding Formula, a new school funding formula adopted in 2013. The Governor also has major new proposals in the area of workforce education and training, including $500 million for adult education regional consortia. The Governor has a relatively generous budget proposal for the California Community Colleges (CCC), including funding for 2 percent enrollment growth, a 1.6 percent cost-of-living adjustment, and $200 million for student support—all on top of a $125 million unallocated base increase and various other increases related to the Governor's workforce initiative. The Governor also would retire all payment deferrals for community colleges and pay off most of the community college mandates backlog. (The Governor also retires all school deferrals and a portion of the school mandates backlog.) The Governor's main higher education proposal is 4 percent ($119 million) base increases for the University of California (UC) and CSU.

MCO Tax and Restoring IHSS Service Hours. The state imposes a tax on managed care organizations (MCOs) to draw down matching federal Medicaid funds. The federal government indicated that taxes structured like California's MCO tax do not comply with federal regulations. The administration proposes to modify the MCO tax to achieve compliance with federal law. As part of that process, the administration proposes to raise additional revenues to provide the nonfederal share of Medicaid funding necessary to restore In-Home Supportive Services (IHSS) authorized service hours that were eliminated as a result of the current 7 percent reduction in these hours enacted in the 2013-14 budget. This restoration of hours by seeking a non-General Fund funding source is consistent with an IHSS litigation settlement agreement adopted by the Legislature.

Includes Placeholder for Cost of New Hepatitis C Medication. The federal Food and Drug Administration recently approved new breakthrough drugs to treat Hepatitis C. These drugs—at $85,000 per treatment regimen—will increase costs across a few state departments. Specifically, inmates

Figure 4

Key Proposition 2 Provisions



[a] Upon budget emergency declaration by Governor and majority votes of both houses of the Legislature, deposits may be suspended or reduced.

in state prisons, patients in state hospitals, and individuals enrolled in Medi-Cal and the AIDS Drug Assistance Program will receive these medications. While costs for the new treatments are uncertain, the administration reserves a total of $600 million across 2014-15 and 2015-16 combined, split between the state General Fund and federal funds.

Proposes Spending $533 Million From Proposition 1 Water Bond. The Governor proposes spending $533 million from the $7.5 billion water bond approved by voters in November 2014. In addition, the administration proposes appropriating the remaining $1.1 billion from the Proposition 1E flood prevention bond approved by voters in 2006.

LAO COMMENTS

Preserving Budget Balance

Governor's Priorities Generally Prudent Ones. In the coming weeks, we will examine the administration's proposals and budget estimates in more detail and report to the Legislature on our findings. The Governor's budgeting philosophy continues to be a prudent one for the most part. In the near term, the Governor's reluctance to propose significant new program commitments outside of Proposition 98 could help avoid a return to the boom and bust budgeting of the past. Moreover, his proposal to address the state's retiree health liabilities over the next few decades would, if fully funded, address the last of state government's large unaddressed liabilities. Over the long run, eliminating these liabilities will significantly lower state costs, affording future generations more flexibility in public budgeting.

Budget Vulnerability Remains. Our November 2014 *Fiscal Outlook* showed how a downturn could throw the budget out of balance, although no recession appears imminent. While the budget is on track to enter the next downturn healthier than it was a decade ago, the state's finances remain vulnerable to the sudden tax revenue declines that will inevitably return with little warning. The array of complex budget formulas—especially those of Propositions 98 and 2—complicate budget planning and could exacerbate this vulnerability in some scenarios. History tells us that strong revenue periods like now are ones that require cautious budgetary decision making.

Higher Revenue Projections

Administration Revenue Numbers Higher. The Governor's plan reflects higher revenue projections compared to the administration's estimates in the June 2014 state budget plan. For 2014-15, the administration raised its General Fund revenue estimates by about $2.5 billion, with higher personal and corporate income taxes offsetting a somewhat weaker sales tax projection. In fact, over the three-year "budget window" (2013-14 through 2015-16 combined), the Governor's Budget projection for the state's "big three" revenues (personal income, sales, and corporation taxes) exceeds our office's November 2014 estimate by $1.3 billion, mostly due to the administration's $900 million higher projection for sales and personal income taxes in 2015-16. The big three taxes make up over 95 percent of General Fund revenue.

2014-15 Revenues Trending Even Higher. Midway through the 2014-15 fiscal year, the state's big three taxes already are running $3.5 billion ahead of the administration's June

2014 projections. For the entire fiscal year, the administration raised its revenue estimates by about $2.5 billion. Therefore, there is a strong possibility that revenues for 2014-15 will be significantly above the administration's new projections. Barring a sustained stock market drop, an additional 2014-15 revenue gain of $1 billion to $2 billion above the administration's new estimate seems likely. Even bigger gains of a few billion dollars more are possible. The exact amount of the likely additional 2014-15 revenue will depend in large part on the following trends:

- 2014 personal income tax (PIT) estimated payments received from high-income taxpayers over the next week (mostly just after the January 15 due date) as well as April and June 2015 income tax payments and refunds.
- The extent to which lower oil prices and the improving economy boost taxable retail sales and other economic activity in 2015.
- How the state's complex accrual policies shift 2014-15 revenue collections to other fiscal years.

Risks Associated With Near-Term Revenue Surge

Strong Revenues May Not Last Long. As we described in our November 2014 *Fiscal Outlook*, additional 2014-15 General Fund revenues likely will almost all go to schools and community colleges, thereby not benefiting the state's financial bottom line. Further, this could increase ongoing school costs by a few billion dollars per year. Yet, state revenue collections now may be peaking, due largely to surging stock prices in 2014. History cautions that this level of peak revenue will not persist for long. Weak revenue growth in an upcoming year could make it difficult to sustain state spending level, with the higher level of school spending generated in 2014-15. As such, the likely higher revenues in the current fiscal year and the resulting increase in ongoing school spending present a potential challenge for the state budget.

Reserves Needed for Budget Risks

Proposition 2 Drives Reserve Levels. Proposition 2 was approved by voters in November and affects the budget for the first time in 2015-16. As we described in our November 2014 *Fiscal Outlook*, Proposition 2 deposits funds to the state's rainy-day fund based on a series of formulas that interact with each other in complex and sometimes counterintuitive ways. (We will analyze the administration's calculations more in the coming weeks.) Under the administration's calculations, total budget reserves grow to $3.4 billion, including a $1.2 billion rainy day fund deposit under Proposition 2. This represents progress in building the state's budgetary reserves.

Are Larger Reserves Needed? With the economy now years past the last recession and with the possibility that volatile capital gains could fall, a $3.4 billion reserve provides little protection for budgetary shortfalls that can reemerge with little warning. The administration also correctly identifies several major budget risks due to federal or court actions in health and human services programs. While it would be difficult to build larger reserves under the administration's current budget estimates, more reserves now would be desirable. To the extent that 2015-16 revenue and capital gains rise above the administration's projections, Proposition 2 likely would require added reserve deposits.

Big Opportunity to Address Debts

Governor Prioritizes Wall of Debt. The Governor coined the term "wall of debt" a few years ago to cover billions of dollars of non-retirement related budget liabilities such as deferred payments to schools and loans from state accounts known as special funds. The state has made significant progress in addressing the wall of debt, including this budget's anticipated elimination of all remaining school payment deferrals. In his budget plan and multiyear budget projections (through 2018-19), the Governor proposes using the portion of Proposition 2 funds dedicated to debt payment exclusively to address the state's non-retirement liabilities, including the remaining special fund loans and prior-year Proposition 98 settle-up obligations.

Governor's Ideas About Retiree Health. The Governor and Legislature made difficult decisions in recent years to reduce future state pension costs and fully fund the California State Teachers' Retirement System (CalSTRS). In his budget proposals, the Governor mentions a number of ideas about how to address the state's largest remaining set of unaddressed retirement liabilities, those related to state government retiree health benefits (now valued at $72 billion, including CSU). We agree that it is time to start difficult discussions with state employee groups and the Legislature on these matters.

Money Needed. The Governor's budget plan articulates a goal of eliminating unfunded state retiree health liabilities within about 30 years. The indispensable component of such an effort is money. Money is needed from various public and employee sources to start paying normal costs (on the retiree benefits earned with each new year of employee service) and to ensure that existing unfunded liabilities are paid off within 30 years or whatever alternative period of time is chosen by state leaders. To meet the Governor's goal, additional payments from all funding sources may approach $2 billion per year in current dollars (growing over time). The administration does not recognize the costs of the ambitious retiree health proposal in its multiyear budget projection (which ends in 2018-19). The administration could have suggested a tentative earmark of a portion of Proposition 2 debt reduction funding during the 2020s to pay for some or all of its plan. The voters approved the dedicated funding for exactly this kind of effort.

Plan Needed for Proposition 2 Debt Payments. The administration does not provide a long-term plan for the 15 years of required annual Proposition 2 debt payments. We advise the Legislature to choose its own priorities for Proposition 2 debt payments in 2015-16 and also consider a short-term and longer-term plan for these debt payments during this legislative session. As we advised in November, we think the Legislature would benefit from soliciting proposals from the administration, the California Public Employees' Retirement System (CalPERS), CalSTRS, UC, and others on how the Proposition 2 moneys could best be used in the future. Addressing the budgetary obligations prioritized by the Governor involves certain benefits, while there would be other benefits from addressing retiree health liabilities, paying off the remaining of the old retirement system for judges, or paying down CalPERS, CalSTRS, or UC liabilities faster. By committing soon to future Proposition 2 debt payments on the retiree health liability, for example, the state potentially could reduce its unfunded liabilities in the near term and generate investment returns and federal dollars.

ECONOMY

Oil Price Collapse

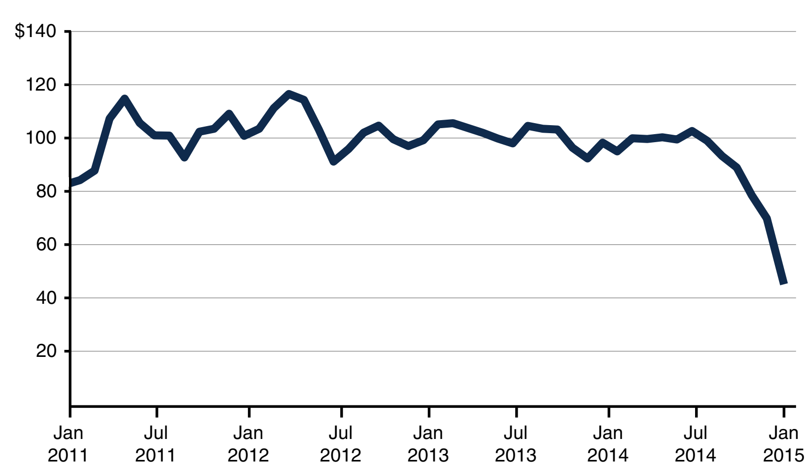
Forecast Does Not Reflect Recent Changes. The administration's new economic forecast projects that real gross domestic product (GDP) for the U.S., a key measure of overall economic activity, rose 2.2 percent in 2014 and will grow by 2.6 percent in 2015 and 2.8 percent in 2016. (A comparison of the administration's economic projections with other recent forecasts will be posted on our California Economy and Taxes blog.) This is a reasonable forecast, but by necessity, the administration had to complete most of its forecasting work before the sharp fall in worldwide oil prices of recent weeks. Like the prices in California's primary oil field displayed in Figure 5, worldwide oil prices have fallen sharply in recent months from over $100 per barrel to about $50 per barrel, with much of this drop occurring during December. By contrast, the administration's forecast assumes roughly $80 per barrel oil prices in the final quarter of 2014, as well as all of 2015. At the same time that oil price declines are helping the economy in various ways, other key economic data have been strong. For example, the preliminary estimate of California's November 2014 job growth (90,100) was the second-highest seasonally adjusted monthly increase since 1990. Based on all these trends, we currently assume that real GDP will grow slightly faster than the administration estimates in 2014 and 2015.

Low Oil Prices Help Economy in Near Term. Oil accounts for more than one third of all U.S. energy use, mostly as vehicle fuel. Some recent studies estimate that lower oil prices should cause overall U.S. economic output to rise by 0.5 percent to 1 percent on a one-time basis, accounting for both the gains to oil users and the losses to oil producers. The positive effect of a price decline on California would most likely be in the same range, if not slightly above the national average. Although California is a net consumer of oil, some areas of the state (such as Kern County) are net producers. Cheaper oil can hurt these local economies.

Figure 5

Price of Oil Dropped Sharply in 2014

Midway-Sunset Oil Price, Dollars Per Barrel



Gasoline Prices Affect Transportation Funding. As oil prices have dropped, so have California's gasoline prices. Last week, the average retail price of gasoline in California was $2.72 per gallon—down a dollar since the first week of October. When prices drop, consumers buy more gasoline. California's transportation funding relies heavily upon gasoline excise taxes. The state's gasoline excise tax has two parts, and low gasoline prices affect each part differently. The first one—an 18-cent "base" excise tax—depends only on the amount of gasoline sold. Low prices lead to higher gasoline consumption, which leads to higher revenue from the base excise tax. The second excise tax on gasoline—resulting from California's fuel tax swap—has a rate that varies from year to year. In the short run, revenue from this tax depends only on the amount of gasoline sold, so low gasoline prices lead to higher revenue. However, the year-to-year rate changes are based on a formula that incorporates past gasoline prices. That means that low gasoline prices this year will lead to a lower excise tax rate—and therefore lower revenue—in future years.

Sagging Global Economy

California's Economy Is Globally Connected. International trade is important to California's economy. The state's largest trading partners include Japan and many European nations. Over the past several months, the near-term economic outlook for many of these countries has considerably worsened. China's economy also is a concern, given inflated asset "bubbles" there and other economic imbalances. These issues may affect California in various ways over the coming year, both positive and negative. On the one hand, California households may benefit from lower-cost imports due to the recent strength of the U.S. dollar in global currency markets. Weakness in economies elsewhere in the world has caused the U.S. dollar to appreciate significantly over the last few months. On the other hand, sagging economic growth in Europe and Japan could be accompanied by falling incomes and rising unemployment there. These factors, along with higher prices resulting in part from the stronger U.S. dollar, could reduce consumer demand for California exports.

REVENUES

The administration now estimates that the big three General Fund taxes will total $105.2 billion in 2014-15 and $110.9 billion in 2015-16, a $5.6 billion year-over-year increase (including technical adjustments shown in Figure 6, see next page).

Revenue Projections Higher

Billions of Dollars More Revenues. As shown in Figure 6, the administration has raised its revenue projections since June by billions of dollars, spread across the three years of the budget window (2013-14 through 2015-16). In general, the administration has raised its personal and corporate income tax projections noticeably: PIT by $1.8 billion in 2014-15 and nearly $1 billion in 2015-16 and corporation tax (CT) by $750 million in 2013-14, over $800 million in 2014-15, and $650 million in 2015-16. Offsetting these increases, the administration has lowered its sales and use tax projections by about $500 million for 2013-14, $400 million in 2014-15, and over $500 million in 2015-16. For the big three taxes combined, which make up over 95 percent of General Fund revenues, the new administration projections increase the June 2014 budget projections by $300 million in 2013-14, $2.25 billion in 2014-15, and $1.1 billion in 2015-16.

Robust Income Tax Collections. The administration's new projections reflect recent months' strong personal and corporate income tax collections by the state, including gains in PIT withholding (generally related to employees' wage income) and low levels of CT refunds. After the administration completed its projections, the state experienced a surge in estimated PIT payments (generally by higher-income taxpayers related to capital gains and business income) in December 2014. Significant periods of income tax collections will occur over the next week, in mid-April, and in mid-June, which, collectively, will be the key to determining the eventual level of 2014-15 state revenues. The big three tax collections for 2014-15 to date, as well as strong economic and stock trends in recent months, lead us to conclude that additional 2014-15 General Fund tax revenues of $1 billion to $2 billion above the administration's

Figure 6

Comparing New Administration Revenue Projections With Other Recent Projections

General Fund and Education Protection Account Combined (In Millions)

	June 2014 Budget Package[a]	Nov. 2014 LAO (Main Scenario)	Jan. 2015 Governor's Budget
2013-14			
Personal income tax	$66,522	$66,667	$66,560
Sales and use tax	22,759	22,251	22,263
Corporation tax	8,107	8,519	8,858
Subtotals, "Big Three" taxes	($97,388)	($97,437)	($97,681)
Insurance Tax	$2,287	$2,371	$2,363
Other revenues	2,163	2,093	2,253
Transfers (net)	347	376	376
Totals	**$102,185**	**$102,277**	**$102,675**
2014-15			
Personal income tax[b]	$70,238	$72,201	$72,039
Sales and use tax	23,823	23,420	23,438
Corporation tax[b]	8,910	9,482	9,748
Subtotals, Big Three taxes	($102,971)	($105,103)	($105,225)
Insurance Tax	$2,382	$2,435	$2,490
Other revenues	2,400	2,050	2,405
Transfer to BSA	-1,606	-1,606	-1,606
Other transfers (net)[b]	-658	-540	-472
Totals	**$105,488**	**$107,442**	**$108,042**
2015-16			
Personal income tax[b]	$74,444	$74,932	$75,403
Sales and use tax	25,686	24,653	25,166
Corporation tax[b]	9,644	10,375	10,293
Subtotals, Big Three taxes	($109,774)	($109,960)	($110,862)
Insurance Tax	$2,499	$2,512	$2,531
Other revenues	2,076	2,018	2,050
Transfer to BSA	-937	-1,974	-1,220
Other transfers (net)[b]	-1,084	-1,118	-842
Totals	**$112,328**	**$111,397**	**$113,380**

[a] 2015-16 figures are Department of Finance multiyear revenue projections as of June 2014.

[b] Reflects adjustments to Governor's budget figures that make the administration's estimates more directly comparable with the LAO figures, but do not change total revenues and transfers listed. Specifically, Governor's Budget personal income and corporation taxes are adjusted upward and Governor's Budget other transfers are adjusted downward by a similar amount. The adjustment makes similar the three sets of estimates' methods for counting tax revenues related to SB 798 of 2014, the College Access Tax Credit Fund legislation.

BSA = Budget Stabilization Account.

new projections are likely, barring a sustained stock market drop during the rest of this fiscal year. Even bigger gains of a few billion dollars more are possible in 2014-15. Future trends in stock prices and business income will affect whether 2015-16 income tax collections climb further, stagnate, or, in the worst case, decline compared to this year's robust levels. Our office expects to release updated revenue projections in May.

Figure 7

Special Fund Loan Repayments Proposed in 2015-16[a]

(In Millions)

Fund Name	Amount
Unemployment Compensation Disability Fund	$303.5
Motor Vehicle Account	300.0
State Courts Facility Construction Fund	220.0
Electronic Waste Recovery & Recycling Account	27.0
Vehicle Inspection Repair Fund	25.0
Hazardous Waste Control Account	13.0
California Health Data and Planning Fund	12.0
Off-Highway Vehicle Trust Fund	11.0
Contingent Fund of the Medical Board of California	10.0
Enhanced Fleet Modernization Subaccount	10.0
Board of Registered Nursing Fund, Professions and Vocations Fund	8.3
Dealers' Record of Sale Special Account	6.5
Accountancy Fund	6.0
Private Security Services Fund	4.0
Debt and Investment Advisory Commission Fund	2.0
Debt Limit Allocation Committee Fund	2.0
Physical Therapy Fund	1.5
Behavioral Science Fund	1.2
Illegal Drug Lab Cleanup Account	1.0
Speech-Language Pathology and Audiology Fund	0.5
Driving-Under-The-Influence Program Licensing Trust Fund	0.4
Total	**$964.8**

[a] The administration's special fund loan repayment—and related Proposition 2—calculations exclude a $102 million 2015-16 payment in the budget connected to prior transfers of weight fee revenues to the General Fund. Such special fund payments are called loans in state law that governs those transactions. The administration also plans to repay a $50 million loan to the State Highway Account that was not assumed in the 2014-15 budget package.

Special Fund Loan Repayments

Loan repayments to special funds are booked on the "revenue side" of the budget as a transfer out of the General Fund (therefore, as a reduction in overall revenues). In 2015-16, the Governor proposes repaying around $1 billion of loans that special funds were required to make to the General Fund to help address multibillion-dollar annual deficits in the last decade. Figure 7 summarizes these proposed repayments. The funds listed are among the hundreds of state accounts other than the General Fund. They fund public services supported by taxes or fees collected for specific purposes.

Proposition 2 Debt Payments. The Governor's clear priority for use of dedicated Proposition 2 debt reduction payments is the repayment of special fund loans. The repayments that he identifies equal 79 percent of his proposed Proposition 2 debt payments in 2015-16. The state could pay off more or less special fund loans now than the Governor proposes, and it could prioritize other eligible Proposition 2 debt reductions, including paying off retiree health liabilities.

Oversight. When the administration proposes repaying a special fund loan, it is a good opportunity for the Legislature to exercise its oversight role concerning that special fund. Are the fund's fee or tax sources too high or too low? Should the services provided by the fund change? Are affected members of the public satisfied with services provided by the fund? Is the special fund still needed?

PROPOSITION 98

Funding for Schools and Colleges Largely Driven by Formulas. State budgeting for K-12 education, the California Community Colleges (CCC), subsidized preschool, and various other state education programs is governed largely by Proposition 98, passed by voters in 1988. The measure establishes a minimum funding requirement, commonly referred to as the minimum guarantee. Both state General Fund and local property tax revenue apply toward meeting the minimum guarantee. The Proposition 98 minimum guarantee is determined by one of three tests set forth in the State Constitution. These tests are based on several inputs, including changes in K-12 enrollment, per capita personal income, and per capita General Fund revenue.

Significant Proposed Increase in Proposition 98 Funding. The Governor's budget package includes substantial new Proposition 98 spending—a total of $7.8 billion. From an accounting perspective, $4.9 billion of this amount is related to 2015-16, $2.3 billion to 2014-15, $371 million to 2013-14, and $256 million to 2009-10. Under the Governor's budget, K-12 Proposition 98 funding rises from $8,931 per student in 2014-15 to $9,571 per student in 2015-16—an increase of $640 (7.2 percent). CCC Proposition 98 funding increases from $6,066 per full-time equivalent (FTE) student in 2014-15 to $6,574 per FTE student in 2015-16—an increase of $508 (8.4 percent).

Changes to the Minimum Guarantee

2013-14 Minimum Guarantee Up $371 Million. As shown in Figure 8, the administration's revised estimate of the 2013-14 minimum guarantee is $58.7 billion, a $371 million increase from the June 2014 estimate. Of this increase, about $200 million is due to General Fund revenue being higher than previously assumed and about $100 million is due to a 0.17 percent increase in K-12 enrollment. Revised estimates of state population and small changes to the minimum guarantee in earlier years account for the remaining difference. Estimated state costs for 2013-14 are up $70 million due to the increase in K-12 enrollment. After accounting for higher enrollment costs, state spending is $301 million below the revised estimate of the minimum guarantee.

2014-15 Minimum Guarantee Up $2.3 Billion. As shown in Figure 8, the administration's revised estimate of the 2014-15 minimum guarantee is $63.2 billion, a $2.3 billion increase from the June 2014 estimate. This increase is almost entirely attributable to General Fund revenue being higher

Figure 8

Increase in 2013-14 and 2014-15 Minimum Guarantees

(In Millions)

	2013-14			2014-15		
	June 2014 Estimate	January 2015 Estimate	Change	June 2014 Estimate	January 2015 Estimate	Change
Minimum Guarantee						
General Fund	$42,731	$42,824	$94	$44,462	$46,648	$2,186
Local property tax	15,572	15,849	277	16,397	16,505	108
Totals	**$58,302**	**$58,673**	**$371**	**$60,859**	**$63,153**	**$2,294**

than previously assumed. Test 1 remains operative in 2014-15, with General Fund revenue increases yielding a near dollar-for-dollar effect on the guarantee. The Governor revises estimated state costs for 2014-15 upward by $279 million due to higher-than-expected K-12 enrollment. These changes result in state spending that is $2 billion below the revised estimate of the minimum guarantee. (The increase in revenue mentioned above results in the state's estimated maintenance factor payment increasing by $1.2 billion—for a total estimated payment in 2014-15 of $3.8 billion.)

2015-16 Minimum Guarantee Up $4.9 Billion Over* 2014-15 Budget Act *Level. As shown in Figure 9, the Governor's budget includes $65.7 billion in total Proposition 98 funding in 2015-16. This is $2.6 billion above the revised 2014-15 guarantee and $4.9 billion above the *2014-15 Budget Act* level. This increase is driven primarily by the higher level of funding in 2014-15 and a 2.9 percent increase in per-capita personal income in 2015-16. (Test 2 is operative in 2015-16, with the guarantee affected primarily by the change in per-capita personal income. Though changes in K-12 enrollment also are part of the calculation of the guarantee, the Governor projects enrollment to be flat from 2014-15 to 2015-16.) The Governor estimates the state will make a $725 million maintenance factor payment in 2015-16—leaving an outstanding maintenance factor of $1.9 billion.

Despite Significant Growth in 2015-16 Guarantee, Only Slight Increase in General Fund Spending. As shown at the bottom of Figure 9, Proposition 98 General Fund for 2015-16 is up only $371 million (1 percent) from the prior year whereas local property tax revenue is up $2.2 billion (13 percent). The primary reason growth in local property tax revenue is so significant has to do with the end of the "triple flip." The Governor's budget assumes the triple flip ends in 2015, thereby triggering the flow of significant local property tax revenues back to school and community college districts from cities, counties, and special districts. Local property tax revenue also is higher in 2015-16 due to growth in assessed property values (at about the historical average).

Figure 9

Proposition 98 Funding

(Dollars in Millions)

	2013-14 Revised	2014-15 Revised	2015-16 Proposed	Change From 2014-15 Amount	Change From 2014-15 Percent
Preschool	$507	$664	$657	-$8	-1%
K-12 Education					
General Fund	$38,005	$41,322	$41,280	-$43	—
Local property tax revenue	13,671	14,184	16,068	1,885	13%
Subtotals	($51,675)	($55,506)	($57,348)	($1,842)	(3%)
California Community Colleges					
General Fund	$4,235	$4,581	$5,002	$421	9%
Local property tax revenue	2,178	2,321	2,628	307	13
Subtotals	($6,413)	($6,902)	($7,630)	($728)	(11%)
Other Agencies	$78	$80	$80	—	—
Totals	**$58,673**	**$63,153**	**$65,716**	**$2,563**	**4%**
General Fund	$42,824	$46,648	$47,019	$371	1%
Local property tax revenue	15,849	16,505	18,697	2,192	13

Additionally, a small part of the growth in 2015-16 is due to local property tax revenues flowing back to school and community college districts from former redevelopment agencies.

Local Control Funding Formula

Provides $4 Billion Increase for Local Control Funding Formula (LCFF). The largest funding increase in the Governor's budget is for the LCFF. As shown in Figure 10, the Governor's budget provides an additional $4 billion for LCFF, reflecting a 9 percent year-over-year increase. The Governor estimates the increase will close 32 percent of the remaining gap between school districts' 2014-15 funding levels and full LCFF implementation rates. Under the Governor's proposal, we estimate that LCFF will be approximately 85 percent funded. The Governor's plan to dedicate most additional ongoing K-12 funding to LCFF implementation is consistent with the budget approach the Legislature has taken the past two years. Dedicating almost all new ongoing K-12 funds to LCFF helps further the phase in and retains the state's emphasis on local control and flexibility.

Figure 10

Proposition 98 Spending Changes

(In Millions)

Revised 2014-15 Proposition 98 Spending	**$63,153**
Technical Adjustments	
Remove prior-year one-time payments	-$3,503
Make LCFF growth adjustments	53
Adjust energy efficiency funds	15
Provide growth for categorical programs	21
Annualize funding for 4,000 new preschool slots	15
Make other adjustments	213
Subtotal	(-$3,186)
K-12 Education	
Fund LCFF increase for school districts	$4,048
Fund Internet infrastructure grants (one-time)	100
Provide K-12 COLA for select programs	71
Increase funding for the Charter School Facility Grant Program	50
Other	2
Subtotal	($4,271)
Workforce Education and Training	
Fund adult education consortia	$500
Fund career technical education grants (one-time)	250
Fund certain noncredit courses at credit rate	49
Fund new apprenticeships in high-demand occupations	15
Increase funding for established apprenticeships	14
Subtotal	($828)
California Community Colleges	
Pay down mandate backlog (one-time)	$125
Provide apportionment increase (above growth and COLA)	125
Fund 2 percent enrollment growth	107
Augment Student Success and Support Program	100
Fund implementation of local student equity plans	100
Provide 1.58 percent COLA for apportionments	92
Subtotal	($650)
Total Changes	**$2,563**
2015-16 Proposition 98 Spending Level	**$65,716**

LCFF = Local Control Funding Formula and COLA = cost-of-living adjustment.

Workforce Education and Training

The Governor's budget proposes $876 million (Proposition 98) in additional spending for various workforce education and training initiatives, as detailed below. (Of this amount, $828 million is attributed to 2015-16 and $48 million to 2014-15.)

Proposes $500 Million for Adult Education Consortia.

The Governor's budget provides $500 million in ongoing funding for adult education programs. This proposal follows a two-year planning period in which school districts, community college districts, and other stakeholders formed 70 adult education consortia to assess, plan, and coordinate adult education services regionally. Under the proposal, the funds would support programs in five instructional areas: (1) elementary and secondary basic skills, (2) citizenship and English as a second language for immigrants, (3) education programs for adults with disabilities, (4) short-term career technical education (CTE) in occupations with high employment potential, and (5) programs for apprentices.

For 2015-16 only, the new funds would replace, dollar-for-dollar, LCFF funds currently allocated to school district-run adult education programs in these five areas. (While the exact amount of the $500 million needed for this purpose would be determined at a later date, the administration estimates it to be about $350 million.) The Superintendent of Public Instruction and the CCC Chancellor's Office would allocate the remainder of the funds to consortia based on regional adult education needs. Each consortium, in turn, would form a seven-member allocation committee representing school districts, community colleges, other adult education providers, local workforce investment boards, county social services departments, and correctional rehabilitation programs, with one public member, to distribute the funding to adult education providers within the region.

The administration indicates that it will provide a more comprehensive proposal, including a new accountability system, student placement criteria, and linked data systems following receipt of regional adult education plans. Statute requires the CCC Chancellor's Office and the California Department of Education (CDE) to submit a joint report by March 1, 2015, detailing these regional plans and making recommendations for additional improvements to the adult education delivery system.

Proposes $250 Million for CTE Incentive Grant Program. The budget provides $250 million for a competitive grant initiative that supports K-12 CTE programs that lead to industry-recognized credentials or postsecondary training. Under the Governor's plan, this appropriation is to be the first of three annual $250 million installments to support CTE infrastructure during LCFF implementation. As a condition of receiving funds, grantees would be required to provide a dollar-for-dollar match, collect accountability data, and commit to providing ongoing support for CTE programs after the grant program expires. Applicants also would be expected to partner with local postsecondary institutions, businesses, and labor organizations. Local education agencies that currently invest in CTE programs and local education agencies that collaborate with each other are to receive funding priority. The administration indicates that it will present additional program details, including grant amounts, at a later date.

Extends CTE Pathways Initiative for One Year. The Governor's plan includes $48 million to extend the CTE Pathways Initiative grant program for an additional year. The initiative is scheduled to sunset at the end of 2014-15. The initiative supports or supplements a variety of CTE programs at schools and community colleges that improve career pathways and linkages across schools, community colleges, universities, and local businesses. The CDE and CCC Chancellor's Office jointly allocate funding annually for programs through an interagency agreement. In previous years, community colleges received about two-thirds of the funding and K-12 programs received about one-third of the funding.

Increases Funding for Apprenticeships. The

Governor provides an augmentation of $29 million for apprenticeship programs (bringing total funding to $52 million). Of the augmentation, $14 million is for existing apprenticeship programs and $15 million is for new programs in occupations with unmet labor market demand. Funding would support both secondary and postsecondary programs.

Continues Existing Workforce Education and Training Programs. The Governor's plan maintains several existing CTE programs under Proposition 98. These include California Partnership Academies, Specialized Secondary Programs, the Agricultural CTE Incentive Program, the CCC Economic Development program, and the Adults in Correctional Facilities program. In addition, the budget includes $49 million to fund certain CCC workforce-related noncredit courses at the credit rate, as required by budget-related legislation adopted in 2014.

Governor's Workforce Education and Training Goals Laudable. The *Governor's Budget Summary* describes a comprehensive approach to workforce development that would align training providers and resources to meet regional and industry workforce needs. The summary characterizes the Governor's budget proposals as a first step toward this broader vision. We think the Governor's focus on coordination and alignment is laudable. Moreover, we acknowledge that forging a coherent system from multiple existing programs is a significant undertaking that will require several years to complete. We believe now is an opportune time to begin this work. Dedicated funding for two of the state's major workforce education and training programs—school district-run adult education and high school Regional Occupational Centers and Programs (ROCP)—will terminate at the end of 2014-15. Moreover, the recent reauthorization of the federal Workforce Investment Act requires enhanced coordination across workforce development providers.

Plan Limits Disruption to Existing Programs. The Governor's plan takes steps to minimize disruption for established adult education providers and ROCP programs during the transition to a more coordinated workforce development system. Specifically, by protecting funding for adult education programs for an additional year and setting a clear expectation that regional consortia will allocate funds following this transition period, the budget retains some continuity of adult education services. Similarly, providing grant funding opportunities for ROCPs for three more years could minimize disruption of their services during the transition to LCFF and development of the new workforce development system.

More Work Needed to Unify Workforce Development Efforts. Although we believe the Governor's workforce initiative contains laudable goals, we believe it has room for improvement. Notably, although the Governor's plan emphasizes regional collaboration, it does nothing to streamline existing, overlapping regional groupings—including the 15 CCC economic development regions, the 49 workforce investment boards, the 70 adult education consortia, and numerous other ad-hoc groupings emerging from recent grant initiatives (such as regional partnerships formed in response to the Career Pathways Trust program). Having so many overlapping regional agencies creates significant duplication for workforce development providers and makes creating coherent programs much more logistically challenging.

In addition, the Governor's proposals could further fragment workforce efforts by augmenting certain existing programs while simultaneously creating new programs with similar workforce objectives. This fragmentation is further exacerbated because adult education consortia also are entrusted with fulfilling similar workforce objectives—CTE and apprenticeships being two of their five priority areas (as specified in statute). We are concerned that such a piecemeal approach could be counterproductive and result in additional redundancies and inefficiencies in the state's workforce development system.

Internet in Schools

Proposes Additional $100 Million for Internet Infrastructure Improvements. The Governor's budget includes $100 million in one-time funding for CDE to administer a second round of Broadband Infrastructure Improvement Grants (BIIG). (The 2014-15 budget provided $26.7 million in one-time funding for the first round of BIIG awards.) These competitive awards would be used to pay for the costs of improving Internet infrastructure to school sites (also known as schools' "last-mile connections"). Eligible applicants must demonstrate they are unable to administer the new Smarter Balanced Assessment Consortium online tests or unable to administer the tests without curtailing their other Internet activities. Grantees must commit to funding the ongoing costs of their new Internet service from their general purpose funds.

Initial Concerns With Governor's Proposal. One initial concern with the Governor's proposal is that the amount of proposed funding does not appear to be linked with an assessment of existing Internet capacity required to administer the online tests. (The K-12 High Speed Network, in consultation with CDE and the State Board of Education, is currently preparing such an assessment. Statute requires this report to be submitted by March 1, 2015. This assessment might help determine how much additional funding, if any, is warranted.) Another initial concern is that the proposal appears to reward certain districts that have chosen to invest less in Internet infrastructure than other districts. The proposal also does not appear to address key underlying issues, such as the willingness of providers to build infrastructure in certain areas of the state.

Outstanding Obligations

Building upon efforts of the past few years, the Governor's budget also includes proposals to pay down outstanding education obligations, as discussed below.

Provides $1.5 Billion to Reduce Mandate Backlog. Estimates of the state's backlog of unpaid claims for education mandates ranges from $4 billion to $5 billion (largely depending on the outcome of active legislation). The Governor proposes to provide $1.5 billion ($1.1 billion for schools and $379 million for community colleges) to reduce this backlog. (From an accounting perspective, $93 million of this amount is scored to 2009-10, $301 million to 2013-14, $975 million to 2014-15, and $125 million to 2015-16.) Funds would be distributed to schools and community colleges on a per-student basis. The Governor indicates the funds for schools could help them implement the academic standards adopted by the state several years ago, though districts are free to spend the funds for any purpose. Similarly, the Governor expects community colleges to use their funds for deferred facilities maintenance, instructional equipment, and other one-time costs, though these funds also may be used for any purpose.

Provides $992 Million to Retire All Remaining Deferrals. As of the *2014-15 Budget Act*, the state had $992 million in outstanding payment deferrals (that is, late payments to schools and community colleges). Of this amount, $897 million relates to schools and $95 million relates to community colleges. The 2014-15 budget package included a statutory provision providing that any increase in the 2013-14 or 2014-15 minimum guarantees first be used to pay down these deferrals. Consistent with this requirement and the updated estimates of the 2013-14 and 2014-15 minimum guarantees, the Governor's budget package includes $992 million to eliminate all deferrals.

Provides Final $273 Million Payment for Emergency Repair Program (ERP). The ERP was created in 2004 through legislation associated with the *Williams* settlement. The program was intended to provide low-performing schools with a total of $800 million for emergency facility repairs. (Of the $273 million proposed for ERP in 2015-16, $163 million comes from a settle-up payment and $110 million comes from unspent prior-year Proposition 98 funds.) Given the state already has provided $526 million for this program, the additional $273 million payment would retire the state's ERP obligation.

Proposed Budget Makes Notable Progress Toward Retiring Education Obligations. The Governor's budget package would allow the state to retire two obligations that have been outstanding for many years. By paying down the remaining deferrals, the state would return to the statutory payment schedule for the first time since 2000-01. For schools and community colleges, returning to the days of timely state payments likely will improve cash flow and reduce reliance on short-term borrowing. For ERP, more than ten years has elapsed since the time the state decided to reimburse districts for emergency repairs. For mandates, though the Governor's plan does not eliminate the backlog, it makes significant progress in paying it down. We believe the Governor's approach to paying off existing obligations makes sense, particularly while state revenues are strong and before the next economic downturn.

Proposition 98 Budget Planning

As discussed earlier in this report, the state's 2014-15 revenue estimates could be up significantly come May relative to the Governor's budget. What might happen to state revenues thereafter is uncertain. Changes to the state's revenue condition will have important implications for Proposition 98 programs—affecting both how much Proposition 98 funding is available and how the Legislature might want to allocate this funding among one-time and ongoing purposes. We discuss these implications in more detail below.

2014-15 Guarantee Could Be Up Notably in May, With Additional One-Time Proposition 98 Funding Required. As mentioned earlier, the guarantee in 2014-15 is highly sensitive to changes in state General Fund revenue, with a near dollar-for-dollar effect on the guarantee. That is, if 2014-15 revenue estimates were to be revised upward by $2 billion this coming May, then the estimate of the 2014-15 guarantee likewise would increase by about $2 billion. The Legislature could begin considering how it might allocate such a large, year-end funding increase to schools and community colleges.

A Caution Against Committing All New Funds to Ongoing Purposes. Were stock market prices to drop in 2015 or growth in the economy and personal income to slow, the guarantee could drop from the level now proposed by the administration for 2015-16. Such a scenario serves as a caution against the state committing all available 2015-16 monies within the Proposition 98 guarantee for ongoing purposes. Were the Legislature to commit all these funds for ongoing purposes, it then would be in the problematic position of having to cut ongoing programs, potentially backpedalling in its implementation of the LCFF.

HIGHER EDUCATION

More Than $1 Billion General Fund Increase for Higher Education. California's publicly funded higher education system consists of UC, CSU, CCC, Hastings College of the Law, the California Student Aid Commission, and the California Institute for Regenerative Medicine (CIRM). As shown in Figure 11, the Governor's budget provides $14.4 billion in General Fund support for higher education in 2015-16. This is $1 billion (8 percent) more than the revised 2014-15 level. About half of the additional funding is for adult education consortia (discussed in the Proposition 98 section of this report). The Governor's other major policy proposals (discussed below) fund base increases at the segments, CCC enrollment growth, CCC student support services, and an award program to increase graduation rates at CSU. The budget also includes funding (not discussed below) for increased participation in Cal Grants, the second-year phase-in of Middle Class Scholarships, and bond repayments that support CIRM research. An additional proposal to fund deferred maintenance at UC and CSU is discussed in the Infrastructure section of this report.

Governor's 2015-16 Higher Education Plan Somewhat Better Tailored to Challenges Facing UC, CSU, and CCC. In his last two budget proposals, the Governor treated the state's two public university systems virtually identically, even though the two systems differ in missions, cost structures, and outcomes. One laudable feature of the Governor's budget plan for 2015-16 is a tailoring of certain proposals to the main challenges facing the different systems. Most notably, the Governor has a proposal for UC that primarily attempts to constrain costs (which remain high compared to other public research universities) and a proposal for CSU that attempts to improve student outcomes (which remain low by various measures). The Governor also targets funding toward student support services at CCC, whose students continue to have very low program completion and graduation rates. Targeting funding proposals to the unique challenges facing each segment is a more effective use of state resources. Though the Governor's plan generally is better tailored than previous years, some of the Governor's proposals treat the segments differently without solid justification.

Figure 11

Higher Education General Fund Support[a]

(Dollars in Millions)

	2013-14 Actual	2014-15 Estimated	2015-16 Proposed	Change From 2014-15 Amount	Change From 2014-15 Percent
University of California	$2,844	$2,991	$3,131	$140	5%
California State University	2,769	3,026	3,179	153	5
California Community Colleges	4,622	5,019	5,443	424	8
California Student Aid Commission	1,703	2,011	2,226	216	11
California Institute for Regenerative Medicine	95	271	383	112	42
Hastings College of the Law	10	11	12	1	13
Awards for Innovation	—	50	25	-25	-50
Totals	**$12,043**	**$13,378**	**$14,399**	**$1,021**	**8%**

[a] Includes General Fund support paid from outside the higher education agencies' budgets for their retirement, facilities, and other costs. Also includes monies that directly offset General Fund.

Base Increases

Proposes Cost-of-Living Adjustment (COLA) for Community Colleges. The Governor provides the community colleges with a $92 million (1.6 percent) COLA. The COLA is calculated pursuant to a formula in state law that uses a state and local price index for government agencies.

Proposes Three Unallocated Base Increases. In addition to the COLA for the community colleges, the Governor provides the system with a $125 million (2.1 percent) unallocated base increase to account for increased operating expenses "in the areas of facilities, retirement benefits, professional development, converting part-time to full-time faculty, and other general expenses." For each UC and CSU, the Governor proposes $119 million (4 percent) unallocated base increases. These increases represent the third annual installment in the Governor's four-year funding plan. Under this plan, the universities received 5 percent annual base funding increases in 2013-14 and 2014-15 and would receive another 4 percent increase in 2016-17. For UC only, the 2015-16 base increase is contingent upon the university (1) not raising tuition in 2015-16, (2) not increasing nonresident enrollment in 2015-16, and (3) taking action to constrain costs. The Governor further expects UC to form a committee, supported by staff of the UC Office of the President and the Governor, to develop proposals to reduce costs, enhance undergraduate access, and improve time-to-degree and degree completion.

Unallocated Approach Raises Concern. Of the four base increases provided by the Governor, only the COLA for the community colleges is associated with a specific purpose. That is, the COLA provided to the community colleges is widely understood to cover increased general operating expenses—such as for faculty and staff salaries and classroom materials—as measured by an inflation index specified in statute. In contrast, the Governor remains silent on the objective of the base increases for UC and CSU, and he does not convey the objective of the additional base increase for CCC clearly (that is, the associated CCC language identifies myriad possible uses, without ensuring that the funds actually are spent on those identified priorities). Because the Governor does not clearly articulate the justification for these three unallocated base increases, the Legislature likely will have difficulty assessing whether the augmentations are needed and ultimately whether any monies provided would be spent on the highest state priorities.

Unallocated Base Increases to UC and CSU Could Be Converted to COLA. A reasonable case could be made that the Governor intends for the UC and CSU unallocated base increases to function as COLAs. For example, both universities' governing boards adopted budgets in November 2014 that assume additional state funds for general cost increases. Moreover, the base increases provided by the Governor are in the ballpark of the COLA he provides to the community colleges. The Legislature could consider taking a more transparent approach that links funding with expected costs by providing base increases for the universities based on an inflation index. Such an approach would be consistent with the way the state in the past has budgeted for UC and CSU and the way it currently budgets for schools and community colleges. Furthermore, the approach itself (replacing unallocated base increases with a COLA and other targeted appropriations) likely would help foster a clearer dialogue regarding the amount required to fund specific higher education priorities, such as enrollment growth, improved student outcomes, pension obligations, and facility maintenance.

Tuition

Assumes No Tuition and Fee Increases. Although the Governor acknowledges in his budget summary that public higher education in California is relatively affordable for resident students (due to high public subsidies, relatively low tuition and fees, and robust financial aid programs), he expects the universities to maintain tuition at current levels. The Governor also proposes no fee increase at the community colleges. UC, CSU, and CCC resident tuition/educational fee levels have been flat since 2011-12.

Changing the Tuition Debate. Currently, much of the discussion surrounding university funding is centered around *who* should pay for cost increases—students and their families or the state. In our view, an equally, if not more important, question pertains to the *overall cost* of a college education and how it increases from year to year. One of the main reasons we have long argued for a share-of-cost fee policy is that any cost increases would affect all parties—state taxpayers, the universities, and students—such that all parties have an interest in monitoring costs and scrutinizing proposed cost increases while keeping an eye on quality and affordability. That is, the first order of such a policy is to shed greater light on overall cost and improve the public dialogue around whether cost increases are appropriate given all competing higher education objectives. A share-of-cost policy also has other benefits, including potentially reducing future volatility in fee levels and resulting in generations of students being treated more equally over time (if the policy were consistently applied).

Enrollment

Governor Expresses Major Concerns With Enrollment-Based Budgeting. Similar to his 2013-14 and 2014-15 budget proposals, the Governor outlines a number of serious concerns with enrollment growth funding. In particular, the Governor asserts that funding enrollment growth does not encourage postsecondary institutions to focus on affordability, student completion, and educational quality. He further states that enrollment-based funding fails to provide incentives for institutions to increase the productivity of the higher education system as a whole.

Provides Enrollment Growth at Community Colleges but Not Universities. The Governor provides $107 million for 2 percent enrollment growth at CCC. This equates to serving about 23,000 additional full-time students. In contrast, the Governor proposes no resident enrollment targets or enrollment growth funding for the universities, consistent with his critique of enrollment-based funding. The Governor's budget documents show resident enrollment flat in the budget year at UC and growing by 0.8 percent at CSU. (In a November 2014 report to the Governor and the Legislature, UC indicated that it would reduce resident enrollment by about 2 percent in 2015-16 unless it receives a larger base augmentation than the Governor proposes. How UC ultimately will adjust 2015-16 enrollment levels in response to the Governor's budget proposal remains unclear.)

Access, Quality, and Cost Controls All Important State Priorities. The Governor makes reasonable observations about the lack of incentives in enrollment-based funding for institutions to improve student outcomes and reduce costs. Nonetheless, linking funding with enrollment serves an important state purpose because it (1) expresses the state's priority for student access and (2) connects funding with student-generated costs. Despite these benefits, the Governor continues to discard the state's longstanding enrollment funding practices for UC and CSU. The administration also has not been supportive of funding a new university eligibility study—as a result, the state has limited information on whether UC and CSU continue to meet Master Plan goals for student access. In contrast, the budgeting approach the Governor takes with CCC, by funding both enrollment and student success, appears to better balance the twin goals of access and quality.

Student Support Services

Proposes Major Augmentation for CCC Student Support. The Governor proposes a $200 million augmentation to CCC's Student Success and Support Program, bringing the total for the program to $472 million. Of the $200 million, the Governor designates half to increase assessment, placement, and orientation for new students, as well as academic counseling and tutoring for both new and continuing students. The CCC Chancellor's Office would allocate these funds based in part on the number and types of support services each district provides. The Governor designates the remaining $100 million to implement local student equity plans. The purpose of these plans is to improve access and outcomes (such as degree or certificate completion) for all students, identify any disparities in achievement for disadvantaged groups, and address any such disparities. The Chancellor's Office would allocate these funds based in part on measures of disadvantage, such as a district's poverty and unemployment rates. (Community colleges could provide the same types of activities under both components of the proposed augmentation but likely would further target activities under the second component to disadvantaged groups.)

Focus on CCC Student Success Warranted, but Approach May Be Too Limited. Several recent reports and CCC outcome data support the need for more attention to CCC student success, and the Legislature has shown strong interest in improving student outcomes. As we noted in our *2014-15 Analysis of the Higher Education Budget*, however, we are concerned that the Governor's approach is too narrowly focused. As state and national research has shown, some types of students can benefit from different support services and many students can benefit from multiple types of support. Currently, the state funds specific types of support for CCC students through eight separate categorical programs. Providing more flexibility to use student support funds would enable colleges to allocate funding in a way that best meets the needs of their students. In addition, the Legislature could explore ways to make improvements in student outcomes a factor in the allocation of support services funding.

Awards for Innovation in Higher Education

Proposes Targeting Awards to Improving Graduation Rates at CSU. The Governor proposes $25 million in one-time awards to CSU campuses that are implementing initiatives to improve four-year graduation rates. This proposal differs from the 2014-15 awards, which will be granted to UC, CSU, and CCC campuses that are achieving a broader set of goals. Similar to last year's awards, a committee comprised of appointees from the Department of Finance, the governing boards of the segments, and the Legislature would make award decisions in a competitive process.

Proposal Raises Several Questions. Consistent with the Governor's emphasis, data suggest that CSU student performance is lackluster, with only 18 percent of full-time freshmen graduating within four years and only about half graduating within six years. The causes of the performance problem and how best to respond to them, however, are less clear. Are CSU's low graduation rates due to lack of preparation among entering freshmen, low retention rates from freshmen to sophomore year, poor fee and financial aid incentives, weak incentives to take 15 units per term, students working excessive hours, lack of access to required courses, or other problems? The Governor's approach to innovation awards appears to tackle a single symptom—that is, low graduation rates—without more comprehensively and systematically addressing underlying issues. We also continue to think relying solely on a small, one-time earmark is a poor budgetary approach for addressing a longstanding CSU performance problem, particularly given student success is so central to CSU's ongoing mission.

HEALTH AND HUMAN SERVICES

Budgetary Uncertainty Related to Federal Actions

The Governor's budget proposal for health and human services (HHS) programs reflects significant fiscal uncertainty relating to federal actions in a number of programmatic areas. We highlight these uncertainties in Figure 12 and discuss some of the key ones in greater detail below.

Figure 12

HHS Budgetary Uncertainty Related to Federal Actions

Issue	Budgetary Uncertainty
Implementation of new federal labor regulations for IHSS and DDS	The 2015-16 budget includes a combined total of $338 million General Fund in IHSS and DDS to make overtime and other required payments pursuant to new federal labor regulations. However, if litigation in the federal courts challenging the legality of the federal regulations is successful, the state would realize General Fund savings.
Pending Presidential executive action on immigration	If the President's executive action takes effect, some undocumented immigrants may newly qualify for state HHS programs, including Medi-Cal and IHSS. This would result in General Fund costs that could be in the hundreds of millions of dollars annually.
Federal funding of developmental centers (DCs)	The budget assumes that the state will retain federal Medicaid funding for DCs, despite DCs not meeting federal certification requirements. If the state does not make sufficient improvements to DCs, then a total of about $95 million in annual federal funding is at risk. Historically, lost federal funds for the DCs have been backfilled with General Fund monies.
Federal CalFresh administration funding target	The federal government typically pays 50 percent of CalFresh administrative costs. However, projected need for federal funds in 2014-15 and 2015-16 exceeds a federal funding maximum target. In the past, federal administrative funds from other states that spend below their respective targets have been made available to California. To the extent that such funds are not available, as much as $270 million in additional General Fund spending would be required over the two years should the state backfill the lost federal funds.
Federal Title IV-E funding (foster care) disallowance	The federal government identified an instance of noncompliance with Title IV-E foster care regulations and has ordered the state to repay Title IV-E funds, with interest, that were disallowed because of the noncompliance. The state has appealed the disallowance, but has also set aside $50 million (General Fund) should the appeal be rejected. These set-aside dollars would become available for other purposes should the state's appeal succeed.

HHS = Health and Human Services; IHSS = In-Home Supportive Services; and DDS = Department of Developmental Services.

The common theme of the budgetary uncertainties displayed is that all items relate to federal actions—including both recently enacted and pending ones—where the status of the federal action is currently uncertain and, in some cases, where the state budgetary implications of the federal action, even if it takes effect, are unclear. In some cases, a lack of accounting for a federal action in the Governor's budget or the making of what turns out to be an erroneous assumption about a federal action could ultimately result in added budgetary cost pressures. This is the case, for example, with the Governor's budget not assuming any additional HHS program costs from the President's pending executive order on immigration. In other cases, however, budgetary assumptions have been made that could ultimately turn out differently and result in budgetary savings. This is the case, for example, with the budget's assumption that recent federal labor regulations affecting IHSS and the Department of Developmental Services (DDS)—currently being challenged in the courts—will stay in effect and result in significant new costs for these two program areas.

Crosscutting Issues

Budget Proposes to Restructure Managed Care Organization (MCO) Tax to Comply With Federal Requirements . . . The state currently imposes a 3.9 percent tax on Medi-Cal MCOs' gross receipts. Under existing law, this MCO tax expires June 30, 2016. The state uses the tax revenue to draw down federal Medicaid funds. The state then uses these federal funds to (1) reimburse Medi-Cal MCOs for the amount of tax paid and (2) offset General Fund spending in Medi-Cal. The federal government recently indicated that taxes structured like California's MCO tax are impermissible sources of revenue for drawing down federal Medicaid funds. The federal government has advised that California—by no later than the end of this legislative session—make changes necessary to bring their tax structures into compliance. The Governor's budget proposes to restructure the state's MCO tax to both comply with federal Medicaid requirements and fund additional purposes, as described immediately below.

. . . and to Fund Restoration of Service Hours for IHSS. Under the Governor's proposal, revenues from the restructured MCO tax will draw down sufficient federal funds to maintain the current General Fund offset ($1.1 billion in 2015-16). The restructured tax will also raise an additional $216 million in 2015-16. This amount will provide the nonfederal share of Medicaid funding needed to restore IHSS hours that were eliminated as a result of the current 7 percent reduction in service hours initially enacted as a budget solution in a prior year. The total cost of restoring these IHSS hours is estimated to be $483 million.

Budget Includes Funds for High-Cost Hepatitis C Drugs. The Governor's budget includes $100 million General Fund in 2014-15 and $200 million General Fund in 2015-16 to pay for new breakthrough drugs used to treat Hepatitis C. These funds are currently not allocated to specific departments, but are reserved for the state's drug costs in treating certain individuals infected with Hepatitis C. These include inmates in state prisons, patients in state hospitals, and individuals enrolled in Medi-Cal and the AIDS Drug Assistance Program. The administration expects these drugs to cost approximately $85,000 per treatment regimen, making them costly relative to most other prescription drugs. There is uncertainty around the exact cost of these drugs and the medical guidelines for prescribing them to individuals infected with Hepatitis C. Given this uncertainty, the amount of funds set aside in the Governor's budget will likely be adjusted as new information becomes available.

Potential Costs Related to President's Immigration Actions. The Governor's budget does not include funding for potential costs related to the President's recent executive actions on immigration. These actions, which are currently pending, are intended to allow certain undocumented immigrants to temporarily stay in the United States without fear of deportation. If the actions are implemented at the federal level, then under existing law some undocumented immigrants may newly qualify for full-scope Medi-Cal, IHSS, and/or the Cash Assistance Program for Immigrants. (The benefits received by undocumented immigrants through these programs are almost entirely funded by the state.) This would result in General Fund costs that could total in the hundreds of millions of dollars annually.

Legal Uncertainty of Federal Labor Regulations Could Create Savings for IHSS and DDS. In 2013, the federal Department of Labor issued regulations for the home-care industry that impact the state's IHSS program and DDS. Under these regulations (originally to take effect in January 2015), the state is required to make overtime payments as well as payments for newly compensable work activities to IHSS providers and provide funding in the DDS budget to enable home-care vendors to make overtime payments. For IHSS, the budget includes a total of $316 million General Fund to fund overtime payments and other newly compensable work activities of IHSS providers. For DDS, the budget includes $22 million to increase rates to vendors that provide home care services to individuals with developmental disabilities. However, a recent federal court case challenges the legality of the new federal labor regulations. The presiding federal district court judge has issued a temporary stay of the regulations until a court hearing scheduled for January 14, 2015. If the outcome of the federal court case ultimately renders all or some of the new federal labor regulations unenforceable, then the state would realize General Fund savings.

Medi-Cal

Budget Assumes Increased Medi-Cal Local Assistance Spending in 2014-15 and 2015-16. The Governor's budget proposes revised 2014-15 Medi-Cal local assistance spending of $17.8 billion General Fund, a $560 million increase, or 3.2 percent, over the 2014-15 budget appropriation. The budget also proposes 2015-16 Medi-Cal spending of $18.6 billion General Fund, a $771 million increase, or 4.3 percent, over revised 2014-15 spending. The increases in Medi-Cal spending are due to a variety of factors, and we are continuing to evaluate these estimates.

Assumes Medi-Cal Caseload of 12.2 Million. The Governor's budget assumes total annual Medi-Cal caseload of 12.2 million for 2015-16. This is a 2.1 percent increase over the revised caseload estimate for 2014-15. The budget projects annual caseload associated with the Patient Protection and Affordable Care Act (ACA) will be 3.3 million, or a 3.8 percent increase compared to 2014-15. This includes 1.1 million enrollees who were previously eligible for Medi-Cal prior to the ACA's implementation. These previously eligible individuals—referred to as the *mandatory* expansion—are assumed to have enrolled as a result of eligibility simplification, enhanced outreach, and other provisions and effects of the ACA. The budget also projects 2 million enrollees—mostly childless adults—who became newly eligible for Medi-Cal under ACA. This is referred to as the *optional* expansion. The remaining 200,000 enrollees are associated with other changes under the ACA, such as express lane enrollment and hospital presumptive eligibility. (Both are streamlined processes that allow certain individuals to enroll in Medi-Cal without completing a full application.)

Developmental Services

Budget Assumes Increased DDS Spending in 2014-15 and 2015-16. The revised DDS budget for 2014-15 is $3.1 billion General Fund, an increase of $137 million (4.6 percent) above the 2014-15 budget appropriation. The 2015-16 budget is proposed to be $3.3 billion General Fund, an increase of $201 million (6.5 percent) above the revised 2014-15 level. Our understanding is that a key driver of these budgeted cost increases is due to caseload growth and higher utilization, and we are continuing to evaluate these estimates.

Federal Funding for Developmental Centers (DCs) at Risk. The state's Department of Public Health (DPH) licenses health facilities and certifies them on behalf of the federal government. Facilities must be certified in order to receive federal Medicaid funding. The state's three DCs—Fairview, Porterville, and Sonoma—have recently been found by DPH to be out of compliance with federal certification requirements generally related to clients' health, safety, and rights. For instance, some DC residents were found to be inadequately protected from abuse or harm. Currently, four living units at Sonoma DC no longer receive federal Medicaid funding as a result of noncompliance with federal certification requirements, requiring a General Fund backfill of about $13 million annually. Federal funding has so far been maintained for other Sonoma DC living units and for Porterville and Fairview DCs. However, without sufficient improvements to the DCs, the problems identified by DPH put DDS at risk of losing an additional $80 million in annual federal Medicaid funding. The current-year budget provides funding to make improvements, and the 2015-16 budget assumes that (1) the three DCs will meet certification requirements and retain federal Medicaid funding and (2) the four living units at Sonoma DC will regain federal funding by March 1, 2015.

CalWORKs

Full-Year Funding for Previously Approved Grant Increase. The Governor's California Work Opportunity and Responsibility to Kids (CalWORKs) proposal includes full-year funding for a 5 percent increase to CalWORKs cash grants that was approved as part of the 2014-15 budget package and is scheduled to go into effect in April 2015. As provided in the 2014-15 budget package, this grant increase is to be funded with certain funds redirected from 1991 realignment revenues, with the General Fund making up the difference if the redirected funds are insufficient. The Governor's proposal assumes that the full-year cost of the grant increase in 2015-16 is $175 million. Redirected realignment revenues are assumed to cover much, but not all, of this cost, with the General Fund covering an estimated shortfall of $73 million.

Foster Care

Funding to Begin Implementation of Continuum of Care Reform. As part of the 2012-13 budget package, the Legislature directed the Department of Social Services (DSS) to convene a stakeholder working group that was to recommend changes to the various foster care settings in which children may be placed—referred to as the "continuum of care"—to promote better outcomes. Concurrent with the release of the *2015-16 Governor's Budget,* DSS has released a report with 19 recommendations based on working group discussions. These recommendations will form the basis of a multiyear plan, yet to be formalized, that would reduce reliance on group home placements in favor of placements with foster families. The Governor's budget proposal includes funding to begin implementation of two of these recommendations: the proposal includes $9.6 million ($7 million General Fund) to (1) increase payments for social worker activities in agencies that typically have served children in foster homes that are at risk of group home placement and (2) provide funding for additional recruitment, outreach, and support of foster families.

RESOURCES AND ENVIRONMENTAL PROTECTION

Water Bond (Proposition 1) Implementation

Proposal. In November 2014, California voters approved the Water Quality, Supply, and Infrastructure Improvement Act of 2014 (Proposition 1). The measure made $7.5 billion in general obligation bond funds available for projects to (1) increase water supplies, (2) protect and restore watersheds, (3) improve water quality, and (4) increase flood protection. The Governor's 2015-16 budget proposes $532.5 million to begin implementing Proposition 1. As shown in Figure 13 (see next page), this amount includes:

- $178 million to multiple agencies for watershed protection and restoration projects.
- $137.2 million to the State Water Resources Control Board (SWRCB) and the Department of Water Resources (DWR) for water recycling projects.
- $135.5 million to the SWRCB for projects to treat drinking water and wastewater.

The proposed expenditures from Proposition 1 are one component of the administration's proposed effort to implement the administration's Water Action Plan (January 2014), which identified actions it intends to take over the next five years.

Cost-Effective Implementation of Proposition 1. It will be important to ensure that Proposition 1 funds are spent in a way that provides the greatest public benefit. In considering the proposed expenditures, the Legislature may wish to consider how the administration intends to select projects (such as the specific criteria), determine the most cost-effective projects, and calculate the benefits of projects. In addition, the Legislature may want to ask implementing agencies to explain how they will ensure that Proposition 1 funds are only used for public benefits and that other funds are made available for any private benefits of projects.

Ensuring Accountability and Oversight. It will also be important to ensure that the Legislature, administration, and the public can ultimately assess the outcomes associated with projects funded by Proposition 1. The Legislature may wish to consider what information or processes would be useful in evaluating how well projects are delivered by state and local agencies. Such measures could allow the Legislature to hold agencies accountable for their performance, as well as inform future decisions about what types of water system-related projects should be funded.

Proposition 1E Flood Control Funding

Background. In November 2006, California voters approved the Disaster Preparedness and Flood Prevention Bond Act of 2006 (Proposition 1E), which made $4.1 billion in general obligation bonds available for flood control projects and required that all funds be appropriated by July 1, 2016. Subsequently, the Legislature passed the Central Valley Flood Protection Act of 2008 (Chapter 364, Statutes of 2007 [SB 5, Machado]). Chapter 364 required the DWR to develop a plan—the Central Valley Flood Protection Plan (CVFPP)—for reducing the risk of flooding in the Central Valley, including recommended actions and projects. Chapter 364 describes a number of objectives that the CVFPP and the recommended actions are intended to meet, such as reducing the risk to human life, linking the flood protection system with the water supply system, and increasing the ecological value of habitat associated with floodplains. The CVFPP was developed by DWR in 2012 and identified $14 billion to $17 billion in total flood control funding needed from various sources.

Proposal. The Governor proposes $1.1 billion (nearly all from Proposition 1E) for DWR to support various flood control activities. This amount is primarily for capital outlay projects, but includes some funding for local assistance and state operations. The proposal would appropriate all remaining Proposition 1E funding. The proposal does not identify specific projects that would be funded. Instead, it would give DWR ten years to commit the funds to projects and an additional two years to expend the funds. (This significantly exceeds the typical three-year appropriation for capital projects.) The proposal would also allow the department to transfer funds between state operations, local assistance, and capital outlay as it deems necessary. The administration has indicated that it will seek legislation to appropriate some funding prior to the passage of the *2015-16 Budget Act* with the intent to expedite flood projects.

Maintaining Appropriate Legislative Authority. The proposed ten-year appropriation period, as well as the ability to transfer funds of this magnitude without legislative approval, is highly unusual. This raises concerns regarding the Legislature's ability to exercise oversight and direct funding to its priorities. The Legislature will want to consider how to balance its interests in expending Proposition 1E funds with its traditional oversight and appropriation authority.

Cost-Effective Spending on Legislative Objectives. The proposed appropriations would fund a fraction of the total cost of the CVFPP. Accordingly, it will be important to ensure that the expenditure of these funds furthers the objectives of Chapter 364 to the greatest degree possible. The Legislature may wish to provide direction to the administration on which

Figure 13

2015-16 Proposition 1 Expenditure Proposals

(In Millions)

Purpose	Department	Amount
Watershed Protection and Restoration		**$178.0**
Watershed restoration projects	Various[a]	139.1
Enhanced stream flow projects	Wildlife Conservation Board	38.9
Water Recyling		**$137.2**
Water recycling projects	SWRCB	131.7
Water recycling and desalination	Water Resources	5.5
Safe Drinking Water		**$135.5**
Drinking water treatment projects	SWRCB	69.2
Wastewater treatement projects	SWRCB	66.3
Water Supply Reliability		**$59.9**
Integrated regional water management	Water Resources	32.8
Water conservation	Water Resources	23.2
Improvements to state water system	Water Resources	3.3[b]
Stormwater management	SWRCB	0.6
Groundwater Sustainability		**$21.9**
Groundwater management	Water Resources	21.3
Groundwater contamination	SWRCB	0.6
Total		**$532.5**

[a] Includes Department of Fish and Wildlife, state conservancies, and Natural Resources Agency.
[b] Does not include $1.4 million proposed for expenditure in 2014-15.

SWRCB = State Water Resources Control Board.

objectives or specific projects it considers to be the highest priority and ask the administration how it will ensure that these funds are spent in the most cost-effective way.

Challenges to Delivering Proposition 1E Projects. The state has faced some challenges in expending Proposition 1E funds, such as difficulties in (1) securing funding for the federal share of certain flood control projects due to limited federal appropriations; (2) identifying projects developed by local agencies that have gone through preliminary design and cleared environmental reviews; and (3) securing local, state, and federal permits needed to complete projects. The Legislature may wish to consider ways to address these challenges.

Various Drought-Related Activities

Proposal. In response to years of below-average rainfall and snowpack, the Legislature appropriated a total of $838.5 million (mostly bond funds) in 2013-14 and 2014-15 for various drought-related programs, such as emergency water supplies, wildland fire suppression, and protection of vulnerable fish and wildlife. As shown in Figure 14, the budget proposes an additional $115 million ($93.5 million General Fund) to continue many of these activities in 2015-16. Over half of these funds are for the California Department of Forestry and Fire Protection to continue expanded fire prevention and suppression activities.

LAO Comments. Although some initial measures of water availability indicate that 2015 could be another dry year, a definitive assessment

Figure 14

Drought-Related Appropriations

(In Millions)

Purpose	Department	2013-14 Actual	2014-15 Actual	2015-16 Proposed
Increased fire suppression and prevention	Forestry and Fire Protection	—	$66.0	$61.8
Emergency drinking water supplies	Public Health/SWRCB	$15.0	—	15.9
Actions to protect fish and wildlife	Fish and Wildlife	2.3	38.8	14.6
Emergency water supply activities and education	Water Resources	1.0	18.1	11.6
Emergency regulations and enforcement	SWRCB	2.5	4.3	6.7
Drought response coordination and guidance	Office of Emergency Services	1.8	4.4	4.4
Food assistance	Social Services	25.3	5.0	—[a]
Grants for local water supply projects	Water Resources	472.5	—	—
Flood control projects	Water Resources	77.0	—	—
Housing assistance	Housing and Community Development	21.0	—	—
Grants for projects that save water and energy	Water Resources	20.0	—	—
Groundwater cleanup and sustainable management	Water Resources/SWRCB	14.0	9.1	—
Drought response and water efficiency	California Conservation Corps	13.0	—	—
Grants for irrigation improvements to save water and energy	Food and Agriculture	10.0	—	—
SWP water-energy efficiency	Water Resources	10.0	—	—
Training for workers affected by drought	Employment Development	2.0	—	—
Water conservation in state facilities	General Services	—	5.4	—
Totals		**$687.4**	**$151.1**	**$115.0**

[a] Does not include a carryover of $7 million General Fund from prior years to 2015-16.

SWRCB = State Water Resources Control Board and SWP = State Water Project.

of water conditions will not be available until closer to the end of California's typical rainy season in April. Thus, it remains to be seen to what extent funding for drought-related activities will be required in 2015-16. The Legislature may wish to ask the administration for additional information on specific, on-going problems that are caused by the drought, and how the magnitude of these problems would change depending on water conditions during the rest of the year. In addition, as discussed above, many of the proposed expenditures would be continuations of the activities performed in previous years. As such, some information on the efficacy of past spending on these programs should be available. The Legislature may wish to ask the administration how the proposed appropriations reflect lessons learned from the drought-related activities funded to date.

Cap-and-Trade Expenditures

Background. The Global Warming Solutions Act of 2006 (Chapter 488, Statutes of 2006 [AB 32, Núñez/Pavley]), established the goal of reducing greenhouse gas (GHG) emissions statewide to 1990 levels by 2020. To help achieve this goal, the state established a cap-and-trade program that places a "cap" on aggregate GHG emissions from large emitters and allocates a certain number of allowances equal to the cap. Large emitters must obtain an allowance for each ton of carbon dioxide equivalent emitted. A portion of the allowances are auctioned by the state and the auction revenues are used to fund various programs intended to reduce GHG emissions.

Cap-and-Trade Expenditures Reflect 2014-15 Budget Agreement. The Governor's budget assumes the receipt of $1 billion in state revenue from cap-and-trade auctions. Chapter 3, Statutes of 2014 (SB 862, Committee on Budget and Fiscal Review), provides continuous appropriations of auction revenues of specified percentages to certain programs. Consistent with that legislation, the Governor's budget assumes that 60 percent of cap-and-trade revenues would be allocated in 2015-16 as follows: (1) 25 percent ($250 million) for the state's high-speed rail project, (2) 20 percent ($200 million) for the Affordable Housing and Sustainable Communities Program, (3) 10 percent ($100 million) for the Transit and Intercity Rail Capital Program, and (4) 5 percent ($50 million) for the Low Carbon Transit Operations Program. The Governor's budget proposes to allocate the remaining $400 million (40 percent)—which is not continuously appropriated—to other state agencies in a manner that is identical to what was provided in the 2014-15 budget. In addition, the administration intends to work with the Legislature and stakeholders in developing a 2030 GHG reduction target and a plan for meeting such a target.

More Revenue Likely Available for Expenditure. The total amount of revenue that will be raised from future cap-and-trade auctions is subject to substantial uncertainty, based on several factors (such as the allowance sale price). If all of the allowances that are estimated to be auctioned in 2015-16 sell for the minimum price set by the state (between $12 and $13), state revenue would exceed $2.3 billion. Based on our preliminary analysis of different factors (such as the outcomes of prior auctions), it is likely that the state will sell most or all of the allowances offered for sale in 2015-16. Therefore, state auction revenue will likely be significantly higher than what is assumed in the budget. To the extent revenues exceed the amount assumed in the budget, those programs that are continuously appropriated specified percentages of auction revenue would receive significantly more funding in 2015-16 than is identified in the Governor's budget. The rest of the additional revenue would be available to be allocated by the Legislature in the budget or future years based on its priorities.

STATE EMPLOYEES AND RETIREES

Most State Employees Scheduled to Receive Pay Increase. The state has active labor contracts—referred to as memoranda of understanding (MOUs)—with all 21 of its employee bargaining units. Pursuant to these MOUs, most state employees are scheduled to receive a 2.5 percent general salary increase in 2015-16. Most of the proposed $560 million ($203 million General Fund) augmentation to employee compensation in 2015-16 would go towards paying these and other scheduled pay increases.

Four Labor Contracts Expire in July. As can be seen from Figure 15, the state's MOUs with four bargaining units will expire in July 2015. The Legislature must ratify any subsequent agreements before they can go into effect. Depending on the terms of any subsequent MOUs, the state's costs in 2015-16 could be higher than proposed. For example, a 1 percent increase in pay for employees in these four bargaining units and their managers would increase state costs by more than $70 million ($40 million General Fund).

Governor Proposes New High Deductible Health Plan. As part of its employee compensation package, the state provides health benefits to eligible employees and retirees. The CalPERS board negotiates and approves premiums for state health plans. The state's contributions towards these premiums are based on a weighted average of the four health plans with the highest enrollment. In an effort to reduce state health plan costs, the Governor proposes directing CalPERS to establish a high deductible/lower premium cost health plan. To make this new plan attractive to employees, the Governor proposes contributing additional funds to a Health Savings Account for participating employees. If the high deductible health plan becomes one of the four most enrolled health plans offered to state employees, the Governor's proposal could reduce the overall amount of money that the state pays for employee and retiree health premiums in the future.

Governor Proposes Civil Service Modernization. The framework for California's state civil service system was established in 1934 by Proposition 7. The civil service requires that all appointments and promotions be made under

Figure 15

Most Current Memoranda of Understanding (MOUs) Will Expire Within Two Years

Bargaining Units With MOUs Expiring July 2015
6 (Corrections) 9 (Professional Engineers) 10 (Scientists) 12 (Craft and Maintenance)
Bargaining Units With MOUs Expiring July 2016
1, 3, 4, 11, 14, 15, 17, 20, and 21 (Units represented by SEIU, Local 1000) 2 (Attorneys and Hearing Officers) 7 (Protective Services and Public Safety) 13 (Stationary Engineers) 16 (Physicians, Dentists, and Podiatrists) 18 (Psychiatric Technicians) 19 (Health and Social Services Professionals)
Bargaining Units With MOUs Expiring July 2017
8 (Firefighter)
Bargaining Units With MOUs Expiring July 2018
5 (Highway Patrol)

a general system based on merit determined by competitive examination. All state positions are subject to civil service requirements unless specifically exempted by the Constitution (for example, judicial, legislative, and university employees). For decades, the state's civil service system has not operated in an optimal manner for either the state, its employees, or the public. We have long recommended that the state significantly revise the civil service system. In our 1995 report, *Reinventing the State Civil Service*, we provided a set of basic principles to assist the Legislature in this endeavor. Over the past two decades, there have been attempts at modernizing the state's civil service. While none of these past efforts yielded significant improvements to the state's civil service, we commend the Governor's expression of interest in modernizing the system.

Retiree Health Benefits

Addressing Unfunded Liability Should Be High Priority. The state pays for retiree health benefits as costs come due on a pay-as-you-go basis. In 2015-16, the state is expected to pay almost $2 billion annually for these benefits for current retirees. Pay-as-you-go is the most expensive way to pay for future obligations and violates the fundamental tenet of public finance that costs should be paid in the year in which they are incurred. Because virtually no money has been set aside to pay for earned retiree health benefits, an estimated unfunded liability of about $72 billion exists. We think that addressing this unfunded liability and developing a system to fund retiree health benefits as they are earned is financially prudent and should be a high priority of the Legislature. Implementing a plan to meet these goals, however, would require significant additional spending to fund a retiree health trust. The most recent valuation of the state's liabilities by the State Controller's Office suggests this additional spending would need to total around $2 billion (current dollars) more annually if the entirety of the unfunded liability is to be retired for state and CSU workers within about 30 years. This funding could come from a mix of General Fund, special fund, federal fund, and employee sources, and reductions in assumed future benefits could substitute for a portion of this funding.

Governor Suggests Discussing Liability at Bargaining Table. As current MOUs expire, the administration indicates that it will negotiate with each bargaining unit a plan to fund retiree health benefits earned in the future. The Governor's stated goal is that employees and the state share the "normal cost" for retiree health benefits. That is, employees and the state each will pay half of the sum actuaries estimate is necessary—combined with assumed future investment earnings—to pay the cost of the benefit that employees earn in a given year. For non-university executive branch employees, the administration indicates that the additional state costs of this plan would be roughly $600 million per year (all funds) a few years from now. The administration also indicates its intent to pay off all of the unfunded retiree health benefit liabilities in about 30 years.

No Funds to Implement Goal in Budget. The Governor does not include any resources for this effort even though—as we discussed earlier—the voters gave the state the ability to use money from Proposition 2 for this purpose. Should the Governor reach agreements with unions on these efforts, it then would be up to the Legislature to consider whether to approve and how to fund such agreements. The Legislature will want to scrutinize any agreement the Governor makes to consider whether it creates new retiree health commitments beyond those in current law and whether such commitments are covered by constitutional contract impairment prohibitions.

OTHER PROPOSALS

Proposition 47 Implementation

Background. Proposition 47, which was approved by voters in November 2014, reduces penalties for certain offenders convicted of nonserious and nonviolent property and drug crimes. The measure also allows certain offenders currently serving sentences for such crimes to request that the courts resentence them to lesser terms. These changes will reduce state prison population and associated costs by (1) making fewer offenders eligible for prison and (2) reducing the terms of the inmates resentenced by the courts. Under the proposition, state savings resulting from its implementation will be used to provide additional funding for mental health and substance abuse treatment, truancy and dropout prevention, and victim services beginning in 2016-17.

Proposal. The Governor's budget assumes that Proposition 47 will reduce the population in the state's 34 prisons by 1,900 inmates in 2015-16. While the proposed budget for the California Department of Corrections and Rehabilitation reflects funding adjustments due to various changes in the prison population, it does not provide a specific savings estimate for the population reduction from Proposition 47. The budget also proposes additional General Fund support for the courts due to increased workload associated with the resentencing hearings—$26.9 million in funding in 2015-16 and $7.6 million in 2016-17.

LAO Comments. The administration's proposal raises several issues for legislative consideration. First, our preliminary analysis indicates that the Governor's budget likely underestimates the reduction in the prison population that will occur from the implementation of Proposition 47. Second, given the expected significant reduction in the prison population over the next few years, it will be important for the Legislature to work with the administration in developing a plan for reducing prison capacity. In developing such a plan, the state should consider the most cost-effective approaches for reducing prison capacity. Lastly, the Legislature could consider providing guidance on how state savings from Proposition 47 will be spent on mental health and substance abuse treatment, truancy and dropout prevention, and victim services beginning in 2016-17. While the measure allocates certain portions of the savings to these specific purposes, it generally does not specify what criteria the administering agencies shall use to identify grant recipients or what requirements shall be placed on the recipients.

Deferred Maintenance

Governor's Proposal. The Governor's budget and the associated five-year infrastructure plan identify state infrastructure deferred maintenance needs of $66 billion, the large majority of which is related to the state's transportation system. The budget proposes one-time spending totaling $504 million from the General Fund (including $379 million in Proposition 98 funds) towards addressing these needs.

Of the total proposed deferred maintenance spending, the Governor proposes $125 million in non-Proposition 98 General Fund support for various entities as shown in Figure 16 (see next page). (By comparison, the 2014-15 enacted budget included up to $200 million in one-time non-Proposition 98 General Fund spending for deferred maintenance, contingent on certain budget conditions being met. This funding was not provided as the Department of Finance determined that the relevant conditions were not satisfied.)

The remaining $379 million of the Governor's proposal is one-time Proposition 98 funds for

Figure 16

Administration's General Fund (Non-Proposition 98) Deferred Maintenance Proposal

(In Millions)

Department/Program	Proposed Amount
University of California	$25
California State University	25
Parks and Recreation	20
Corrections and Rehabilitation	15
Developmental Services	7
State Hospitals	7
California Fairs	7
General Services	5
State Special Schools	3
Emergency Services	3
Military	2
Forestry and Fire Protection	2
Veterans Affairs	2
Food and Agriculture	2
Total	**$125**

the California Community Colleges. Under the proposal, this funding could be used to address deferred maintenance, but is available to districts for any one-time purpose. In addition, the Governor's budget highlights the administration's desire to explore additional funding options for addressing the significant maintenance and repair needs on the state's highway system.

Focus on Deferred Maintenance Is Positive. We believe that it is important for the state to address its accumulated deferred maintenance needs. While deferring annual maintenance lowers costs in the short run, it often results in substantial costs in the long run. As such, we commend the Governor for his continued interest in addressing the state's deferred maintenance backlog. As the Legislature evaluates the specifics of the Governor's proposal, it may want to consider whether the proposed projects have been prioritized to meet the state's most pressing deferred maintenance needs. The Legislature may also want to (1) explore whether the administration has a long-term plan to address the remaining deferred maintenance backlog and (2) request that the administration identify and take steps to address the specific factors that have contributed to the development of the backlog.

Cash Flow Borrowing

Because General Fund revenues and expenditures tend to peak in different months, the state regularly borrows from internal sources (the state's hundreds of special funds) and external sources (the revenue anticipation notes [RANs] sold annually to investors) to ensure there is sufficient cash available to meet payment obligations throughout the year. The administration's projection of cash flow assumes that the state does not issue a RAN in 2015-16. (The budget includes $20 million for interest and issuance costs associated with the RAN, an amount that can be deleted from the budget if the state does not need a RAN.) If the projections of the state's cash position hold, 2015-16 would be only the second year since the mid-1980s that the state has not issued a RAN, a reflection of how much the state has improved its finances in recent years.

APPENDIX

State Spending Summary

(In Billions)

	2014-15[a]		2015-16	
	June 2014 Budget Act	Jan. 2015 Governor's Budget (Estimated)	Jan. 2015 Governor's Budget (Proposed)	Change From 2014-15 (Governor's Budget Figures)
General Fund				
K-14 Education	$49.7	$52.1	$52.6	$0.5
UC, CSU, and Other Higher Education	7.9	8.0	8.6	0.6
Subtotals, Education	($57.5)	($60.1)	($61.2)	($1.2)
Health and Human Services	$29.7	$30.5	$31.9	$1.4
Corrections and Rehabilitation	9.6	10.0	10.2	0.2
Legislative, Judicial, and Executive	3.0	3.0	3.1	0.1
General Government and Government Operations	4.5	4.3	3.1	-1.2
Natural Resources and Environmental Protection	2.3	2.6	2.6	0.1
Business, Consumer Services, and Housing	0.8	0.8	0.6	-0.2
Other	0.5	0.4	0.5	0.1
Totals	**$108.0**	**$111.7**	**$113.3**	**$1.6**
Special Funds				
Health and Human Services	$19.4	$19.3	$20.5	$1.3
Transportation	8.4	8.5	8.8	0.3
General Government and Government Operations	5.6	6.1	4.8	-1.3
Natural Resources and Environmental Protection	4.1	4.6	4.2	-0.3
Legislative, Judicial, and Executive	3.0	3.0	3.1	0.1
Corrections and Rehabilitation	2.4	2.4	2.5	0.1
Other	1.5	1.8	1.6	-0.2
Totals	**$44.3**	**$45.6**	**$45.5**	**—**
Project Spending, Selected Bond Funds				
Transportation	$1.9	$1.4	$2.2	$0.7
Natural Resources and Environmental Protection	1.0	3.0	1.9	-1.1
K-12 and Higher Education	0.8	0.4	1.4	1.1
Other	0.4	0.5	0.4	-0.1
Totals	**$4.0**	**$5.3**	**$5.9**	**$0.6**
Federal Funds				
Health and Human Services	$69.9	$68.6	$72.5	$3.9
Education	12.2	12.5	12.3	-0.2
Labor and Workforce Development	7.4	7.5	7.2	-0.3
Transportation	6.1	5.4	5.9	0.5
Other	2.4	2.5	2.5	-0.1
Totals	**$98.0**	**$96.5**	**$100.4**	**$3.9**

[a] General Government costs in 2014-15 include $1.6 billion of one-time costs to retire economic recovery bonds pursuant to Proposition 58 (2004).

Note: Debt service and employee compensation costs generally are budgeted by program area. Via a routine budgeting mechanism, for 2014-15, hundreds of millions of dollars in certain General Government budget items in the June 2014 budget act were distributed across departments statewide before the January 2015 budget proposal in order to cover increases in departmental personnel costs.

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