The 2015-16 Budget:

# Possible May Revision Scenarios

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# EXECUTIVE SUMMARY

***State Revenues Appear to Be Surging.*** In the January 2015 estimates accompanying the *2015-16 Governor's Budget*, the administration raised its revenue projections by billions of dollars for 2013-14 through 2015-16, relative to assumptions in the June 2014 budget package. Given the positive state tax collections of recent months, there is a significant potential that these estimates will increase even more in May—particularly for the current fiscal year (2014-15). History cautions that such revenue surges prove temporary.

***Revenue Surge May Limit Ability to Fund Priorities Other Than Schools.*** Surprisingly perhaps, these revenue trends pose a risk for the state budget mainly because higher revenues in 2014-15 boost ongoing spending on schools and community colleges under Proposition 98, potentially making it harder for the state to balance its budget in 2015-16 and beyond. The factors driving school spending upward now make it more difficult to fund other potential state budget priorities, such as augmentations for non-school programs, debt payments, and budget reserves.

***Hypothetical Budget Scenarios Intended to Help Legislature Plan.*** This report provides a preview of possible scenarios that the state's elected leaders may face while finalizing the 2015-16 budget package in May and June. Using the Governor's budget proposals as a starting point, we present five hypothetical May Revision scenarios with higher revenues of varying amounts and describe their effects on the budget's bottom line. Given the number of variables involved, many other outcomes are possible. We do *not* produce a new revenue or budget outlook in this report. Rather, we consider the key factors that may affect May estimates—principally revenues, the Proposition 98 minimum guarantee for schools and community colleges, and Proposition 2, the debt payment and budget reserve measure passed by voters in November 2014.

***Modest Budget Problem Emerges in Various Hypothetical Scenarios.*** Under four of the five scenarios, the state would face a budget problem—meaning that spending cuts, revenue increases, or other actions would be necessary to balance the budget in 2015-16. The emerging budget problem is principally due to higher assumed 2014-15 revenues that boost Proposition 98 spending on an ongoing basis. Under these five scenarios, the share of the assumed revenue increases across 2013-14 through 2015-16 going to Proposition 98 ranges from 86 percent to 125 percent. In addition, the higher assumed revenues increase (1) Proposition 2 requirements and (2) mandate reimbursements to cities, counties, and special districts under a provision of the June 2014 budget package. While these scenarios present some challenges for the state's elected leaders, they would be quite modest compared to the state's budget problems of just a few years ago.

***Legislature Has Options to Address Situation.*** The Legislature has various options to address a potential budget problem. While the Legislature could draw down part of the $1.6 billion rainy-day deposit made before Proposition 2, reduce non-Proposition 98 spending, or increase revenues, it has other options for dealing with its budget situation. These options include (1) exploring changes in Proposition 98 calculations that would provide somewhat less growth to education programs to minimize the negative effects on the rest of the budget, (2) making choices in implementing

Proposition 2 that reduce the amount of reserve deposits and/or debt payments, and (3) scrutinizing the administration's spending estimates and proposals to ensure they reflect expected program costs for the coming year.

***Governor Must Present Balanced Budget Plan.*** The Governor will have to present a balanced budget plan to the Legislature in May. If actions are needed to keep the budget in balance, the administration's choices range from adjusting calculations of arcane budget formulas with minimal programmatic impact to spending cuts and/or revenue increases. (While the Governor also could declare a Proposition 2 budget emergency, a budget emergency seems unlikely under the fiscal calculation specified in the measure.) In our *Overview of the May Revision,* we anticipate describing the ways the administration keeps its budget plan in balance. Our *Overview* also is likely to focus on how the Governor proposes to spend a large influx of new school funding and meet the budget reserve and debt payment requirements of Proposition 2.

# INTRODUCTION

Given the positive state tax collections of recent months, there is a significant potential of higher-than-projected state revenue—particularly for the current fiscal year (2014-15). Surprisingly perhaps, these trends pose a risk for the state budget because higher revenues in 2014-15 boost ongoing spending on schools and community colleges under Proposition 98, potentially making it harder for the state to balance its budget in 2015-16 and beyond. While a great opportunity for schools and community colleges, higher revenues at this time could mean that actions—such as cuts to non-Proposition 98 programs—may be necessary to address a budget problem in 2015-16. In light of this risk, we present five hypothetical scenarios to illustrate the potentially negative effects of higher 2014-15 revenues on the budget's bottom line.

***Purpose of Report.*** This report provides a preview of possible budgetary outcomes that the state's elected leaders may face while finalizing the 2015-16 budget package in May and June. We do *not* produce a new revenue or budget outlook in this report. Rather, we consider the key factors that will affect May estimates. In general, this report's scenarios discuss revenues and spending relative to the administration's January 2015 budget estimates.

# BACKGROUND

### Balanced Budget Requirement

***$534 Million Proposed for Key Reserve.*** Proposition 58 (2004) requires the annual state budget to be balanced. The Special Fund for Economic Uncertainties (SFEU) balance is the key test of the balanced budget requirement. (While voters approved a reconstituted Budget Stabilization Account, or BSA, in Proposition 2 last year, this "rainy-day" fund can only be accessed under certain conditions.) Figure 1 shows the General Fund condition under the Governor's January budget proposal. The administration proposes a year-end balance in the SFEU of $534 million in 2015-16. This means that up to $534 million in General Fund erosions—including revenue losses and/or unanticipated costs—could occur before the state would face a "budget problem." (A budget problem typically refers to the

**Figure 1**

**Governor's Budget General Fund Condition**

*Includes Education Protection Account (In Millions)*

| | 2013-14 | 2014-15 | 2015-16 |
|---|---|---|---|
| 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.

amount of cuts or other actions needed to bring the SFEU to $0, thereby resulting in what traditionally has been considered a balanced General Fund budget.) Because the balance of the SFEU is the traditional key test of the balanced budget requirement, we refer to the SFEU's balance as the budget's "bottom line."

### Governor's January Budget Proposal

***Administration Increased Its Revenue Estimates.*** In the January 2015 estimates accompanying the Governor's budget, the administration raised its revenue projections by billions of dollars for 2013-14 through 2015-16, relative to assumptions in the June 2014 budget package. For the "big three" General Fund taxes combined, the administration increased its June 2014 budget projections by $300 million in 2013-14, $2.3 billion in 2014-15, and $1.1 billion in 2015-16. (The big three taxes—the personal income tax, sales and use tax, and corporation tax—make up over 95 percent of General Fund revenues and nearly all state revenues that factor into calculations concerning the Proposition 98 minimum guarantee.)

***Proposition 98 Funding Level Increases $7.8 Billion Over Amount Assumed Last June.*** As part of its budget package, the administration updated its estimates of the Proposition 98 minimum guarantee for 2013-14, 2014-15, and 2015-16. (See the nearby box for more information about the calculation of the minimum guarantee.) For 2013-14, the minimum guarantee has increased $371 million over the amount assumed last June, primarily due to increases in General Fund revenue and K-12 attendance. For 2014-15, the minimum guarantee has increased $2.3 billion since last June, due almost entirely to higher revenue and a higher maintenance factor payment. For 2015-16, the minimum guarantee has increased $4.9 billion over the *2014-15 Budget Act* level, primarily due to the increase in the prior-year guarantee coupled with year-to-year growth in per capita personal income. The Governor's budget also assumes the state makes a $256 million "settle-up" payment related to meeting the minimum guarantee in earlier years. Taken together, these changes mean that schools and community colleges will receive $7.8 billion in new Proposition 98 funding under the Governor's January budget. Of this increase, $5.1 billion is covered by additional General Fund spending and $2.7 billion is covered by increases in local property tax revenue.

### Recent Revenue Trends

***Tax Collections Exceeding Estimates.*** At the time this report was prepared, 2014-15 tax revenues were running hundreds of millions of dollars above the administration's updated forecast. Two key personal income tax trends suggest even more upside for 2014-15 revenues. First, withholding has been strong. (Withholding refers to amounts withheld for state taxes from individuals' paychecks, bonuses, and certain other payments.) In addition, elevated stock market levels suggest a strong potential for higher estimated payments—quarterly payments paid primarily by businesses and high-income individuals on expected taxable income for which there is no withholding, such as capital gains on sales of stock and other assets. Based on these trends, 2014-15 revenues through June could exceed the administration's estimates by billions of dollars. April 2015 will be the next key month for assessing 2014-15 revenues, particularly for the personal income tax.

### Despite Increasing Revenues, Risks to the Budget's Bottom Line

***Higher Revenues Usually Increase Resources Available for Non-Proposition 98 Budget.*** When contemplating changes in revenues, a common rule of thumb used to be that Proposition 98 would

## Proposition 98 Minimum Funding Level

***Proposition 98 Sets Minimum Funding Level for Schools and Community Colleges.*** State budgeting for schools and community colleges is governed largely by Proposition 98, passed by voters in 1988. The measure, modified by Proposition 111 in 1990, establishes a minimum funding requirement, commonly referred to as the minimum guarantee. The minimum guarantee is determined each year by a series of formulas, or "tests," set forth in the State Constitution. These formulas take into account various inputs, including changes in student attendance, General Fund revenue, per capita personal income, and the level of funding provided in the prior year. Both state General Fund and local property tax revenue apply toward meeting the minimum guarantee.

***Constitutional Provision Helps State Balance Budget When General Fund Revenue Drops or Grows Slowly.*** In certain years, the Constitution allows the state to provide less funding for schools and community colleges than otherwise required. This reduction, however, creates a future obligation known as "maintenance factor." In general, when growth in state General Fund revenue is relatively strong, the state must provide additional Proposition 98 funding toward paying off this obligation. The exact amount of maintenance factor paid is controlled by a formula in the Constitution. Until 2012-13, the state administered this formula in a way that directed 50 percent to 60 percent of new state revenue to Proposition 98 when maintenance factor was outstanding, allowing the remainder to be spent on other programs in the state budget. In 2012-13, the state began administering this formula differently. Under certain situations, the state now can be required to dedicate virtually all new revenue toward Proposition 98. Because of this change, the state has limited ability in some years—including 2014-15—to build reserves or make programmatic augmentations outside of Proposition 98.

***A State Law Sometimes Requires Additional Funding on Top of the Constitutional Formulas.*** Whereas the Constitution allows the state to provide less school funding than otherwise required in certain years, a state law adopted in the early 1990's requires a supplemental school appropriation when the minimum guarantee is not growing as quickly as the rest of the state budget. Though the exact amount of the supplement is controlled by formula, the supplement limits the effect on schools when General Fund revenue grows slowly or drops. (The size of the supplement is capped at the amount needed to ensure the minimum guarantee grows at the same rate as per capita personal income.)

***"Spike Protection" Limits Ongoing Effect of Revenue Surges.*** Another provision of Proposition 98 prevents the minimum guarantee from growing too quickly when year-over-year growth in state General Fund revenue is particularly strong. Specifically, in years when the minimum guarantee increases at a much faster rate than per capita personal income, spike protection excludes a portion of Proposition 98 funding from the calculation of the minimum guarantee in the subsequent year. That is, while spike protection does not cap the amount by which school funding may increase in any particular year, it does prevent a portion of that increase from having a permanent effect on the minimum guarantee.

receive about 40 percent of any new revenue in years when no maintenance factor existed. For example, if May Revision revenue estimates increased by $1 billion for the current fiscal year, one could assume that Proposition 98 funding requirements would increase by roughly $400 million and the remaining $600 million would be available for other programs in the budget. When the state owed maintenance factor, one could assume that a higher percentage—between 50 percent and 60 percent of new revenue—would go toward meeting a higher Proposition 98 minimum guarantee. As described in the box on page 7, however, under the state's recent administration of its maintenance factor, higher revenues in 2014-15 increase the Proposition 98 minimum guarantee almost dollar for dollar. This also increases the 2015-16 guarantee to some extent, even if the additional revenues prove temporary. In some scenarios, this makes it difficult for the state to build reserves, fund existing operating costs, and make augmentations outside of Proposition 98.

***Surging 2014-15 Revenues Mean Non-Proposition 98 Cuts May Be Needed.*** Given the tax collection trends discussed earlier, revenues in 2014-15 appear to be surging. Holding other factors constant, increases in General Fund revenues in 2014-15 beyond the Governor's budget estimates tend to increase General Fund spending on Proposition 98 on an ongoing basis. To illustrate, a revenue increase of $2.5 billion in 2014-15 with no change in 2015-16 revenues increases General Fund spending on Proposition 98 by about $2.4 billion in 2014-15 and $1.8 billion in 2015-16. This means that the budget's bottom line would be roughly $1.8 billion worse off beginning in 2015-16, making it harder for the Legislature to balance the budget in 2015-16 and future years. The combination of revenues possibly surging in 2014-15 and the resulting higher Proposition 98 requirements in 2014-15 and 2015-16 is the primary reason that the state could face a budget problem as early as 2015-16.

# FIVE HYPOTHETICAL MAY REVISION SCENARIOS

Below, we present five hypothetical May Revision scenarios with higher revenues in 2014-15 and 2015-16 of varying amounts, and describe their effects on the budget's bottom line (the SFEU balance). Four of the five scenarios result in a budget problem to be addressed in the 2015-16 budget, as shown in Figure 2. The revenue assumptions and spending effects of these scenarios are summarized in Figure 3. Given the number of variables involved, many other outcomes are possible. In the box on page 10, we describe assumptions common to all five revenue scenarios.

**Figure 2**

**Budget Shortfalls in 2015-16 Result From Four Scenarios**

*General Fund (In Millions)*

| Scenario | Governor's Budget SFEU Reserve | Scenario Impact on Bottom Line | Resulting SFEU Reserve[a] |
|---|---|---|---|
| 1 | $534 | -$1,844 | -$1,309 |
| 2 | 534 | -1,658 | -1,124 |
| 3 | 534 | -1,372 | -837 |
| 4 | 534 | -1,072 | -538 |
| 5 | 534 | -144 | 391 |

[a] If negative, actions equal to this amount would be necessary to balance the 2015-16 budget.
SFEU = Special Fund for Economic Uncertainties.

**Figure 3**

**Summary of Five Hypothetical Budget Scenarios**

*General Fund (In Millions)*

| | Higher Assumed Revenues | | | Higher Spending/Proposition 2 Requirements[b] | | | |
|---|---|---|---|---|---|---|---|
| Scenario | 2014-15 | 2015-16 | Total[a] | Proposition 98 | Proposition 2/ Mandates | Total | Impact on Bottom Line |
| 1 | $2,500 | $1,250 | $3,850 | $4,799 | $894 | $5,693 | -$1,844 |
| 2 | 4,000 | 2,500 | 6,600 | 7,252 | 1,006 | 8,258 | -1,658 |
| 3 | 2,500 | 2,500 | 5,100 | 4,910 | 1,561 | 6,471 | -1,372 |
| 4 | 4,000 | 4,000 | 8,100 | 7,329 | 1,843 | 9,172 | -1,072 |
| 5 | 2,500 | 4,000 | 6,600 | 5,703 | 1,040 | 6,743 | -144 |

[a] $100 million higher revenues assumed for 2013-14 in all scenarios.
[b] Over 2013-14 through 2015-16 combined.

**Assumptions Common to All Five Revenue Scenarios**

***2013-14 Revenues Assumed to Increase by $100 Million.*** The May Revision will include revised revenue estimates for 2013-14. While it is plausible that revenues in 2013-14 could be revised upward or downward by hundreds of millions of dollars, we assume a modest gain of $100 million in all five scenarios. This increases General Fund spending on Proposition 98 by $56 million in each scenario. (While changes in accrued 2012-13 revenues could also occur in May, we assume no 2012-13 revenue changes here.)

***Local Government Mandates "Trigger."*** The 2014-15 budget package included a trigger that requires additional General Fund tax revenues—after satisfying increased Proposition 98 General Fund spending requirements—be provided to cities, counties, and special districts for pre-2004 mandate reimbursements. Under the administration's January 2015 estimates, $533 million of the $800 million outstanding reimbursements will be repaid. This means that, under current law, local governments essentially have "second call"—after the "first call" of Proposition 98—on the next $267 million in higher tax revenues for 2013-14 and 2014-15 combined.

***Assumes Proposition 98 Funded at Minimum Guarantee.*** Under all scenarios, we assume the state funds right at the estimate of the minimum guarantee (no higher or lower through suspension).

***Scenarios Assume Administration's January 2015 Estimates of Local Property Taxes.*** In 2015-16, a change in local property taxes would change state General Fund spending on Proposition 98, either increasing or decreasing the Special Fund for Economic Uncertainties (SFEU) balance. (In general, changes in estimates of most components of 2014-15 local property taxes do not change General Fund spending on Proposition 98.) The administration and our office will release updated estimates of local property tax revenue in May.

***Assumes Proposition 98 Supplemental Appropriation Applies to Proposition 2 Calculation.*** One provision of Proposition 2 requires the state to calculate how revenue from capital gains taxes affects the Proposition 98 minimum guarantee. We assume the constitutional and statutory provisions of Proposition 98 apply in calculating Proposition 2 requirements. One of these statutory provisions—the supplemental appropriation—increases the size of the reserve deposit and debt payments under our scenarios, contributing to a lower SFEU balance than if we did not include the supplemental appropriation. (For 2015-16, the supplemental appropriation was not a factor in the administration's January estimates of Proposition 2 requirements but could become an issue in the May Revision estimates.)

***Remaining Non-Proposition 98 Spending Unchanged From Governor's Budget.*** Each of the five scenarios assume that spending outside of Proposition 98 remains unchanged from the Governor's budget. The May Revision, however, will include revised estimates of non-Proposition 98 spending that will affect the budget's bottom line. For example, revised estimates of caseload in health and human services programs could produce a net savings (or cost), increasing (or decreasing) the budget's bottom line.

### Scenario 1—Small 2014-15 Revenue Surge

***Small Surge Produces Biggest Budget Problem.*** As shown in Figure 4, scenario 1 assumes a small surge in 2014-15 revenues. Specifically, we assume a $2.5 billion revenue increase in 2014-15 with a $1.25 billion revenue increase in 2015-16, relative to the administration's January 2015 estimates. In 2014-15, the $2.5 billion higher assumed revenues increase Proposition 98 spending by $2.4 billion. Note that the increase in Proposition 98 spending for 2015-16 ($2.4 billion) is far greater than the assumed revenue increase in 2015-16 ($1.25 billion). Because revenue increases in 2014-15 ratchet up the Proposition 98 guarantee on an ongoing basis, the higher spending levels shown for 2014-15 mostly persist in 2015-16 regardless of the budget's ability to accommodate the increased spending. In addition, the $250 million higher assumed capital gains taxes increase Proposition 2 requirements by $735 million, with half going to added debt payments and half to increasing the BSA balance. The increase in Proposition 2 requirements is greater than the increase in assumed capital gains taxes due to complex interactions with Proposition 98.

***$1.3 Billion Problem.*** Across the period, the $3.9 billion higher assumed revenues increase spending and Proposition 2 requirements by $5.7 billion. This erodes the SFEU balance by $1.8 billion, resulting in a $1.3 billion budget problem.

**Figure 4**

**Scenario 1—Small 2014-15 Revenue Surge Erodes SFEU Balance by $1.8 Billion**

*General Fund (In Millions)*

| How Much More Revenue and Capital Gains? | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Capital gains taxes[a] | — | — | $250 | $250 |
| Other revenues[b] | $100 | $2,500 | 1,000 | 3,600 |
| **Totals, Increased Revenues** | **$100** | **$2,500** | **$1,250** | **$3,850** |

| How Much More in Spending and Proposition 2 Requirements? | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Proposition 98 spending | $56 | $2,385 | $2,359 | $4,799 |
| Local government mandates | 44 | 115 | N/A | 159 |
| Proposition 2 requirements | — | — | 735 | 735 |
| **Totals, Increased Spending** | **$100** | **$2,500** | **$3,093** | **$5,693** |

| What Is the Change in 2015-16 Reserve Levels? | End of 2015-16 | | |
|---|---|---|---|
| | **Governor's Budget** | **Scenario 1** | **Difference** |
| **Reserves** | | | |
| SFEU balance | $534 | -$1,309 | -$1,844 |
| Pre-Proposition 2 BSA balance | 1,606 | 1,606 | — |
| Proposition 2 BSA balance | 1,220 | 1,587 | 367 |
| **Total Reserves** | **$3,361** | **$1,884** | **-$1,477** |

[a] Relevant for Proposition 2 calculations only. Therefore, these are listed separately for 2015-16, the first year when Proposition 2 is in effect. For 2013-14 and 2014-15, increased capital gains taxes are included in "other revenues."

[b] Does not reflect changes to required BSA deposits.

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

### Scenario 2—Larger 2014-15 Revenue Surge

***Larger Surge in 2014-15 Revenues Produces Similar Outcome.*** As shown in Figure 5, scenario 2 assumes a $4 billion revenue increase in 2014-15 with a $2.5 billion revenue increase in 2015-16, relative to the administration's January 2015 estimates. In this scenario, the $4 billion higher revenue assumption for 2014-15 increases Proposition 98 spending by $3.9 billion. This ratchets up the minimum guarantee, with Proposition 98 spending requirements ($3.3 billion) exceeding higher assumed revenues ($2.5 billion) in 2015-16. The 2015-16 Proposition 98 spending increase under this scenario would have been higher but for the spike protection feature of Proposition 98. Specifically, under this scenario, incremental revenue increases in 2014-15 reach a point at which the Proposition 98 formula no longer builds in further ongoing spending increases in 2015-16 and beyond. In addition, the $750 million higher assumed capital gains taxes increase Proposition 2 requirements by $836 million, mostly due to complex interactions with Proposition 98.

***$1.1 Billion Budget Problem.*** Across the period, the $6.6 billion higher assumed revenues increase spending and Proposition 2 requirements by $8.3 billion. This erodes the SFEU balance by $1.7 billion, resulting in a $1.1 billion budget problem that would have to be addressed in the 2015-16 budget.

**Figure 5**

**Scenario 2—Larger 2014-15 Revenue Surge Erodes SFEU Balance by $1.7 Billion**

*General Fund (In Millions)*

**How Much More Revenue and Capital Gains?**

| | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Capital gains taxes[a] | — | — | $750 | $750 |
| Other revenues[b] | $100 | $4,000 | 1,750 | 5,850 |
| **Totals, Increased Revenues** | **$100** | **$4,000** | **$2,500** | **$6,600** |

**How Much More in Spending and Proposition 2 Requirements?**

| | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Proposition 98 spending | $56 | $3,874 | $3,321 | $7,252 |
| Local government mandates | 44 | 126 | N/A | 170 |
| Proposition 2 requirements | — | — | 836 | 836 |
| **Totals, Increased Spending** | **$100** | **$4,000** | **$4,158** | **$8,258** |

**What Is the Change in 2015-16 Reserve Levels?**

| | End of 2015-16 | | |
|---|---|---|---|
| | Governor's Budget | Scenario 2 | Difference |
| **Reserves** | | | |
| SFEU balance | $534 | -$1,124 | -$1,658 |
| Pre-Proposition 2 BSA balance | 1,606 | 1,606 | — |
| Proposition 2 BSA balance | 1,220 | 1,638 | 418 |
| **Total Reserves** | **$3,361** | **$2,120** | **-$1,241** |

[a] Relevant for Proposition 2 calculations only. Therefore, these are listed separately for 2015-16, the first year when Proposition 2 is in effect. For 2013-14 and 2014-15, increased capital gains taxes are included in "other revenues."

[b] Does not reflect changes to required BSA deposits.

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

### Scenario 3—Equal Revenue Gains in 2014-15 and 2015-16

***2015-16 Revenue Increase Must Be About Same as 2014-15 to Absorb Higher School Spending.*** As shown in Figure 6, scenario 3 assumes $2.5 billion higher revenues in each of 2014-15 and 2015-16. The cumulative revenue increase assumed under scenario 3 ($5.1 billion) exceeds the cumulative increase in Proposition 98 spending ($4.9 billion). This demonstrates that—until the spike protection provisions of Proposition 98 kick in for 2014-15—the increase in 2015-16 revenues essentially must be equal to or greater than the increase in 2014-15 revenues to accommodate increased school funding requirements under Proposition 98. The state still faces a budget problem under scenario 3 because of the higher Proposition 2 budget requirements of $1.4 billion (resulting from $750 million higher assumed capital gains taxes). The increase in Proposition 2 requirements is nearly double the higher assumed increase in capital gains taxes due to interactions with Proposition 98.

***$837 Million Budget Problem.*** Across the period, the $5.1 billion higher assumed revenues increase spending and Proposition 2 requirements by $6.5 billion. This erodes the SFEU balance by $1.4 billion, resulting in an $837 million budget problem.

**Figure 6**

**Scenario 3—Equal Revenue Gains in 2014-15 and 2015-16 Erode SFEU Balance by $1.4 Billion**

*General Fund (In Millions)*

**How Much More Revenue and Capital Gains?**

| | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Capital gains taxes[a] | — | — | $750 | $750 |
| Other revenues[b] | $100 | $2,500 | 1,750 | 4,350 |
| **Totals, Increased Revenues** | **$100** | **$2,500** | **$2,500** | **$5,100** |

**How Much More in Spending and Proposition 2 Requirements?**

| | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Proposition 98 spending | $56 | $2,385 | $2,469 | $4,910 |
| Local government mandates | 44 | 115 | N/A | 159 |
| Proposition 2 requirements | — | — | 1,402 | 1,402 |
| **Totals, Increased Spending** | **$100** | **$2,500** | **$3,871** | **$6,471** |

**What Is the Change in 2015-16 Reserve Levels?**

| | End of 2015-16 | | |
|---|---|---|---|
| | Governor's Budget | Scenario 3 | Difference |
| **Reserves** | | | |
| SFEU balance | $534 | -$837 | -$1,372 |
| Pre-Proposition 2 BSA balance | 1,606 | 1,606 | — |
| Proposition 2 BSA balance | 1,220 | 1,921 | 701 |
| **Total Reserves** | **$3,361** | **$2,690** | **-$671** |

[a] Relevant for Proposition 2 calculations only. Therefore, these are listed separately for 2015-16, the first year when Proposition 2 is in effect. For 2013-14 and 2014-15, increased capital gains taxes are included in "other revenues."

[b] Does not reflect changes to required BSA deposits.

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

### Scenario 4—Equal but Larger Revenue Gains

***Revenues Outpacing Proposition 98 Spending but Proposition 2 Requirements Significant.*** Similar to scenario 3, we assume an equal amount of incremental revenue increases in 2014-15 and 2015-16, as shown in Figure 7. Unlike scenario 3, however, assumed revenues increase by $4 billion rather than the $2.5 billion in each of 2014-15 and 2015-16. Similar to scenario 2, spike protection reduces the guarantee from what it would have been otherwise. This explains why the $4 billion higher assumed revenues in 2015-16 increase Proposition 98 spending by only $3.4 billion in that fiscal year. Under this scenario, the budget's bottom line worsens somewhat due to Proposition 2. Specifically, the $1 billion higher assumed capital gains taxes increase Proposition 2 requirements by $1.6 billion, again mostly due to interactions with Proposition 98.

***$538 Million Budget Problem.*** Across the period, the $8.1 billion higher assumed revenues increase spending and Proposition 2 requirements by $9.2 billion. This erodes the SFEU balance by $1.1 billion, resulting in a $538 million budget problem.

**Figure 7**

**Scenario 4—Equal but Larger Revenue Gains Erode SFEU Balance by $1.1 Billion**

*General Fund (In Millions)*

**How Much More Revenue and Capital Gains?**

| | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Capital gains taxes[a] | — | — | $1,000 | $1,000 |
| Other revenues[b] | $100 | $4,000 | 3,000 | 7,100 |
| **Totals, Increased Revenues** | **$100** | **$4,000** | **$4,000** | **$8,100** |

**How Much More in Spending and Proposition 2 Requirements?**

| | 2013-14 | 2014-15 | 2015-16 | Total |
|---|---|---|---|---|
| Proposition 98 spending | $56 | $3,874 | $3,398 | $7,329 |
| Local government mandates | 44 | 126 | N/A | 170 |
| Proposition 2 requirements | — | — | 1,673 | 1,673 |
| **Totals, Increased Spending** | **$100** | **$4,000** | **$5,072** | **$9,172** |

**What Is the Change in 2015-16 Reserve Levels?**

| | End of 2015-16 | | |
|---|---|---|---|
| | Governor's Budget | Scenario 4 | Difference |
| **Reserves** | | | |
| SFEU balance | $534 | -$538 | -$1,072 |
| Pre-Proposition 2 BSA balance | 1,606 | 1,606 | — |
| Proposition 2 BSA balance | 1,220 | 2,057 | 837 |
| **Total Reserves** | **$3,361** | **$3,125** | **-$236** |

[a] Relevant for Proposition 2 calculations only. Therefore, these are listed separately for 2015-16, the first year when Proposition 2 is in effect. For 2013-14 and 2014-15, increased capital gains taxes are included in "other revenues."

[b] Does not reflect changes to required BSA deposits.

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

### Scenario 5—2015-16 Revenue Increase Larger Than 2014-15

***SFEU Worse Off, but No Budget Problem.*** As shown in Figure 8, scenario 5 assumes a greater revenue increase in 2015-16 than in 2014-15. Specifically, we assume that revenues increase $2.5 billion in 2014-15 and $4 billion in 2015-16. Under this scenario, revenue growth in 2015-16 ($4 billion) outpaces the increase in Proposition 98 spending ($3.3 billion). Concerning Proposition 2, we assume $1 billion higher capital gains taxes in both scenarios 4 and 5. Whereas the assumption increased Proposition 2 requirements by $1.6 billion in scenario 4, Proposition 2 requirements are up only $881 million in scenario 5. This is due to interactions between Proposition 98 and Proposition 2 in scenario 5 that are relatively favorable for the budget's bottom line.

***Budget "In the Black."*** Across the period, the $6.6 billion higher assumed revenues increase spending and Proposition 2 requirements by $6.7 billion. Under scenario 5, the SFEU balance decreases by $144 million, producing a positive year-end balance of $391 million for 2015-16. Relative to scenario 4, $1.5 billion less in revenue assumed under scenario 5 results in $929 million more in resources available in the SFEU. This demonstrates that under the current budget situation, revenues do not necessarily bear a direct relationship with the overall budget condition. Moreover, we assume the same amount of higher revenues in scenarios 2 and 5, but the budget's

**Figure 8**

**Scenario 5—2015-16 Revenue Increase Larger Than 2014-15 Erodes SFEU Balance by $144 Million**

*General Fund (In Millions)*

| How Much More Revenue and Capital Gains? | 2013-14 | 2014-15 | 2015-16 | Totals |
|---|---|---|---|---|
| Capital gains taxes[a] | — | — | $1,000 | $1,000 |
| Other revenues[b] | $100 | $2,500 | 3,000 | 5,600 |
| **Totals, Increased Revenues** | **$100** | **$2,500** | **$4,000** | **$6,600** |

| How Much More in Spending and Proposition 2 Requirements? | 2013-14 | 2014-15 | 2015-16 | Totals |
|---|---|---|---|---|
| Proposition 98 spending | $56 | $2,385 | $3,262 | $5,703 |
| Local government mandates | 44 | 115 | N/A | 159 |
| Proposition 2 requirements | — | — | 881 | 881 |
| **Totals, Increased Spending** | **$100** | **$2,500** | **$4,143** | **$6,743** |

| What is the Change in 2015-16 Reserve Levels? | End of 2015-16 | | |
|---|---|---|---|
| | Governor's Budget | Scenario 5 | Difference |
| **Reserves** | | | |
| SFEU balance | $534 | $391 | -$144 |
| Pre-Proposition 2 BSA balance | 1,606 | 1,606 | — |
| Proposition 2 BSA balance | 1,220 | 1,661 | 441 |
| **Total Reserves** | **$3,361** | **$3,657** | **$296** |

[a] Relevant for Proposition 2 calculations only. Therefore, these are listed separately for 2015-16, the first year when Proposition 2 is in effect. For 2013-14 and 2014-15, increased capital gains taxes are included in "other revenues."

[b] Does not reflect changes to required BSA deposits.

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

bottom line is $1.5 billion better off in scenario 5. This demonstrates that—under the current budget situation—the effect of revenues on the budget's bottom line depends more on *when* the state books the revenue than the total revenue increase.

# LAO COMMENTS

***Higher Revenues in 2014-15 May Produce Budget Problem in 2015-16.*** Under each of our hypothetical scenarios, the bottom line of the budget would be worse off. In scenarios 1 through 4, actions—such as cuts to non-Proposition 98 programs—would be necessary to address a budget problem in 2015-16. While noteworthy given healthy growth in General Fund revenues, these budget problems would be quite modest compared to the state's budget problems of just a few years ago. Under scenario 5, the budget is balanced, but resources available for allocation in the budget are eroded by about $144 million.

***The "Plus Side" to the Scenarios.*** While the above scenarios present challenges to the state's bottom line, there are also positive outcomes. Schools and community colleges would benefit from an even larger influx of new funding. School funding increases in 2014-15 would be available for any one-time purpose—from additional mandate payoffs to facilities grants (perhaps as part of reforming the school facilities program). Higher 2015-16 funding could be used to make even greater progress in meeting the Local Control Funding Formula targets. In addition, all five scenarios result in greater Proposition 2 requirements, meaning the state would pay down more debts and build up the BSA by a greater amount, which may prove helpful in a future budget downturn.

***Legislature Has Options to Address Situation.*** Given the five revenue scenarios presented in this report, it may seem as though the major decisions in the budget have already been made by constitutional formulas. The Legislature, however, has options for dealing with its budget situation, including the changes in Proposition 98, Proposition 2, and other areas of the budget. We describe several options below.

***Explore Changes in Proposition 98 Calculations.*** The state has options that would allow it to reduce General Fund spending on Proposition 98 below the level otherwise required. One option involves counting additional local property tax revenue toward the minimum guarantee. As described in our February publication *The 2015-16 Budget: Proposition 98 Education Analysis,* the state could free up about $400 million General Fund if it chose to count a greater share of the local property tax revenue in certain school districts toward the minimum guarantee. The state also could free up about $125 million in General Funding spending in each of 2014-15 and 2015-16 if it adjusted the minimum guarantee to reflect the additional ongoing local revenue schools have received from the dissolution of redevelopment agencies since 2012-13. If state revenue were to rise significantly by May, schools still would receive significantly more funding than assumed in the Governor's January budget even if the state were to adopt both of these options.

***Choices in Implementing Proposition 2.*** As we discussed in our March 2015 report, *The 2015-16 Budget: The Governor's Proposition 2 Proposal*, the state's elected leaders face key choices in implementing Proposition 2 that will affect the amount of Proposition 2 requirements. For example, in the five hypothetical scenarios presented in this publication, we assume that the Proposition 98 statutory supplemental appropriation applies for Proposition 2 calculations. Depending upon the May estimates, administering the Proposition 2 calculations without this statutory supplement could reduce Proposition 2 requirements by hundreds of millions of dollars without affecting the total funding provided to schools and community colleges. Other Proposition 2 options include the following:

- ***Count Transportation Loans Toward Proposition 2 Requirements.*** As we have discussed in recent publications, there is a strong argument that the Legislature could count $186 million of certain transportation loan repayments toward meeting Proposition 2 debt payment requirements. To achieve savings, this may require special fund loan repayments or Proposition 98 settle up in smaller amounts than the Governor proposed.

- ***Redesignate Proposition 98 Settle Up.*** The state could redesignate a portion of the Proposition 98 settle-up funding included in the Governor's budget to count more of that funding toward meeting Proposition 2 requirements. To achieve savings, this option may require special fund loan repayments in smaller amounts than the Governor has proposed.

- ***Count More Debt Payments to Proposition 2 by Moving Them to 2015-16.*** The Legislature could move 2014-15 debt payments that could count toward the Proposition 2 requirements to the measure's first year, 2015-16. For example, the payments to local governments for pre-2004 mandates scheduled for 2014-15 arguably could be moved to 2015-16 for this purpose. To achieve savings, this also may require smaller special fund loan repayments or Proposition 98 settle up.

- ***Budget Emergency.*** A budget emergency declaration would allow the BSA reserve deposit for 2015-16 to be reduced. As we described in our recent Proposition 2 budget analysis, however, a budget emergency seems unlikely under the fiscal calculations specified in the measure (though a budget emergency could be declared on the basis of a natural disaster).

***Scrutinizing Estimates and Proposals.*** In recent years, there has been a trend of non-Proposition 98 spending coming in lower than budgeted amounts. Those budgeted amounts generally have reflected administration estimates at the time the annual budget was passed. Accordingly, the Legislature will want to ensure that the administration's estimates best reflect expected program costs for the coming year.

***Governor Must Present Balanced Budget Plan.*** The Governor will have to present a balanced budget plan to the Legislature in May. If actions are needed to keep the budget in balance, the administration's choices range from adjusting calculations of arcane budget formulas with minimal programmatic impact to spending cuts and/or revenue increases. In our *Overview of the May Revision,* we anticipate describing the ways the administration keeps its budget plan in balance. Our *Overview* also is likely to focus on how the Governor proposes to spend a large influx of new school funding and meet the budget reserve and debt payment requirements of Proposition 2.

## LAO Publications

This report was prepared by Ryan Miller, with Proposition 98 analysis by Kenneth Kapphahn, and reviewed by Jason Sisney. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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