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California State Senate

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BUDGET AND FISCAL REVIEW

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Agenda

January 24, 2013
9:30 a.m. or upon adjournment of Session
Room 4203

Overview of the
Governor's 2013-14 Proposed Budget

I. Presentations by:

Mr. Michael Cohen, Chief Deputy Director
Department of Finance

Mr. Mac Taylor, Legislative Analyst

II. Public Comment

Attachments:
A. Quick Summary of the Governor's Proposed 2013-14 Budget (Senate Budget and Fiscal Review Committee)

B. Overview of the Governor's 2013-14 Budget (Legislative Analyst's Office)

COMMITTEE ON BUDGET & FISCAL REVIEW
Room 5019, State Capitol
Sacramento, CA 95814

SENATOR MARK LENO, CHAIR

Quick Summary

Proposed 2013-14 Budget

January 10, 2013

The purpose of this Quick Summary is to provide members and staff of the Legislature with an overview of the Governor's proposed budget for 2013-14. More detailed reviews of the proposals will be developed as the Committee reviews the proposals in public hearings. If you have questions, please contact the committee at (916) 651-4103.

Overall Budget Proposal

The Governor has proposed a budget for 2013-14 which is essentially balanced with respect to revenues and expenditures, and includes several additional proposals that would build a reserve of approximately $1.0 billion. The budget also includes the continuation of established efforts to pay down budgetary debt from past years. Consecutive years of forecasted budget shortfalls of roughly $20 billion have been addressed through significant spending reductions—largely in the areas of corrections, health and human services and education—and increased revenues approved by the voters. As a result, the General Fund is expected to end the current year essentially balanced (with a narrow reserve of $167 million) with the proposed 2013-14 budget incorporating a reserve of approximately $1 billion. The budget includes a total of $99.3 billion in General Fund revenues and other available resources and $97.7 billion in General Fund expenditures. Overall, General Fund spending in 2013-14 is expected to grow by approximately 5 percent from the current year, largely as a result of increased expenditures in education and health care. To provide some context, state budget expenditures peaked in 2007-08 with General Fund spending of about $103 billion. As a share of the state economy, General Fund spending is at its lowest level since 1972-73.

Overview of Governor's Budget Proposal

The Governor's budget proposal includes $99.3 billion in General Fund revenues and other resources and $97.7 billion in total General Fund expenditures, providing for a $1.0 billion reserve. The expenditures in 2013-14 are proposed to be about $4.7 billion higher than revised 2012-13 expenditures. Additional funding is proposed for K-12 education, higher education, and health care. Additional resources that have allowed for modest and largely workload-related expansions are the result of stable underlying revenue growth and temporary taxes approved by the voters in November 2012. The General Fund budget details are summarized in the table below.

2012-13 and 2013-14
General Fund Summary
(Dollars in Millions)

	Revised 2012-13	Proposed 2013-14
PRIOR YEAR BALANCE	-$1,615	$785
Revenues and transfers	95,394	98,501
TOTAL RESOURCES AVAILABLE	**$93,779**	**$99,286**
Non-Proposition 98 Expenditures	$55,487	$56,780
Proposition 98 Expenditures	37,507	40,870
TOTAL EXPENDITURES	**$92,994**	**$97,650**
FUND BALANCE	$785	$1,636
Encumbrances	$618	$618
Special Fund for Economic Uncertainties	$167	$1,018
BUDGET STABILIZATION ACCOUNT	**--**	**--**
TOTAL AVAILABLE RESERVE	**$167**	**$1,018**

Current-Year Budget Update

The 2012-13 Budget, adopted in June 2012, included significant expenditure reductions and a reliance on proposed temporary taxes. In the Governor's proposed 2012-13 Budget, the shortfall was $10.3 billion – including a $1.1 billion reserve. By May the budget situation had deteriorated and the deficit had increased to $16.7 billion for the period ending June 30, 2013. This was due to a reduced revenue outlook, higher costs to fund schools, and decisions made by the federal government and courts to block previously-approved budget cuts. In early June, the Legislature adopted a budget that included most of the Governor's May Revision framework, relying primarily on additional expenditure reductions, as well as passage of a tax initiative on the November 2012 ballot (coupled with additional "trigger" budget reductions if the tax initiative were not approved). The budget plan contained $16.6 billion in total solutions for the period ending June 30, 2013, including $8.1 billion in expenditure reductions, $6.0 billion in additional revenues and $2.5 billion in other solutions, as listed in the figure below.

2012-13 Budget Solutions
General Fund
(Dollars in Millions)

EXPENDITURE REDUCTIONS	
Health and Human Services	$1,846
Education	2,349
Other Expenditure Reductions	3,893
TOTAL EXPENDITURE REDUCTIONS	**$8,089**
REVENUES, TRANSFERS AND LOANS	
Additional Revenues	$6,033
Transfers and Loans	2,518
TOTAL REVENUES, TRANSFERS AND LOANS	**$8,551**
TOTAL SOLUTIONS	**$16,640**

The 2012-13 Budget was predicated on the passage of the Governor's tax proposal placed before the voters in November. The measure, as approved, raises tax rates for the personal income tax and the sales and use tax on a temporary basis. The additional revenues consist of:

- **Personal Income Tax Rates on High Income Taxpayers**—Increases personal income taxes for high income taxpayers for seven years, beginning tax year 2012. Under prior law, the maximum marginal personal income tax rate was 9.3 percent. This measure temporarily raises personal income tax rates for higher incomes by creating three new tax brackets with rates above 9.3 percent.

    - A 10.3 percent tax rate on income between $250,000 and $300,000 for individuals and $500,000 and $600,000 for joint filers.
    - An 11.3 percent tax rate on income between $300,000 and $500,000 for individuals and $600,000 and $1 million for joint filers.
    - A 12.3 percent tax rate on income in excess of $500,000 for individuals and $1 million for joint filers.

- **Sales and Use Tax Rate Increase**—Increases the sales and use tax rate by 0.25 percent for four years. The tax increase goes into effect January 2013 and extends through December 2016.

The budget proposal assumes that the current budget will remain balanced by a narrow margin of $167 million, as opposed to the roughly $950 million reserve adopted in the budget. This modest deterioration was due to erosion of some of the solutions adopted with respect to programmatic reductions, a lower increase in property tax related revenues and assets that offset General Fund K-12 expenditures, and other miscellaneous factors including reductions in certain revenue sources.

Proposed Budget Expenditures

Unlike the current year, the proposed budget essentially incorporates no significant new programmatic reductions. The table below summarizes the Governor's proposed expenditures by program area. The most noteworthy changes are in education. For the first time since the recession began in 2008, education funding will increase. The largest change in expenditure by program area is in K-12 education where the Governor proposes $2.8 billion in additional expenditures to fully fund the Proposition 98 guarantee. Funding levels will increase by $1,100 per student over 2012-13. In higher education, the budget provides stable funding over multiple years. Other significant expenditure increases occur in health and human services, largely to expand health care coverage.

General Fund Expenditures
Current and Budget Year
(Dollars in Millions)

Program Area	Revised 2012-13	Proposed 2013-14	Change	% Change
K-12 Education	$38,323	$41,068	$2,745	7.2%
Higher Education	$9,776	$11,109	$1,333	13.6%
Health and Human Services	$27,121	$28,370	$1,249	4.6%
Corrections and Rehabilitation	$8,753	$8,805	$52	0.6%
Business, Consumer Services and Housing	$217	$645	$428	197.2%
Transportation	$183	$207	$24	13.1%
Natural Resources	$2,022	$2,062	$40	2.0%
Environmental Protection	$47	$46	-$1	-2.1%
Labor and Workforce Development	$345	$329	-$16	-4.6%
Government Operations	$661	$742	$81	12.3%
General Government				
Non-Agency Departments	$480	$528	$48	10.0%
Tax Relief / Local Government	$2,520	$421	-$2,099	-83.3%
Statewide Expenditures	$502	$772	$270	53.8%
Legislative, Judicial and Executive	$2,044	$2,546	$502	24.6%
Total	**$92,994**	**$97,650**	**$4,656**	**5.0%**

Other Budget Components

Budget Reserve

The Governor has proposed a balanced budget that includes no significant program reductions. As an integral part of the proposal, the budget includes measures that would result in establishing a modest reserve for economic uncertainties. The components that account for the approximately $1.0 billion reserve are:

- Suspending four local government requirements that have been newly identified as mandates for a savings of $104 million.
- Using 2012-13 funds appropriated above the Proposition 98 minimum guarantee to prepay obligations to schools under previous court decisions for a savings of $172 million.
- Continuing to use miscellaneous state highway account revenues to pay for transportation bond debt service for savings of $67 million.
- Extending the hospital quality assurance fee for additional resources.
- Extending the gross premiums tax on Medi-Cal managed health care plans for additional resources of $364 million.

Debt Management and Cash

The budget proposes to continue the Governor's established procedure of working down the so-called "Wall of Debt," the term applied to the accumulation of debts, deferrals, and budgetary obligations that occurred over recent years. In 2013-14, the Governor proposes to dedicate $4.2 billion to repay these types of budgetary borrowing. The proposed budget incorporates a long-term plan to continue this process over the next several years. At the end of 2010-11, the debt accumulation was approximately $35 billion; by the end of 2012-13, this is expected to drop to $28 billion. The budget plan is structured such that upon the expiration of the temporary taxes, the wall of debt is substantially addressed.

The budget reflects the state's moderately improved cash position. Maintaining an adequate cash balance allows the state to pay its bills on a timely basis. Given that the state receives revenues on an uneven basis throughout the year, the state's cash position varies. In order to cover the low points in the state's cash position, the state engages in short-term cash flow borrowing using internal resources or deferrals, as well as through external borrowing. The budget relies on internal borrowing, but given the improvement in the cash status, no new education payment deferrals are incorporated in the budget. In addition, a short-term (within the budget year) Revenue Anticipation Note (RAN) borrowing of $7 billion is incorporated in the Governor's proposed budget.

General Fund Revenues

California relies on a broad range of taxes and other revenues to support the activities of the General Fund. However, the personal income tax, sales and use tax and corporation taxes typically account for just over 90 percent of General Fund revenues. For the budget year, the personal income tax is expected to generate $61.8 billion (63 percent), the sales and use tax $23.3 billion (24 percent) and the corporation tax $9.1 billion (9 percent). For the current year, the personal income tax and the sales and use tax show slight improvements (less than 1 percent) over the 2012 Budget Act. In contrast, the corporation tax shows an erosion of about 10 percent, continuing a long-term trend.

Based on continued moderate economic growth in the state and the passage of two tax measures in November 2012, the major revenue sources are expected to grow by 2.5 percent for the personal income tax, 1.1 percent for the sales and use tax, and 2.2 percent for the corporation tax. The budget includes increased revenues from personal income taxes and sales and use taxes due to the passage of Proposition 30. Personal income tax revenues will increase by $3.2 billion in 2011-12, $4.8 billion in 2012-13 and $4.9 billion in 2013-14. Sales and use tax revenues will increase by $611 million and $1.3 billion in 2012-13 and 2013-14, respectively. The passage of Proposition 39 will result in additional corporation tax revenues of $440 million in 2012-13 and $900 million in 2013-14.

Enhanced Budgeting Process

In 2011, the Legislature passed SB 14, mandating that Performance Based Budgeting be implemented in all state agencies. The measure was subsequently vetoed by the Governor. The Governor issued an executive order, Executive Order B-13-11, directed the Department of Finance to modify the budget process to increase efficiency and place a greater emphasis on accomplishing goals. The Administration has already conducted zero-base reviews for state hospitals and state prisons. The proposed budget reflects a continued effort by the Administration to implement the Enhanced Budget Process Executive Order. This Budget proposal includes the following provisions:

- Each board, bureau, commission or division within the Department of Consumer Affairs to directed to determine appropriate enforcement and licensing performance measures. Performance measure data will continue to be provided annually in each year's budget.

- The California Department of Human Resources (CalHR) is streamlining services, expanding the use of consortium examinations, accelerating the approval process for routine personnel issues, and modernizing training classes that are available online.

- Both the Department of Transportation (Caltrans) and the Department of Public Health (DPH) are in the process of a multiyear process to zero-base their budgets.

Additionally, the Department of Veterans Affairs, the Department of Resources Recycling and Recovery, and the Department of Toxic Substance Controls will begin the review process in order to initiate the enhanced budgeting process.

Realignment Implementation Status

The budget continues the 2011 State-local Realignment and reflects continued implementation of 2011 Public Safety Realignment component. Through Chapter 15, Statutes of 2011 (AB 109), this realignment created a community-based correctional program where lower-level offenders remain under local jurisdictions. The Administration continues to work collaboratively with counties and other stakeholders to address implementation issues associated with Realignment. However, the Budget does not propose any additional programmatic changes related to AB 109. The 2011 Realignment also included fiscal, and in some instances programmatic, changes that impacted multiple health and human services programs. The Governor's Budget does not propose any additional programmatic changes related to the 2011 realignment of these health and human services programs. Funding for realigned programs can be found in the 2011 Realignment Estimate display in Item 5196 of the Governor's Budget.

Major Budget Components – Summary by Program Area

Overall Proposition 98 – K-14 Education

Current Year – Overall Funding Levels. The Governor's Budget estimates that the Proposition 98 guarantee will be **$53.5 billion** reflecting a number of adjustments in 2012-13. These adjustments include a $426 million increase in the minimum guarantee from new revenues generated by tax increases approved by statewide voters as part of Proposition 39 in November 2012. The net of all these adjustments leaves the minimum guarantee $163 million below the level appropriated by the 2012-13 budget act, as revised. The Budget continues this additional $163 million and scores funds to retire existing Proposition 98 "settle-up" obligations.

Budget Year – Overall Funding Levels. The Budget provides Proposition 98 funding of **$56.2 billion** for K-14 education in 2013-14, an increase of $2.7 billion above the revised 2012-13 budget. This level of funding includes a $520 million increase in the Proposition 98 minimum guarantee as a result of new Proposition 39 revenues. The Administration estimates that Proposition 98 will be a Test 3 year in 2013-14.

Reduction of Inter-Year Payment Deferrals. The Budget proposes an increase of approximately **$1.9 billion** in Proposition 98 General Fund to reduce inter-year budgetary deferrals for K-14 education in 2013-14. This proposed amount provides approximately $1.8 billion for K-12 schools and $179 million for community colleges.

Proposition 39 Funding for Energy Efficiency Programs. The Governor proposes to allocate all energy efficiency funding required by Proposition 39 to schools and community colleges beginning in 2013-14. As such, the Budget provides $450 million to establish a new Energy Efficiency Program for K-12 schools and community colleges in 2013-14 and proposes to continue funding for this purpose at $500 million a year for the following four years. Of the $450 million proposed in 2013-14, $400.5 million (89 percent) would be appropriated to K-12 schools and $49.5 million (11 percent) would be appropriated to community colleges. The Department of Education and the Community College Chancellor's Office would be responsible for allocating funding on a per student basis and could consult with the California Energy Commission and Public Utilities Commission on regulations for use of the funds.

Proposition 98 - K-12 Education -- Major Spending Proposals

The Governor's budget includes a year-to-year increase of nearly **$2.1 billion** in Proposition 98 funding for K-12 education in 2013-14. Per the Governor, ongoing K-12 Proposition 98 per pupil expenditures increase from **$7,967** provided in 2012-13 to **$8,304** in 2013-14. The Governor's major K-12 spending proposals are identified below.

New K-12 School Finance Formula and Appropriations. The Governor proposes an increase of **$1.6 billion** to implement a new **Local Control Funding Formula** for both school districts and county offices of education beginning in 2013-14. The formula would be phased in over a seven year period, estimated to be completed by 2019-20. The new formula replaces the Weighted Pupil Formula proposed by the Governor last year, but includes some similar and some new features based upon input from education stakeholders.

The proposed Local Control Funding Formula collapses K-12 revenue limits and almost all categorical programs into one formula accompanied by new accountability requirements. Major features of the new formula are summarized below:

- Provides a base grant, with per-student funding varying by grade span for grades K-3, 4-6, 7-8 and 9-12. (The Administration estimates a base rate of approximately $6,816 per student, equal to the current undeficited statewide average base revenue limit. New funding would be allocated to bring districts to new targeted funding levels including reflecting the base grant, plus supplemental fund and grade span factors. For example, districts further from the target level would receive a larger share of new funds. Districts with funding above the targeted level would receive no additional funds.)

- Provides supplemental funding based on the number of disadvantaged students (unduplicated counts of low-income students, English learner students, and students in foster care). Supplemental funding is equal to 35 percent of the base grant. Funding supplements also include a concentration factor for districts where more than 50 percent of students are disadvantaged. When the proportion of low-income students, English learner students, and students in foster care exceeds 50 percent of its total student population, the school district will receive an additional concentration grant equal to 35 percent of the base grant for each low-income student, English learner student, and student in foster care above the 50 percent threshold.

- Provides supplemental funding for elementary and high school: additional supplement for K-3 (intended to be used for Class Size Reduction) and for 9-12 (intended to be used for career technical education). In future years, districts would have to maintain class sizes of 24 or fewer students in order to qualify for K-3 supplement.

- Excludes two categorical programs –Targeted Instructional Improvement Grants (TIIG) and Home-to-School Transportation – from the new formula. Funding for these programs would be permanently locked in at existing allocations, but districts use those funds for any purpose.

- Excludes a number of programs from the new formula and continues these programs as separate categorical programs, such as Special Education, After School Education and Safety, Child Nutrition, Preschool and various programs that are not distributed to all districts (High-Speed Internet Access, Fiscal Crisis Management and Assistance Team, etc.)

- Includes a new two-part funding formula for county offices of education to provide a per-student allocation for students in community and court schools and unrestricted funding stream for general operations and support for school districts. This allocation would be made based county office operations as well as on the number of students and number of districts in the county.

- Requires that all school districts produce and adopt a District Plan for Student Achievement concurrent and aligned with each district's annual budget and spending plan. Plans are required to address how districts will use state funding received through the new funding formula toward improvement in following categories:

    - Basic conditions for student achievement qualified teachers, sufficient instructional material, and school facilities in good repair.

    - Programs or instruction that benefit low-income students and English language learners.

- Implementation of Common Core content standards and progress toward college, career readiness, as measured by the Academic Performance Index, graduation, completion of college preparatory and career technical education.

- Eliminates most programmatic and compliance requirements that school districts, county offices of education, and charter schools are currently subject to under the existing system of school finance. Important requirements that remain in place include federal accountability requirements, as well as fiscal and budgetary controls and academic performance requirements.

Reduction of Inter-Year Payment Deferrals. Budget provides an increase of $1.8 billion Proposition 98 General Fund to reduce inter-year budgetary payment deferrals for K-12 education in 2013-14. This new funding will reduce total, ongoing inter-year deferrals to $5.6 billion for K-12 schools at the end of 2013-14.

New Energy Efficiency Program. The Governor proposes $400.5 million in new Proposition 39 funds (see previous section) that would be available to K-12 schools for energy efficiency projects. The Department of Education would be responsible for allocating funding on a per student basis and could consult with the California Energy Commission and Public Utilities Commission on regulations for use of the funds. The Governor proposes to continue funding for this purpose for four additional years.

Mandate Block Grant Funding. As a continuation of education mandate reforms enacted in 2012-13, the Budget proposes to increase the K-12 Mandate Block Grant by $100 million in 2013-14 to fund two additional K-12 mandates – High School Science Graduation Requirement and Behavior Intervention Plans – in 2013-14. This will bring total funding for the K-12 Mandate Block Grant to approximately $267 million in 2013-14. The Governor proposes legislation to restructure the state Behavioral Intervention Plan program, in order to eliminate most state reimbursable costs for mandate.

Adult Education and Apprenticeship Realignment. The Budget proposes to consolidate administration of Adult Education and Apprenticeship programs within the California Community Colleges. Currently Adult Education programs are funded and administered by both K-12 school districts and community colleges. The Governor proposes to eliminate this bifurcated system and create a more accountable and centralized adult education learning system within the community colleges. The Budget proposes $315.7 million Proposition 98 funding community colleges for this purpose in 2013-14. Of this amount, $300 million is new Proposition 98 funding and $15.7 million is shifted from the K-12 Apprenticeship Program. The Budget proposes to allocate funding for the consolidated program through a new Adult Education Block Grant based upon the number of adults served.

Other K-12 Education Budget Proposals

Charter Schools. The Budget proposes the following changes intended to address financial and operational challenges for charter schools identified by the Governor:

- Shifting the Charter School Facility Grant Program and the Charter School Revolving Loan Program from the Department of Education to the California School Finance Authority to improve the efficiency of charter school program administration and disbursement of funds to local charter schools. The Authority already administers similar programs.

- Modifying the funding determination process for non-classroom based charter schools by limiting it to the first and third years of operation in most instances. Charter schools that are found to be out of compliance with minimum standards and applicable laws will be required to comply with annual funding determinations.

- Expanding the Charter Schools Facility Grant Program to include eligibility for non-classroom based charter schools, as these schools still have facility needs for instructional support.

- Extending for five additional years the 2012-13 requirement that school districts with identified surplus property and facilities first offer to sell those resources to charter schools before selling them to other entities or disposing of those assets.

Special Education. The Governor proposes to retain the Special Education programs outside of the new Local Control Funding Formula. However, the Budget includes the following proposals intended to simplify and consolidate special education funding in order to address funding inequities and inefficiencies in these programs. As such, the Budget includes the following:

- Eliminating the integration of federal funds in the state's AB 602 calculation and treating both funding streams separately to remove unnecessary complications in the formula and help equalize funding among special education local plan areas.
- Consolidating funding for several special education program add-ons into the base AB 602 formula calculation, while collapsing another 15 special education add-on programs into 10 based on similar activities.

The Governor's proposal does not affect funding for realignment of mental health services for special education. These funds will continue to be set aside for this purpose.

School Facility Funding Flexibility. The Governor proposes to make permanent provisions of current law that provide temporary funding flexibility to K-12 schools. Without extension, these statutory provisions are set to expire over the next two years. The Governor proposes the following changes:

- **Routine Maintenance Contributions**. Eliminate the minimum contribution requirement for routine maintenance.

- **Deferred Maintenance Program Matching Requirement.** Eliminate the required local district set-aside for deferred maintenance contributions.

- **Surplus Property.** Allow districts to use the proceeds from the sale of any real and personal surplus property for any one-time general fund purposes.

Technology Based Instruction. The Budget proposes statutory changes that will enable school districts to offer "asynchronous" online courses through a streamlined and outcome-focused independent study agreement. Asynchronous instruction does not involve the simultaneous participation of all students and instructors. The Governor intends to provide more flexibility to online instruction which currently requires immediate supervision of a teacher.

Other K-12 Proposition 98 Adjustments

Revenue Limit Growth. The Budget assumes continued state-level growth in K-12 enrollments statewide for purposes of funding revenue limits. More specifically, the Budget provides an increase of $304.4 million in 2012-13 for school district and county office of education revenue limits as a result of an increase in projected average daily attendance (ADA) compared to the 2012-13 budget act. The Budget provides an increase of $2.8 million in 2013-14 for school districts and county offices of education as a result of projected growth in ADA for 2013-14.

Categorical Program Growth. The Budget provides additional growth funding for two categorical programs -- $48.5 million for Charter Schools and $3.6 million for Special Education programs.

Cost-of-Living Adjustment Increases. The Budget provides $62.8 million to support a 1.65 percent cost-of-living-adjustment (COLA) for a specific group of categorical programs not included in the Governor's proposed Local Control Funding Formula. These specific programs include: Special Education, Child Nutrition, American Indian Education Centers, and the American Indian Early Childhood Education Program.

Emergency Repair Program. The Budget provides $9.7 million in one-time Proposition 98 funds for the Emergency Repair Program in 2013-14.

K-12 Federal Fund Adjustments

Child Nutrition Program. The Budget provides an increase of $77 million for 2013-14 in federal local assistance funds to reflect growth of nutrition programs at schools and other participating agencies.

Child Care and Development

Over the last several years, Child Care and Development programs have sustained major budget reductions, including provider payment reductions, as well as administrative changes and service reductions. The Governor proposes essentially a flat budget for child care and preschool programs in 2013-14, with some adjustments compared to 2012-13 including the following:

- Stage 2 – A decrease of $21 million non-Proposition 98 General Fund in 2013-14, primarily to reflect a decline in the number of eligible CalWORKs Stage 2 beneficiaries. In 2010-11, approximately 6,000 children were determined eligible for diversion services in Stage 2. Currently, these children and their eligible families are re-entering Stage 3 in 2012-13, and this population trend will persist into 2013-14. Total base cost for Stage 2 is $398.3 million.

- Stage 3 – An increase of $24.2 million non-Proposition 98 General Fund in 2013-14 primarily to reflect the transfer of approximately 6,000 children from Stage 2 to Stage 3. Total base cost for Stage 3 is $172.6 million.

- Child Care and Development Funds – A net decrease of $9.8 million federal funds in 2013-14 to reflect removal of one-time carryover funds available in 2012-13 ($20.7 million), an increase of $16.8 million in one-time carryover funds, and a decrease of $5.9 million in available base grant funds.

The Governor is not proposing any major administrative restructuring of the subsidized child care program, as proposed last year. Instead, the Governor proposes to have the Department of Social Services convene a stakeholder group to assess the current structure of the child care system and to identify opportunities for streamlining and other improvements to programs in the system.

Higher Education

Multi-Year Stable Funding Plan

- Across all higher education segments, proposes a multi-year funding plan. UC, CSU, and Hastings budgets will increase by five percent per year in 2013-14 and 2014-15, and by four percent in each of the subsequent two years. CCC funding will also increase by five percent in 2013-14, and then grow significantly over the subsequent years.

- The segments are expected to maintain current tuition and fee levels for the life of the plan. No tuition and fee increases are proposed because the year-over-year GF increases, when coupled with savings from expected reforms such as the use of technology to deliver quality education to greater numbers of students in high demand courses, improved course management and planning, and increased use of summer sessions, and savings from current segmental efforts to increase efficiencies, provide sufficient funding to each segment to negate the need for any such increases.

- Each segment is directed to use the increased funding to achieve the following priorities: (1) improvements in time-to-completion; (2) improvements in graduation and completion rates; and (3) increases in transfer students enrolled at CSU and UC and successful credit and basic skills course completion at CCC. *The Budget does not contain any concrete goals in this regard nor any established process to monitor each segments' progress towards the priorities. The Budget also does not include any enrollment targets.*

- To shorten students' time-to-degree, reduce costs for students and the state, and increase access to more courses for other students, the number of units students can take while receiving a GF subsidy at any of the segments during the life of the plan will be capped:

  - For UC and CSU in the first two years, the limit would be 150 percent of degree requirements (for example, 180 units for a standard bachelor's degree and 90 units for an associate degree). The limit would eventually be reduced to the equivalent of about one extra year of full-time attendance (for example, 150 units for a bachelor's and 90 for an associate).

  - For CCC, students will be allowed to take no more than 90 semester credit units (150 percent of the standard 60 semester credit units required to earn an associate's degree or credits for transfer) starting in 2013-14.

- For the community colleges, includes two policy changes to improve performance:

  - Change census accounting practices by adding a second census date at the end of each academic term. Over a five-year-period, the earlier census date (which is currently in the third or fourth week of the each semester) would gradually be phased-out. Any enrollment monies that districts "lose" due to this policy change would be transferred to district categorical programs that fund student support services (such as counseling). This proposal will apportion funding by focusing on completion at the end of the term, thereby incentivizing districts to focus on outcomes.

  - Require all students seeking financial aid, including Board of Governor's (BOG) Fee Waivers, to fill out a Free Application for Federal Student Aid (FAFSA) form. This change is proposed to ensure that only financially needy students are determined eligible for the BOG fee waiver program and to ensure program integrity. Any savings will be reinvested to further increase course offerings and student services.

University of California – Specific Adjustments

- Augmentation of $125.1 million GF for core instructional costs. Included in that amount is $10 million to increase the number of courses available through the use of technology. This augmentation is in addition to the $125 million GF that UC will receive in 2013-14 for not increasing tuition and fees in 2012-13, as required by the Budget Act of 2012.

- Shifts debt service costs for UC capital improvement projects into UC's budget to require UC to factor these costs into its overall fiscal outlook and decision making. This will result in a $201.7 million GF increase for general obligation debt service payments and a $9.4 million GF increase to adjust for increased lease-revenue debt service payments. No further augmentations will be provided for either form of debt service payment. Any new capital expenditures will be subject to approval by the Administration and there will be limits on the amount of the budget that can be spent on capital expenditures.

- $6.414 million GF increase to cover increased costs for retired annuitant dental benefits.

Hastings College of the Law – Specific Adjustments

- Augmentation of $392,000 GF for core instructional costs.

- Increase of $1.2 million GF to reflect the shift of general obligation bond debt service costs into Hastings' budget to require Hastings to factor these costs into its overall fiscal outlook and decision making process. No further augmentations will be provided for this purpose.

- $56,000 GF increase to cover increased costs for retired annuitant dental benefits.

California State University – Specific Adjustments

- Augmentation of $125.1 million GF for core instructional costs. Included in that amount is $10 million to increase the number of courses available through the use of technology. This augmentation is in addition to the $125 million GF that CSU will receive in 2013-14 for not increasing tuition and fees in 2012−13, as required by the Budget Act of 2012.

- Proposes to shift debt service costs for CSU capital improvement projects into CSU's budget to require CSU to factor these costs into its overall fiscal outlook and decision making. This will result in a $198.1 million GF increase for general obligation debt service payments and a $19.5 million GF increase to adjust for increased lease-revenue debt service payments. No further augmentations will be provided for either form of debt service payment. Any new capital expenditures will be subject to approval by the Administration and there will be limits on the amount of the budget that can be spent on capital expenditures.

- $51.4 million GF increase to fund the annual increase in costs for CSU's required employer pension contribution to CalPERS. CSU's base budget includes roughly $460 million for this purpose. In future years, CSU will continue to receive annual GF adjustments based on current payroll; however, if CSU chooses to add employees or increase wages beyond 2012- 13 levels, CSU would be responsible for the associated pension costs. This change is proposed to require CSU to factor these costs into its overall fiscal outlook and decision-making process.

- Proposes budget trailer bill language to provide CSU with the same statutory authority to negotiate or set employee health care benefit rates that is provided to the California Department of Human Resources for other state employees. Currently, CSU pays 100 percent of the health care premiums for its employees and 90 percent for employees' family members. However, for most other state employees, the state pays either 80 or 85 percent of employees' health care premiums and 80 percent for family members. This proposal is intended to provide CSU with a tool to better manage and negotiate the entirety of its personnel costs.

- Decrease of $473,000 GF to reflect decreased costs for retired annuitant dental benefits.

- Item 6645 was added to the annual budget act in 2012 to display CSU's employer costs for health benefits for its retired annuitants (previously these costs were budgeted within Item 9650, which contains the state's costs for health benefits for retired annuitants). The Budget Act of 2012 included $247.3

million ($240.3 million GF) for these CSU costs. The Governor's Budget proposes an increase of $37.9 million GF to adjust for increased costs and properly account for non-GF costs (overall non-GF costs are $792,000 in 2013-14, a decrease of $6.3 million over what was provided in 2012-13).

- $2.5 million GF augmentation to provide funding per Chapter 575, Statutes of 2012 (SB 1028), to establish the California Open Education Resources Council and the California Digital Open Source Library.

California Community Colleges – Specific Adjustments

Please see the K-12 section of this report for additional information on the overall K-14 Proposition 98 budget, including Proposition 39 revenues and expenditures included in Proposition 98.

- Augmentation of $196.9 million Proposition 98 GF in base apportionment funding, representing a 3.6 percent increase to general purpose community college funding.

- Augmentation of $16.9 million to expand the number of courses available through the use of technology.

- Increase of $179 million Proposition 98 GF to reduce the deferral debt owed to the community colleges to $622 million. The 2012-13 budget reduced the debt to $801 million (from an accumulated total of $961 million). This level of deferral "buy down" is consistent with, and proportional to, the payment of deferred funding in K-12 education. The reduction of the overall deferral will reduce the borrowing costs borne by districts as a result of the funding deferrals.

- Increase of $49.5 million Proposition 98 GF to undertake clean energy efficiency projects consistent with Proposition 39, the California Clean Energy Jobs Act. Community colleges can also use the funds to expand career technical educational training and on-the-job work experience training in partnership with the California Conservation Corps and participating community conservations corps programs.

- Increase of $315.7 million Proposition 98 GF to realign adult education from K-12 education to within the community college system. Of that total, $300 million is to reconstitute the adult education program within, and $15.7 million is to shift the Apprenticeship Program to, the community colleges. The funding will be allocated from a new categorical block grant based on the number of students served and only for core instructional areas such as vocational education, English as a Second Language, elementary and secondary education, and citizenship.

- Increase of $133.2 million Proposition 98 GF to reflect reduced property tax estimates. The Budget also includes an increase of $47.8 million Proposition 98 GF in 2012-13 to offset lower-than-anticipated property tax revenues from the elimination of redevelopment agencies.

Student Financial Aid

- Proposes no <u>new</u> policy changes to the Cal Grant Program.

- <u>Maintains</u> proposals contained in the Budget Act of 2012 that will result in the following changes to the Cal Grant Program in 2013-14:

    - Maximum new tuition awards will be reduced from $9,223 to $9,084 at private nonprofit (independent) institutions. This award level also applies to private for-profit institutions that were accredited by the Western Association of Schools and Colleges (WASC) as of July 1, 2012. *Beginning in 2014-15*, maximum new tuition awards at nonprofit institutions and WASC-accredited for-profit institutions will be reduced further, to $8,056.

    - Maximum new tuition awards at all other private for-profit institutions will be reduced to $4,000 beginning in 2013-14.

    - Cal Grant eligible students attending an ineligible institution will not be able to renew their Cal Grant for the 2013-14 academic year if they choose to remain at that ineligible institution.

- Maintains the phase-out of Student Loan Assumption Programs for Teachers and Nurses for savings of roughly $6.6 million GF. Eligible renewal awards will continue to be funded through 2015-16.

- Adjusts the 2012-13 budget to increase Cal Grant Program funding by $61 million GF and by $161.1 million GF in 2013-14 to reflect increased participation in the Cal Grant program. Of the 2013-14 amount, $19.5 million is attributable to the first of implementation of the California Dream Act.

- Proposes an offset of $60 million GF in Cal Grant Program costs due to the availability of surplus funds from the Student Loan Operating Fund (SLOF), which receives proceeds from the federal guaranteed student loan program. *The Budget Act of 2012 included an offset of $84.7 million GF from this same fund source.*

- Offsets a total of $942.9 million in Cal Grant Program GF costs to reflect increased Temporary Assistance to Needy Families (TANF) Program funds available through an interagency agreement with the Department of Social Services. *This level is an increase of $139.2 million over the level of offset of Cal Grant Program GF costs included in the Budget Act of 2012.*

Resources and the Environment

- **Cap and Trade Revenues** – Proposes expenditure authority of $400 million and adjusts current year expenditures to $200 million, a reduction of $300 million from previous year estimates. This reflects recognition of an initial over-estimation of revenues from the auction of cap and trade allowances. The first allowance auction resulted in $55.8 million in proceeds to the state and $233 million directly to investor-owned utilities. Two more auctions are proposed in February and May of this year.

- **Timber Harvest Plan Assessment Implementation** – Proposes increases of $6.6 million and 49 positions for Timber Harvest Plan review. This implements Chapter 289, Statutes of 2012 (AB 1492) which established a one percent assessment on lumber and other building products sold in California primarily for the purpose of funding in-state timber harvest plan reviews. Funding will be distributed to the five state agencies responsible for timber harvest plan review. Fees will be reduced by about $1 million in the Department of Fish and Wildlife and State Water Resources Control Board to reflect the assessment.

- **Electric Program Investment Charge Funding Proposed** – Proposes an increase of $193 million and 58 positions to implement the Electric Program

Investment Charge (EPIC) mainly in the Energy Commission. The EPIC program was created by the California Public Utilities Commission as a successor to the Public Goods Charge. The Legislature approved $1 million in 2012 to allow the Energy Commission to provide the Legislature with an investment plan for review prior to program funding approval.

- **Department of Parks Fiscal Overhaul and Reorganization Implementation** – Proposes a savings of $1.1 million and seven positions from the previously approved merger of the Department of Boating and Waterways into the Parks Department. There are no major proposed budget changes at the department and one adjustment to the Off-Highway Vehicle (OHV) program. The multiple recent financial and program investigations conducted by the Administration and Controller were released. While the investigations confirmed concerns raised in 2012, no discrepancy was found in the OHV Trust Fund balance. The budget proposes a $5 million increase to OHV local assistance grants to pre-budget reduction levels in 2012.

- **Major Changes to Environmental Protection Programs Wait Until Spring** – Announces that multiple major proposals to overhaul and adjust fee programs in environmental protection programs will not be released until sometime in spring. These include proposals to provide a funding plan for water quality issues in disadvantaged communities, overhaul hazardous waste fees and reform beverage container recycling funding.

- **Salton Sea Funding Proposed** – Proposes to allocate $12 million (Proposition 84 bond funds) to the Department of Fish and Wildlife to implement a pilot restoration project at the Salton Sea. This is a portion of a total allocation of about $28 million in the Resources Agency (mainly Department of Water Resources) for Salton Sea Capital Outlay and administration. The Legislature approved $2 million in 2012 to fund a report detailing a cost-effective implementation plan for the Sea that was vetoed by the Governor.

- **Proposition 39 Funding Proposed in Proposition 98 Education Budget** – Proposes to allocate $450 million, the Proposition 39 energy efficiency funding, for distribution by the Department of Education and the Chancellor's Office for California Community Colleges. Suggests that schools may consult with the state's energy agencies in order to prioritize the use of funding and are encouraged to consider partnering with the California Conservation Corps existing Energy Corps program. (See page 10 – Overall Proposition 98 – k-14 Education.)

Transportation

Department of Transportation Funding – Provides for total expenditures of $12.8 billion for the department, including $11.5 billion for highway transportation. The primary sources of funding for the department is federal funds plus state taxes on gasoline and diesel fuel and vehicle weight fees (about $8.1 billion), with additional funds from Propositions 1B bonds (about $2.2 billion) and reimbursements from local governments (about $1.8 billion).

Transit Funding – Provides about $390 million for transit operations from the sales tax on diesel fuel. This revenue is associated with the "fuel tax swap" legislation, which was adopted three years ago and restored state funding for transit operators. Additionally, Proposition 1B expenditures for transit capital are anticipated at $480 million in 2013-14.

Weight Fee Transfer for General Fund Relief – Proposes to transfer $907 million in truck weight fees to pay transportation-related debt service. Additionally, proposes to transfer $38 million in truck weight fee revenue to the GF. Under the modified "fuel tax swap" enacted two years ago, truck weight fee revenue is generally directed to transportation-related bond debt, but in 2013-14 weight fee revenue exceeds debt. This proposal is similar to action over the past two years and would transfer "excess" weight fee to the GF, wherein it will be repaid in out years to cover bond debt when that debt exceeds annual weight fee revenue.

Federal funding: MAP-21 – Maintains existing federal funding split between state and local transportation agencies. Federal transportation revenues are designated in the Moving Ahead for Progress in the 21st Century Act, known as "MAP-21," which President Obama signed into law on July 6, 2012. MAP-21 provides $105 billion to maintain FY 2012 funding levels (adjusted for inflation) for federal transportation programs through FFY 2013-14. California will receive essentially the same amount of total funding per year under MAP-21 as it did under the prior act, although funding per program differs. Federal funds make up a significant portion (about 13 percent) of California's transportation budget. MAP-21 consolidates and eliminates many programs, Caltrans and CTC have established a funding scheme for the current fiscal year that preserves existing funding and the Governor's Budget reflects that scheme.

Department of Motor Vehicles – Provides $980,000 to DMV for start-up costs related to implementing SB 1298 (Padilla), Chapter 570, Statutes of 2012, which requires DMV to adopt regulations to permit autonomous vehicles (*i.e.*, driverless cars) on California's streets and highways. The Governor's budget proposes two additional positions at DMV for this purpose, but also proposes $750,000 for a contract with UC Berkeley to assist DMV with development of the regulations.

High-Speed Rail – Proposes $3.12 billion ($2.16 billion from Proposition 1A of 2008 and $958 million in federal funds) in capital outlay funding to acquire property and right-of-way access to begin construction of the initial operating segment in the Central Valley. Also, proposes state operations funding of $121 million (almost all from Proposition 1A of 2008 bond funds) to fund "blended system" local and high-speed rail projects in the Bay Area and Southern California; and to continue oversight and communications contracts while augmenting state staff by 15.5 positions – to bring total funded positions to 86.

Statewide Infrastructure Needs – Proposes no new revenue source for transportation infrastructure to meet identified funding needs but notes that the Transportation Agency will convene beginning this spring a workgroup to refine the 2011 needs assessment, explore long term pay-as-you-go funding options, and evaluate the most appropriate level of government to deliver high priority investments. The California Transportation Commission (CTC) issued its 2011 Statewide Transportation System Needs Assessment, which identified over $500 billion in transportation infrastructure needs over the next ten years.

Cap and Trade Revenues – Anticipates expenditure of $200 million in Cap and Trade auction permit revenues in the budget year and notes that, because transportation is the single largest contributor of greenhouse gas emissions, reducing transportation emissions should be a top priority in the three-year investment plan for expenditure of these revenues. The top identified priority is high-speed rail. AB 1532 (Perez), Chapter 807, Statutes of 2012, requires the Department of Finance to develop this three-year plan in time for the May Revise.

Health and Human Services

The Governor's budget includes a total of $105.1 billion ($28.4 billion General Fund and $76.7 billion other funds) for health and human services that serve low-income, vulnerable individuals and families.

Health

Health Care Reform

The federal Affordable Care Act (ACA) increases access to private and public health care coverage through various mechanisms including:

- *California's Health Benefit Exchange (Covered California).* Covered California is a new insurance marketplace that will offer an opportunity to purchase affordable health insurance using federally funded tax subsidies for millions of Californians with incomes up to 400 percent of the federal poverty level (FPL). The open enrollment period will begin October 1, 2013 and coverage begins January 1, 2014. Covered California has many program elements focused on ensuring its premiums are as affordable as possible.

- *Streamlining Eligibility and Retention.* The streamlining of eligibility, enrollment, and retention rules for persons currently eligible for Medicaid.

- *Expanding Coverage to Low-Income Adults.* The expansion of Medicaid coverage to adults with incomes up to 138 percent of FPL.

Currently Eligible Individuals. The budget includes $350 million General Fund for 2013-14 (for six months) and projects $700 million General Fund annually thereafter as placeholder for the costs of providing coverage to individuals who are currently eligible for Medi-Cal (but not presently enrolled). It is expected that these currently eligible individuals will enroll in Medi-Cal because of streamlining in income eligibility (based on the Modified Gross Income—MAGI) and redeterminations that it would make it easier for individuals to enroll and remain on Medi-Cal; the individual mandate (under the ACA) that requires most individuals to obtain health coverage; and the extensive marketing by Covered California (California's health benefit exchange) about health care coverage options.

Expansion to Adults with Incomes Up to 138 Percent of FPL. The budget presents two options for expanding Medi-Cal coverage to adults with incomes up to 138 percent of FPL and does not include any fiscal estimates for these costs. Under both of these options, the benefit package offered would be comparable to what is available today in Medi-Cal, but would exclude long-term care coverage.

These two options are:

- *State-Based Option.* The first option is a state-based Medi-Cal expansion that would build upon the existing state-administered Medi-Cal program.
- *County-Based Option.* The second option is a county-based Medi-Cal expansion that would build upon the Low Income Health Program (LIHP). The LIHP is a voluntary, county-run program to provide a Medicaid-like coverage to individuals with incomes up to 138 percent of the FPL. There are 17 LIHPs in operation and each county can have different income eligibility requirements. The LIHP is authorized under a federal waiver and the county-based option would also require waiver of specified federal requirements.

The Administration has presented these options as a framework to begin discussions with counties and stakeholders, including the Legislature, on how the state and local governments should share the risks and costs associated with expanding public health coverage to this population. Currently, counties pay for care for adults who are not currently eligible for Medi-Cal through their local indigent health care service programs. The state provides funding from the 1991 health realignment to partially fund these costs.

There are several key aspects of ACA implementation for which federal guidance has not yet been issued including the methodology for claiming enhanced federal funding for the expansion of Medi-Cal coverage for low-income adults. Under the ACA, the federal government will pay for 100 percent of the costs for this population with funding gradually decreasing to 90 percent in 2020.

Department of Health Care Services (DHCS)

The budget proposes $63 billion ($15.9 billion General Fund) for DHCS.

Medi-Cal Program. The budget proposes total expenditures of $60.9 billion ($15.6 billion General Fund) for 2013-14 to serve about 8.7 million Medi-Cal eligible individuals, an increase in caseload of about 5.9 percent primarily due to the transition of children from the Healthy Families Program to Medi-Cal. This is a 3.9 percent increase in General Fund spending from the prior year.

Hospital Quality Assurance Fee Extension. Administration proposes extending the hospital quality assurance fee, which will sunset on December 31, 2013. This fee provides funds for supplemental payments to hospitals and offsets the costs of health care coverage for children. A reduction of $310 million General Fund is assumed as a result of extending this fee.

Gross Premium Tax Reauthorization. Administration proposes to reauthorize the Gross Premium Tax on Medi-Cal managed care plans on a permanent basis. Reauthorizing this tax will generate General Fund savings of $85.9 million in 2012-13 (in the Managed Risk Medical Insurance Board budget for the Healthy Families Program) and $217.3 million in 2013-14 (in the Medi-Cal program).

Coordinated Care Initiative/Duals Demonstration Project. Administration includes $170.7 million General Fund savings in 2013-14 and future annual savings of $523.3 million General Fund as a result of this initiative. The 2012 budget authorized the Coordinated Care Initiative (CCI) by which persons eligible for both Medicare and Medi-Cal (dual eligibles) would receive medical, behavioral, long-term supports and services, and home- and community-based services coordinated through a single health plan in eight demonstration counties. Budget year savings have been revised compared to previous estimates as the population estimated to be included in CCI has decreased, the scheduled phasing for the enrollment in CCI has been delayed until September 2013, and the state has not yet developed a Memorandum of Understanding with the federal CMS to implement CCI. Trailer bill legislation would be needed to reflect these changes and to implement the agreement with the federal CMS.

Medi-Cal Managed Care Efficiencies. DHCS is seeking new ways to implement additional efficiencies in Medi-Cal managed care. The framework of this proposal is unclear at this time since trailer bill legislation has not yet been received. Further, the proposal is unclear on the role of the Legislature in the continued operation of the Medi-Cal Program. A decrease of $135 million General Fund is budgeted for this proposal.

Limit Annual Open Enrollment for Medi-Cal Enrollees. A reduction of $1 million General Fund is assumed by limiting Medi-Cal enrollees to an annual open enrollment, in lieu of being able to change plans more frequently throughout the year. This proposal requires trailer bill legislation.

Provider Rate Reductions. AB 97 (Chapter 3, Statutes of 2011) enacted provider rate reductions. DHCS was prevented from implementing many of the reductions due to court injunctions. The budget assumes positive resolution of the court injunctions in March 2013 instead of summer 2012, resulting in General Fund costs of $261 million in 2012-13 and savings of $431 million in 2013-14.

Managed Risk Medical Insurance Board (MRMIB)

The budget proposes $611 million ($21.7 million General Fund) for MRMIB. This is a decrease of $143.9 million General Fund compared to the Budget Act of 2012 as a result of the transition of Healthy Families Program enrollees to Medi-Cal.

Gross Premium Tax Reauthorization. As discussed above, Administration proposes to reauthorize the Gross Premiums Tax on Medi-Cal managed care plans and includes $85.9 million General Fund savings in MRMIB's budget for 2012-13 as a result of this tax being reauthorized.

Phase-Out of Managed Risk Medical Insurance Program (MRMIP) and Pre-Existing Condition Insurance Program (PCIP). MRMIP and PCIP will phase-out with the implementation of the federal Affordable Care Act in 2014, as individuals on MRMIP and PCIP would be eligible for coverage under California's Health Benefit Exchange (Covered California).

Access for Infants and Mothers Program (AIM) and County Health Initiative Matching (CHIM) Fund Program Remain at MRMIB. Administration proposes that AIM and the CHIM program continue to be administered by MRMIB.

Department of Public Health (DPH)

The budget proposes $3.4 billion ($114.5 million General Fund) for DPH. This is a decrease of about $17 million General Fund compared to the Budget Act of 2012.

AIDS Drug Assistance Program (ADAP). The budget reflects a net decrease in ADAP funding of $12.7 million in 2013-14. This is primarily a result of the transition of ADAP clients to the Low Income Health Program and the transition of ADAP clients to other payer sources due to the implementation of the federal Affordable Care Act.

Zero-Base Budget Review. DPH was one of four departments selected to pilot zero-base budgeting (ZBB). In traditional budgeting, a department incrementally builds upon its prior year budget by either adding or subtracting funds from existing programs, in ZBB, the department builds its budget from the ground up, reassessing how it currently spends and allocates resources within each program. Initial findings from this pilot will be provided in February 2013.

Department of State Hospitals (DSH)

The budget proposes $1.6 billion ($1.5 billion General Fund) for support of DSH. The patient population is projected to reach a total of 6,560 in 2013‑14.

Stockton Activation and Bed Migration — Proposes $100.9 million General Fund to activate 514 beds at the California Health Care Facility (CHCF). This includes $67.5 million for additional staff to complete the activation of CHCF and $33.4 million for the full-year costs of positions approved in the Budget Act of 2012.

Safety and Security — Proposes a reduction of $5.6 million General Fund to reflect an updated Personal Duress Alarm System (PDAS) project scheduled for Metropolitan and Patton State Hospitals. The Budget maintains funding to continue the PDAS upgrade at Atascadero and Coalinga State Hospitals. Upgrade of the PDAS at Napa State Hospital was successfully completed in November 2012

Emerging Population Trends — Proposes $20.1 million in Reimbursements for the estimated increase in civil commitments. No adjustment is included in the Budget for pending commitments. DSH maintains wait lists of patients awaiting admission to its five hospitals and two psychiatric programs. Since June 30, 2012, the DSH has seen a steady increase in its wait list numbers for Incompetent to Stand Trial and Mentally Disordered Offender commitments. DSH will continue to monitor the pending commitments and, if necessary, develop options to address these wait lists.

Department of Alcohol and Drug Programs

In order to eliminate the Department of Alcohol and Drug Programs (DADP) on July 1, 2013, as approved in the 2012-13 State Budget, all substance use disorder programs would be transferred to the Department of Health Care Services. The Office of Problem Gambling would transfer to the Department of Public Health.

The administrative functions of the Drug Medi-Cal Program were transferred to the Department of Health Care Services on July 1, 2012. The Drug Medi-Cal program functions were transferred to counties as part of the 2011 Realignment.

Human Services

Developmental Services

The Department of Developmental Services provides services and supports to around 260,000 consumers with developmental disabilities. Over the last several years, the system has sustained major budget reductions, including operations and provider payment reductions, as well as administrative changes, cost control measures and some service reductions. The Governor proposes an overall 2013-14 budget for developmental services of $4.9 billion ($2.8 billion GF). This includes a $177.5 million ($89.2 million GF) increase associated with a higher number of consumers anticipated to receive services from regional centers.

- **Operations & Provider Payments:** The Governor's budget recognizes the scheduled sunset of a 1.25 percent reduction in regional center operations and community-based provider payments. This reduction was in effect for 2012-13 and was preceded by reductions of three percent in 2008-09 and 2009-10 and 4.25 percent in 2010-11 and 2011-12. As a result of the sunset, the Department's budget increases by $46.7 million ($32 million GF) in 2013-14.

- **Proposition 10 Funding:** The Governor's budget does not rely on $40 million that was provided from 2009-10 through 2012-13 by the California Children and Families Commission to support services for children from birth to five years old. As a result, the Department's budget increases by $40 million GF.

- **Sonoma Developmental Center:** Sonoma Developmental Center's Intermediate Care Facility is the subject of pending federal decertification and state license revocation actions due to instances of abuse and neglect, as well as concerns about staffing, practice, services, and governance. The Governor's budget assumes that the Department's appeals of these actions will succeed and that no federal funding will be lost.

- **Annual Family Program Fee:** The Governor's budget permanently continues the Annual Family Program Fee, which would otherwise sunset June 30, 2013. The fee is $150 or $200 per family with adjusted gross income of 400 percent or more of the federal poverty level. Its collection saves $7.2 million GF annually.

California Work Opportunity and Responsibility to Kids (CalWORKs)

The CalWORKs program provides temporary cash assistance and welfare-to-work services to low-income families with children. Over the last several years, the program has sustained very significant reductions, including a decrease from 60 to 48 months in the amount of time adults can receive assistance in a lifetime and additional restrictions that will result in some adults losing all assistance after 24 months. The changes have also included successive reductions to monthly cash assistance grants and temporary reductions in employment services funding, as well as a programmatic restructuring that created some additional flexibilities and other more restrictive policies. The Governor proposes an overall 2013-14 budget of $5.4 billion in federal, state and local funds for the program and estimates a caseload of 572,000 families (an increase of 0.7 percent).

- **Employment Services:** The Governor's budget proposes an increase of $142.8 million GF in 2013-14 to support the implementation of program changes enacted in 2012-13. The funds are for employment services for adults participating in the welfare-to-work program.

- **Child Care:** The Governor's budget proposes to have the Department of Social Services convene a stakeholder group to assess the current structure of child care and opportunities for streamlining and improvements.

In-Home Supportive Services (IHSS)

The IHSS program provides personal care and domestic services to approximately 420,000 low-income individuals who are aged, blind, or who have disabilities. Over the last several years, the enacted budgets have included major reductions and changes to the IHSS program, some of which have been implemented while others have been enjoined from implementation due to litigation.

- **Across-the-Board Reductions:** The Governor's budget recognizes the scheduled sunset on June 30, 2013 of a 3.6 percent reduction in authorized services for all IHSS recipients and correspondingly increases the program's budget by $59.1 million GF. However, the proposed budget also assumes $113.2 million GF savings from partial-year implementation of a 20 percent reduction in authorized services for all IHSS recipients, with specified exceptions. This reduction was triggered by lower than expected 2011-12 revenues, but has thus far been enjoined from taking effect by a federal court. The Governor's budget assumes success in that litigation such that the reduction can take effect in November 2013.

- The Governor's budget also assumes adjustments to previously enacted budget changes. This includes:

  - An increase of $92.1 million associated with more restrictive requirements to draw down enhanced federal matching funds under the Community First Choice Option. Beginning July 2013, the enhanced funding will be available only for recipients who meet nursing home level of care standards.

  - An increase of $47.1 million related to recently enacted county maintenance-of-effort requirements which base the counties' share of the non-federal portion of IHSS costs on 2011-12 expenditures, as well as an annual growth factor and 1991-92 realignment revenue levels.

  - $30.2 million GF savings associated with a requirement, enacted in 2011-12, for recipients to obtain a certification of need from a health care provider.

- The Governor's budget also makes changes to the anticipated schedule and fiscal estimates associated with implementing the Coordinated Care Initiative, which impacts the IHSS program. See the Health Section of this report.

Other

- **SSI/SSP:** The Supplemental Security Income/State Supplementary Payment (SSI/SSP) program provides monthly cash assistance to eligible individuals who are aged, blind, or who have disabilities. The estimated caseload for the SSI/SSP program includes a 1.3 percent increase to 1.3 million recipients. The

Governor's budget reflects an estimated cost-of-living increase of 1.7 percent in 2013 and 1.1 percent in 2014 for the SSI portion of the grants, which is federally funded. The budget also assumes a corresponding increase in state costs for benefits under the Cash Assistance for Immigrants (CAPI) program.

- **Child Welfare Automation:** The Governor's budget includes $1 million ($482,000 GF) and 9 positions in 2013-14 to oversee procurement of a Child Welfare Services-New System project to replace the existing Child Welfare Services/Case Management System.

Local Government

- **Redevelopment.** As part of the 2011-12 budget, local redevelopment agencies (RDAs) were dissolved. The adopted legislation (later upheld by the courts) allowed for continued payment of obligations secured by the property tax increment, but redirects "unobligated" property taxes to the local taxing entities—primarily to local school districts, cities, and counties. As obligations are paid off, the amount of property taxes going to local governments and schools will increase. Additional property tax revenue received by local school districts offsets the Proposition 98 General Fund obligation on a dollar-for-dollar basis and thus represents a General Fund savings. Given the difficulties involved in the RDA wind-down, accurately estimating the property tax revenue freed-up for local schools has been a challenge. The challenges apply to both the additional flow of property tax revenues as well as the one-time distribution of assets. As part of the 2012 Budget Act, the amount of additional property taxes going to schools (one-time and on-going) was estimated to be $3.2 billion in 2012-13 and $1.6 billion in 2013-14. As a result of the continuing flow of data and information from the RDA successor agencies and analysis by the Department of Finance, the proposed budget reduces these amounts to $2.1 billion in 2012-13 and $1.1 billion in 2013-14.

- **Local Mandates.** The Governor's Budget suspends non-education local mandates that were suspended in the current year to achieve General Fund savings. The proposed budget also proposes to defer the 2012-13 costs associated with mandates incurred prior to 2004-05 and continue this deferral through 2014-15. As a result, the proposed budget basically continues current year actions to suspend certain mandates and defer the pre-2004 mandate costs. In general, the only local government mandates funded and in effect would be those related to law enforcement and property tax. The amount budgeted for these active non-education mandates is $48 million GF. The administration also proposes exploring ways to improve the mandate process, consistent with the mandate reform efforts in K-12 education. Finally, the suspension of certain new mandates will generate savings that will assist in establishing a reserve, as described in the “Introduction.”

General Government

- **California Department of Veterans Affairs (CDVA)** – Includes $406 million in total funding ($316 million in General Fund and $90 million various funds) for the department. Funding included for the admittance of patients in 2013 in both the Fresno and Redding Veterans Homes.

- **Department of General Services (DGS)** – Reflects a $5.6 million reduction achieved through operational efficiencies, decreases state bond expenditures by $1.6 million and 20 positions within the Office of Public School Construction, and increases the Special Repairs program budget by $11 million to fund several deferred maintenance projects in state-owned buildings to allow DGS to further consolidate agencies and departments into state owned facilities.

- **Department of Housing and Community Development (HCD)** – Reflects a slight increase in funding within the Housing Policy Division. The Housing Policy Division is responsible for review of housing elements submitted by local entities. The increase in staff will ensure there is a continued emphasis on adequate housing stock, and will work to align housing plans with transportation and land use plans.

- **Gambling Control Commission** – Proposes a reduction of $5.4 million ($2.3 million Indian Gaming Special Distribution Fund and $3.1 million Gambling Control Fund) to reflect the transfer of the Compliance and Licensing Divisions to the Department of Justice.

- **Department of Consumer Affairs** – Displays additional enforcement performance data designed to track the amount of time it takes between a complaint being received by one of the 26 boards, 9 bureaus or 2 committees and its resolution.

- **Unemployment Insurance Fund Deficit** – Utilizes $291.1 million GF to pay the third interest payment due to the federal government for the quarterly loans the Employment Development Department (EDD) has been obtaining from the federal government since January 2009 to cover the Unemployment Insurance (UI) Fund deficit and make payment to UI claimants without interruption. The UI Fund deficit was $9.9 billion at the end of 2012 and is projected to be $10.2 billion at the end of 2013. Interest will continue to accrue, and be payable annually, until the principal on the UI loan is repaid. Federal law requires that the interest payment come from state funds.

  In both 2011-12 and 2012-13 the state borrowed from the Unemployment Compensation Disability Fund (DI Fund) to make the required interest payments to the federal government. These loans against the DI Fund total $611.7 million. The Budget does not include a proposal to repay these loans.

  The Budget is also silent on how to fund future interest payments for funds borrowed from the federal government to pay UI benefits and a proposed solution to the insolvency of the UI Fund. The Administration indicates that proposals will be developed to address all three of these problems during a series of stakeholder meetings convened by the Secretary of the Labor and Workforce Development Agency that will begin by February 1, 2013.

- **Unemployment Insurance (UI) Benefit Payments –** Increases total benefit payments to $12.9 billion in 2012-13 and $9.5 billion in 2013-14, to reflect the recent extension of federal extended benefits through December 2013 and a reduction in the unemployment rate.

- **Enhanced Data Sharing –** Reflects increased revenues totaling $2 million in various payroll taxes, including increased penalty assessments and interest of $649,000, as a result of a review of revenue collection functions of the Franchise Tax Board and the Employment Development Department which identified additional data sharing opportunities.

- **Workers' Compensation Reform Implementation –** Increases by $152.9 million (Workers' Compensation Administration Revolving Fund) and 82 positions to implement the reforms prescribed in Chapter 363, Statutes of 2012 (SB 863). Included is a $120 million increase for permanent disability payments as part of the Special Earnings Loss Supplement program, also known as the return−to−work program. Overall, these resources will support

Chapter 363 reforms to medical provider networks, workers' compensation liens, fee schedules, medical care administrative procedures, permanent disability benefits, the Special Earnings Loss Supplement program, and independent medical and bill review processes.

- **Workers' Safety and Labor Standards Enforcement –** Proposes to permanently eliminate the July 1, 2013 sunset date for the employer surcharge for the Occupational Safety and Health Fund and the Labor Enforcement and Compliance Fund, thereby providing an ongoing funding source to support enforcement programs. These programs, which include investigations, inspections, and audits, protect lawful employers from unfair competition while ensuring employees are not required or permitted to work under unlawful conditions.

- **Elimination of the Targeted High Hazard Assessment –** Replaces $9.1 million in revenues from this assessment with a $9.1 million increase in the Occupational Safety and Health Fund assessment. This will result in all safety, workplace injury prevention, and enforcement efforts being funded through this single assessment.

- **Compliance Monitoring Unit –** The unit was created in 2009 to ensure prevailing wages are paid by contractors on public works projects. The monitoring costs were to be paid from specified bond funds that support projects. These revenues have not been sufficient to meet program requirements. The Budget includes various strategies to stabilize the unit, including: (1) a redirection of $2.5 million GF to the unit from worker's safety and labor standards enforcement activities, with a corresponding backfill to those programs from the employer surcharge; (2) a $5 million loan from the Targeted Inspection and Consultation Fund; and (3) cost recovery from other sources that support these public works projects.

- **Employee Compensation –** Increases by $247 million GF ($255.1 million other funds) for previously negotiated top step adjustments and health care benefit contribution increases for active employees. For most employees, the adjustments offset previously implemented and ongoing higher employee retirement contributions.

- **Pension Contributions –** Increases by $48.7 million GF ($46.5 million other funds) for the state's employer pension contribution. Included in the total is

$42.2 million GF ($21 million other funds) directed at the state's unfunded pension liability to reflect the savings resulting from increased employee contributions under Chapter 296, Statutes of 2012 (Assembly Bill 340), Public Employees' Pension Reform Act of 2012. Prior to the adoption of Chapter 296, generally any increased employee pension contributions offset the employer's contribution. Chapter 296 requires any savings in employer contributions from increased employee contributions be directed to the state's unfunded pension liability, subject to appropriation in the annual budget act.

- **Bond Debt Service –** General Fund debt service expenditures, after various other funding offsets, will increase by $872.4 million (17.6 percent), to a total of $5.8 billion, over the current year expenditures. This increase is comprised of $779.7 million for General Obligation (GO) debt service ($5.1 billion total) and $92.7 million for lease-revenue bonds ($766.2 million total). The greater than normal increase in GO debt service is the result of lower than normal current year debt service because the State Treasurer's Office was able to structure prior bond sales to accommodate the $1.9 billion Proposition 1A financing obligation that is due June 2013.

- **California Five‑ Year Infrastructure Plan --** The Administration will release the 2013 Five‑Year Infrastructure Plan later this year. The Plan will outline the Administration's infrastructure priorities for the next five years for the major state infrastructure programs, including high‑speed rail and other transportation, resource programs, higher education, and K‑12 education. Given the state's increased debt burden and General Fund constraints, the Plan will examine agencies' reported needs assessments, the use of General Fund‑backed debt, and place less of a reliance on future voter-authorized GO bonds.

- **Cashflow Borrowing** – The budget includes $150 million GF for interest costs associated with cashflow borrowing. This includes $50 million for special fund borrowing and $100 million in external borrowing (or Revenue Anticipation Notes [RANs]). Cashflow borrowing is not a budget solution and funds borrowed in one year are fully repaid within the same fiscal year. Cashflow borrowing is also discussed in the "Introduction."

- **Budgetary Loans from Special Funds** – The budget includes $31.5 million for interest on budgetary loans. The Governor indicates that at the end of 2012-13, special fund budgetary loans will total $4.1 billion, which will drop to $3.5 billion by 2014-15.

- **Franchise Tax Board –** Franchise Tax Board (FTB) is charged with administering the personal income tax and the corporation tax. The budget calls for an increase of $152.2 million for the Enterprise Data to Revenue (EDR) Project to continue implementation. FTB estimates the project will generate additional General Fund revenues of $4.9 billion through 2017. Ongoing revenues are estimated to be in excess of $1 billion annually when the project is fully implemented. In addition, as part of a review of the revenue collection functions of FTB and the Employment Development Department (EDD), additional data‑ sharing opportunities have been identified in the near term that will increase revenues. The Budget includes an increase in Personal Income Tax collections of $3 million General Fund by FTB and $800,000 General Fund by EDD as a result of these efforts.

Corrections and Judiciary

- **California Department of Corrections and Rehabilitation (CDCR)** – Proposes total funding of $9 billion ($8.7 billion General Fund and $252 million other funds) for CDCR.

- **CDCR Population** – While the adult inmate population continues to decline as a result of Realignment, new admissions are currently trending higher than the 2012 Budget Act projections. The Budget Act projected an adult inmate average daily population of 129,961 in the current year. The current year adult inmate population is projected to exceed Budget Act projections by 2,262 inmates, a 1.7 percent increase, for a total population of 132,223. The budget year adult inmate population is projected to be 128,605, a 2.7 percent decrease of 3,618 inmates. The current projections also reflect a decrease in the parolee population of 4,052 in the current year compared to Budget Act projections, for a total average daily population of 57,640. The parolee population is projected to be 42,958 in 2013−14, a decrease of 14,682.

  The budget year population decreases are primarily due to the shifting of lower-level inmates to counties pursuant to public safety realignment (Chapter 15, Statutes of 2011), reductions in the number of felony probationers entering state prison, and the passage of Prop 36, which revised the Three Strikes Law. The budget proposes a decrease of $1.7 million GF to reflect these changes.

- **CDCR Mental Health Population** – Proposes a decrease of $4.3 million in 2012-13 and $7.9 million in 2013-14 to reflect adjustments in the Mental Health Staffing Ratios based on changes in the number of inmates projected to require mental treatment.

- **DeWitt Nelson Correctional Annex (DeWitt)** – Proposes $16.2 million for pre-activation and activation staffing for DeWitt, which is an annex to the California Health Care Facility in Stockton. Construction is scheduled to be completed by February 2014, intake will begin in March 2014, and the facility will be fully operational by May 2014.

- **California Health Care Facility (CHCF)** – Proposes $2.3 million for the CHCF operation. Construction is due to be completed by May 2013, intake will begin July 2013, and the facility will be fully operational by December 2013.

- **Community Corrections Performance Incentive Grants** – Proposes $35.8 million for the California Community Corrections Performance Incentive Act of 2009 (SB 678, Leno). SB 678 established a system of performance-based funding that shares GF savings with county probation departments when they demonstrate success in reducing the number of adult felony probationers going to state prison.

- **CDCR, Division of Juvenile Justice (DJJ) Population** – The DJJ's average daily ward population is decreasing when compared to the 2012 Budget Act projections. Specifically, the ward population is projected to decrease by 120 in 2012−13, for a total population of 871 and slightly increase to 913 in 2013−14. The ward population has decreased significantly in recent years, due primarily to fewer parole violators being housed by DJJ as a result of Chapter 729, Statutes of 2010 (AB 1628), which shifted supervision responsibility for wards released from DJJ to the counties beginning in January 2011. The budget proposes decreases of $3.1 million GF ($1.1 million Proposition 98 GF) in 2012-13 and $2.2 million ($1.1 million Proposition 98 GF) in 2013-14 to reflect these changes.

  DJJ Parole - Pursuant to Chapter 41, Statutes of 2012 (SB 1021), juvenile parole ended on January 1, 2013 and all juveniles remaining on parole as of December 31, 2012 were discharged. Savings resulting from the elimination of juvenile parole will be realized in the Division of Adult Parole Operations, which assumed responsibility for juvenile parolees in 2011−12.

Board of State and Community Corrections (BSCC) – Proposes total funding of $129.2 million ($44.3 million GF) for the BSCC.

- **BSCC Position Augmentation** – Proposes 9 positions, funded from existing resources, for research activities, the administration of the local jail construction financing program authorized by Chapter 42, Statutes of 2012 (SB 1022), and other administrative functions necessary for the Board to operate as an independent entity.

- **City Law Enforcement Grants** – Proposes $4 million GF in 2012-13 and $7.5 million GF in 2012-14 to augment $20 million included in the 2012 Budget Act for city law enforcement grants.

- **Judicial Branch –** Proposes total funding of $3.1 billion ($1.2 billion GF) for the Judicial Branch.

- **Court Construction Transfer** – Proposes a $200 million transfer from the Immediate and Critical Needs Account to offset GF support of trial court operations as the courts adapt to a new reserve policy limiting trial court reserves to one percent. This transfer will delay additional courthouse construction projects up to one year, but will allow some of the most critical projects to continue, as determined by the Judicial Council.

- **Long Beach Courthouse** – Proposes $34.8 million from the Immediate and Critical Needs Account to fund the new Long Beach Courthouse service fee payment.

- **Trial Court Efficiencies** – Proposes a range of statutory changes that will reduce workload through administrative efficiencies, increase user fees to support ongoing workload at the trial courts, and assist the Judicial Branch in effectively managing monthly trial court cash flow issues.

The 2013-14 Budget:

Overview of the Governor's Budget

MAC TAYLOR • LEGISLATIVE ANALYST • JANUARY 2013

LAO

EXECUTIVE SUMMARY

Governor's Proposal

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

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

LAO Comments

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

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

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

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

OVERVIEW

The Governor's Budget Proposal

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

How the Administration Arrived at Its Budget Forecast

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

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

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

Figure 1

Budget Expenditures

(Dollars in Millions)

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

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

Figure 2

Governor's Budget General Fund Condition

Includes Education Protection Account (In Millions)

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

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

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

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

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

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

Key Components of the Budget Plan

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

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

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

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

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

The Administration's Multiyear Forecast

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

Figure 3

Major Proposals in the Governor's Budget

General Fund (In Millions)

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

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

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

QEIA = Quality Education Investment Act.

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

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

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

LAO Comments

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

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

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

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

ECONOMICS AND REVENUES

Administration's Economic Forecast

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

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

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

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

Figure 4

Administration's January 2013 Economic Forecast

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

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

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

LAO Comments

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

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

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

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

Figure 5

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

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

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

NA = Not applicable.

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

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

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

Administration's Revenue Forecast

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

Personal Income Tax

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

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

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

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

Figure 6

Administration's Multiyear Revenue Forecast

General Fund and Education Protection Account Combined (In Millions)

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

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

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

NA = Not applicable.

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

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

Figure 7

Comparisons With Prior Revenue Forecasts

General Fund and Education Protection Account Combined (In Millions)

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

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

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

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

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

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

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

Sales and Use Tax

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

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

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

Corporation Tax

Large Reductions in Non-Proposition 39 CT Revenue Forecast. As discussed in our November *Fiscal Outlook* publication, CT collections have been very weak recently, and there are major difficulties with forecasting this tax at the present time. Similar to our office's November forecast, the administration now is lowering its *2012-13 Budget Act* forecasts for CT revenues to reflect the recent dramatic weakness in CT collections. The administration now is projecting $7.6 billion, as compared to $8.5 billion in the budget act. This $7.6 billion includes about $440 million of increased CT revenues due to passage of Proposition 39 in November 2012. Accordingly, if Proposition 39 had not passed, CT revenues for 2012-13 would be declining to $7.1 billion, a 16 percent drop compared to the budget act projections from June 2012. While we cannot fully explain the reasons for this precipitous drop, it is likely due in part to major tax policy changes made in recent years. The administration's 2013-14 forecast includes $900 million of Proposition 39 revenues, the growth of which accounts for part of the $1.6 billion increase in CT for that fiscal year.

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

Estate Tax

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

Special Fund Loan Repayment Transfers

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

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

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

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

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

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

Figure 8

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

(In Thousands)

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

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

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

- What level of reserves will the special fund have after the proposed loan repayment is executed?
- What level of reserves does the fund need to cope with routine seasonal cash flow fluctuations and/or periodic annual declines in revenue? (This answer is likely to vary among special funds.)
- When was the last time that the fund's fees were adjusted? Is a temporary or permanent fee decrease appropriate, given the proposed loan repayment?
- What special fund activities are operating well and which are operating below expectations? Is targeted additional special fund spending needed after the loan repayments? Will such spending be sustainable, given current fee levels?
- Do the special fund's activities duplicate those in other state departments or at the local or federal level? Should any of these activities be ended? Are new activities needed to address important new state priorities?

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

EXPENDITURE ISSUES

Proposition 98

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

Adjustments to Proposition 98 Minimum Guarantee

Estimate of 2012-13 Minimum Guarantee Changes Slightly, Grows Notably in 2013-14. For 2012-13, the administration's estimate of the Proposition 98 minimum guarantee is $53.5 billion—down $54 million from the budget act estimate. Proposition 98-related spending, however, is estimated to be $163 million above the minimum guarantee. To bring spending down to the minimum guarantee, the Governor proposes to reclassify $163 million in 2012-13 appropriations as funds for meeting a statutory obligation associated with the Quality Education Investment Act (QEIA). For 2013-14, the Governor proposes to fund at the administration's estimate of the minimum guarantee—$56.2 billion. The $2.7 billion year-to-year increase in the guarantee is driven by the state's healthy year-to-year increase in General Fund revenues. Part of this increase is due specifically to growth in Proposition 39 revenues, as discussed below.

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

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

Figure 9

Proposition 98 Funding[a]

(Dollars in Millions)

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

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

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

Major Proposition 98 Proposals

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

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

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

Figure 10

Governor's Major Proposition 98 Budget Changes

(In Millions)

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

[a] Adds Graduation Requirements and Behavioral Intervention Plans.

[b] Applies to special education, child nutrition, and California American Indian education centers.

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

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

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

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

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

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

Positive Aspects of Governor's Proposition 98 Budget Plan

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

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

Proposal to Streamline School Finance System Has Many Positive Features. The Governor's proposal to restructure the way the state allocates K-12 funding also has many strong components. Most importantly, it would replace a complicated, top-down system with one that is more transparent, better linked with student costs, and locally driven. It also would transition gradually to the new system, ensuring that the vast majority of districts receive funding increases in 2013-14 and the coming years, while simultaneously making progress towards a more rational distribution of funds. Though the Governor's overall school finance plan has considerable merit, we believe the Legislature could strengthen it by making a few modifications. Specifically, we recommend against the Governor's plan to exclude two large programs that have particularly antiquated funding formulas (Targeted Instructional Improvement Grant and Home-to-School Transportation) from the new formula. Additionally, the Legislature likely will want to work with the administration to explore ways to ensure that districts are using supplemental funds to benefit disadvantaged students as well as ensure districts have strong incentives to do routine maintenance on their facilities (given the state's large investment in these facilities over the last decade).

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

Some Concerns With Four of Governor's Proposition 98 Proposals

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

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

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

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

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

Serious Concerns With Governor's Proposition 39 Proposal

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

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

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

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

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

Higher Education

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

Governor Raises Major Concerns About Higher Education in California

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

Figure 11

Higher Education General Fund Support[a]

(Dollars in Millions)

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

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

Major Higher Education Proposals

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

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

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

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

Proposes to Cap Number of Units State Subsidizes. In addition, the Governor proposes placing a limit on the number of units the state would subsidize per student. Under the proposal, students taking units in excess of the cap generally would be required to pay the full cost of instruction. For 2013-14 and 2014-15, the Governor proposes a cap of 150 percent of the standard units needed to complete most degrees at UC and CSU (270 quarter-units at UC and 180 semester-units at CSU). Thereafter, the Governor proposes a cap of 125 percent of the standard required units at UC and CSU—about one extra year of coursework. For the community colleges, the Governor proposes a cap of 90 semester-units beginning in 2013-14. This cap also equates to about one extra year of coursework beyond that required for transfer. According to the Governor, the unit cap is intended to create an incentive for students to shorten their time-to-degree, reduce costs for students and the state, and increase access to more courses for other students.

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

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

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

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

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

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

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

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

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

Dissolution of Redevelopment Agencies

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

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

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

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

Figure 12

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

(In Millions)

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

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

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

Federal Patient Protection and Affordable Care Act

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

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

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

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

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

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

Governor Outlines Two Alternatives For Implementing Optional Medi-Cal Expansion

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

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

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

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

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

LAO Comments on Medi-Cal Expansion Proposal

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

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

County-Based Option Raises Policy and Implementation Issues. The county-based option raises important policy considerations for the Legislature. For example, the ACA envisions and, in some instances, requires administrative streamlining and simplification of health care programs for low- and moderate-income populations. Adopting the county-based option would potentially complicate these efforts. Under the state-based option, state-administered Medi-Cal would serve as the health care coverage program for nearly all qualified persons with income below 138 percent FPL—thereby simplifying program administration. In contrast, the county-based option would potentially continue fragmentation of state and local health care programs. Low-income childless adults would be enrolled in county-administered programs, while families with children and persons with disabilities would be enrolled in the state-administered Medi-Cal Program.

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

Budget Suggests Making Major Changes to State-County Relationship

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

LAO Comments on Changing State-County Relationship

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

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

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

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

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

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

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

Fiscal Estimates Are Incomplete. There are several potential costs and savings related to ACA implementation that are not included in the Governor's budget. As discussed above, the budget does not assume any state savings or costs associated with the optional Medi-Cal expansion. In addition, the budget does not assume savings from reduced enrollment in other state health programs—such as the Family Planning, Access, Care, and Treatment Program and the Breast and Cervical Cancer Treatment Program—that may result from the additional health coverage options made available under the ACA. The Legislature will need to account for these and other ACA-related fiscal effects in the 2013-14 spending plan.

Key ACA Policy Decisions Remain

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

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

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

California Department of Corrections and Rehabilitation

Budget Reflects Population Trends and Recent Administrative Actions

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

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

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

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

Other Issues

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

Infrastructure

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

Possible Effects on Education and Transportation, Among Other Areas. The administration discusses potential infrastructure changes in several policy areas. In transportation, the Governor plans to convene a working group to identify state spending priorities, consider long-term, pay-as-you-go funding options, and evaluate the division of responsibilities between state and local government. In higher education, the Governor once again proposes to shift the universities' general obligation bond debt-service payments into their base budgets. The administration asserts that this would limit the segments' capital spending by highlighting the trade-offs between spending on infrastructure versus operations. The Governor also suggests that now is an appropriate time to consider the state's role in funding K-12 facilities and outlines the administration's principles for any future state funding. Lastly, the administration intends to release a five-year infrastructure plan later this year, which will outline the administration's infrastructure priorities for the next five years. (If released, this would be the first statewide plan since the introduction of the Governor's budget in 2008-09.) Consistent with the alternatives discussed above, the administration states that the plan will rely less on future voter-authorized general obligation bonds than the state has over the past decade.

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

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

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

Unemployment Insurance Fund Insolvency

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

Effects of the Continuing Insolvency. For each year that the state carries a federal loan balance, UI taxes paid by employers are incrementally increased. The proceeds from these increased tax revenues are used to pay down the principal on the state's federal loan. Absent corrective action, the administration projects that the federal loan will not be fully repaid until sometime after 2020. Until then, state interest payments on the federal loan remain a significant annual liability.

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

Local Government Mandates

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

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

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