California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

ROOM 5019, STATE CAPITOL
SACRAMENTO, CA 95814

Mark Leno, Chair

(916) 651-4103
FAX (916) 668-7004

Agenda

January 23, 2014
9:30 a.m. or upon adjournment of Session
Room 4203

Overview of the Governor's 2014-15 Proposed Budget

I. Presentations by:

Keely Bosler, Chief Deputy Director
Department of Finance

Mac Taylor, Legislative Analyst

II. Public Comment

Attachments:

A. Quick Summary of the Governor's Proposed 2014-15 Budget
(Senate Budget and Fiscal Review Committee)

B. Overview of the Governor's 2014-15 Budget
(Legislative Analyst's Office)

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

SENATOR MARK LENO, CHAIR

Quick Summary

Proposed 2014-15 Budget

January 9, 2014

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 2014-15. 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 2014-15 which includes resources of $108.7 billion and expenditures of $106.8 billion. Based on the budget proposal, the General Fund would end the 2014-15 year with a reserve of almost $1 billion and include the deposit of $1.6 billion to the Budget Stabilization Account (BSA). The budget also includes the continuation of established efforts to pay down budgetary debt from past years, but proposes a more aggressive payment schedule. The 2014-15 budget benefits from past years of spending reductions and restraints, temporary taxes approved by the voters in 2012, and a steadily improving state economy.

As a result of the combined efforts of the Administration and the Legislature, the General Fund is in the most solid position in years. In the current year, the fiscal position of the state is expected to be substantially better than when the budget was adopted in June, with additional revenues resulting in a substantial increase in the year-end reserve to $3.3 billion. The proposed 2014-15 budget builds from this base, incorporating a general reserve and BSA of approximately $2.6 billion. Overall, General Fund spending in 2014-15 is expected to grow by approximately 8.5 percent from the current year, driven largely by increases in education funding—K-12 and higher education—and debt repayment. To provide some context, state budget expenditures previously peaked in 2007-08 with General Fund spending of about $103 billion. Thus, the budget year is the first year in which expenditures will be at or above the level of seven years ago.

Overview of Governor's Budget Proposal

The Governor's budget includes $108.7 billion in General Fund revenues and other resources and $106.8 billion in total General Fund expenditures, providing for a $967 million reserve as well as setting aside an additional $1.6 billion for the BSA. Expenditures in 2014-15 are proposed to be about $8.3 billion higher than revised 2013-14 expenditures. Significant additional funding is proposed for K-12 education, higher education, and early debt repayment, with some increases for health and human services, and corrections and rehabilitation. Additional resources that have allowed for measured expansions and workload growth are the result of very positive revenue growth based on the general economic upturn. The General Fund budget details are summarized below.

2013-14 and 2014-15
General Fund Summary
(Dollars in Millions)

	Revised 2013-14	Proposed 2014-15
PRIOR YEAR BALANCE	$2,528	$4,212
Revenues and transfers	$100,147	$104,503
TOTAL RESOURCES AVAILABLE	**$102,675**	**$108,715**
Non-Proposition 98 Expenditures	$57,515	$61,731
Proposition 98 Expenditures	$40,948	$45,062
TOTAL EXPENDITURES	**$98,463**	**$106,793**
FUND BALANCE		
Encumbrances	$955	$955
Special Fund for Economic Uncertainties	$3,257	$967
BUDGET STABILIZATION ACCOUNT	**--**	**$1,591**

Current-Year Budget Update

The 2013-14 budget, adopted in June 2013, contained measured increases in expenditures from the prior year, with relatively isolated—but important—restorations in selected areas. The Governor's proposed 2013-14 budget, included $98.5 billion in General Fund (and Education Protection Account) revenues, with expenditures of $97.7 billion. The Administration estimated that a $2.4 billion surplus would be sufficient to erase the $2.2 billion 2011-12 deficit. In January 2013, the Administration also projected that the $167 million ending balance (the first in years) and a $851 million operating surplus in 2013-14, would produce a reserve in 2013-14 of approximately $1.0 billion.

By May of 2013, the budget situation had improved modestly, based on Department of Finance (DOF) projections, largely as a result of somewhat improved revenue estimates. The Administration's revenue estimates at May Revision grew by $749 million for 2011-12, 2012-13 and 2013-14, combined (including a $500 million loan to the General Fund from cap and trade revenues). The May Revision called for certain realignment changes resulting in budget savings. Initially, the Legislature adopted the Legislative Analyst's Office's (LAO) more optimistic revenue projections; however, after negotiations with the Administration, lower revenue estimates were adopted that resulted in a smaller projected surplus. The adopted budget resulted in a 2012-13 reserve of $254 million and a 2013-14 reserve of approximately $1.1 billion. Additional spending on corrections, approved by the Legislature in August, reduced the expected reserve to approximately $700 million.

Instead of having to address major shortfalls, the state 2013-14 budget augmented several programs:

- **School Funding.** Major components included $2.1 billion under Prop 98 for the new Local Control Funding Formula (LCFF), $1.25 billion for Common Core State Standards, and $4.3 billion (2012-13 and 2013-14) to pay down K-14 deferrals.

- **Medi-Cal Expansion.** Adopted in special session, the expansion adopts a state-based plan to exercise the option, under federal health care reform, to cover more than one million additional low-income individuals.

- **Program Restorations and Augmentations.** Various program restorations were implemented, including: $63 million for the judicial branch, $17 million for adult dental care, $143 million for mental health services infrastructure, $67 million for enhanced mental health and substance abuse services, increased resources for CalWORKs, and a new financial aid program for higher education.

Since the budget was adopted, there have been several spending adjustments—particularly in the education and corrections areas—as well as significant improvements from the revenues adopted in the budget. The difference between the adopted and revised current year budget are presented below.

General Fund Expenditures
Current Year Adopted and Revised
(Dollars in Millions)

Program Area	**Adopted 2013-14**	**Revised 2013-14**	**Change**	**% Change**
K-12 Education	$39,661	$41,333	$1,672	4.2%
Higher Education	$10,923	$11,173	$250	2.3%
Health and Human Services	$28,084	$28,330	$246	0.9%
Corrections and Rehabilitation	$8,911	$9,361	$450	5.1%
Business, Consumer Services, Housing	$646	$646	$0	0.0%
Transportation	$206	$151	-$55	-26.7%
Natural Resources	$2,124	$2,127	$3	0.1%
Environmental Protection	$46	$47	$1	2.2%
Labor and Workforce Development	$299	$298	-$1	-0.3%
Government Operations	$742	$753	$11	1.5%
General Government				
Non-Agency Departments	$523	$519	-$4	0.8%
Tax Relief / Local Government	$421	$420	-$1	0.2%
Statewide Expenditures	$917	$611	-$306	-33.4%
Legislative, Judicial and Executive	$2,778	$2,694	-$84	-3.0%
Total	**$96,281**	**$98,463**	**$2,182**	**8.5%**

Proposed Budget Expenditures

Like the current year, the proposed budget incorporates additional but restrained new programmatic increases. The table below summarizes the Governor's proposed expenditures by program area. The most noteworthy changes are in education. The largest change in expenditure by program area is in K-12 education, where the Governor proposes $3.9 billion in additional expenditures to fully fund the Proposition 98 guarantee. On-going funding levels per student are expected to be $8,469 in 2013-14 and $9,194 in 2014-15. In higher education, the budget provides additional stable funding over multiple years. Finally, the Governor makes a significant commitment of resources to paying down debt and setting up a reserve.

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

Program Area	**Revised 2013-14**	**Proposed 2014-15**	**Change**	**% Change**
K-12 Education	$41,333	$45,251	$3,918	9.5%
Higher Education	$11,173	$12,377	$1,204	10.8%
Health and Human Services	$28,330	$28,793	$463	1.6%
Corrections and Rehabilitation	$9,361	$9,560	$199	2.1%
Business, Consumer Services, Housing	$646	$745	$99	15.3%
Transportation	$151	$212	$61	40.4%
Natural Resources	$2,127	$2,175	$48	2.3%
Environmental Protection	$47	$54	$7	14.9%
Labor and Workforce Development	$298	$268	-$30	-10.1%
Government Operations	$753	$685	-$68	-9.0%
General Government				
Non-Agency Departments	$519	$610	$91	17.5%
Tax Relief / Local Government	$420	$437	$17	4.0%
Statewide Expenditures	$611	$1,191	$580	94.9%
Legislative, Judicial and Executive	$2,694	$2,844	$150	5.6%
Economic Recovery Bonds Payment	-	$1,591	$1,591	-
Total	**$98,463**	**$106,793**	**$8,330**	**8.5%**

Other Budget Components

The Governor's Budget proposes some major policy and budgetary changes. Some of the more important aspects of the budget proposal are outlined below:

Budget Reserve

As an integral part of the proposal, the budget includes measures that would result in additional reserves for economic uncertainties. The proposed budget includes a constitutional amendment to strengthen the state's BSA reserve fund, which it terms a 'Rainy Day Fund.' The key components of the proposal are:

- **Deposits to the Fund.** Basing deposits on when capital gains revenues rise to more than 6.5 percent of General Fund tax revenues.

- **New Prop 98 Reserve.** Creating a Proposition 98 reserve, whereby spikes in funding would instead be saved for future years of decline and be used to smooth school spending to prevent the damage caused by cuts. The reserve would not alter the guaranteed level of funding under Proposition 98.

- **Size of Reserve.** Doubling the maximum size of the Rainy Day Fund from five percent to 10 percent of revenues.

- **Supplemental Payments.** Allowing supplemental payments to the Wall of Debt or other long-term liabilities in lieu of a year's deposit.

- **Fund Withdrawals.** Limiting the maximum amount that could be withdrawn in the first year of a recession to half of the fund's balance. This will ensure that the state does not overly rely on the fund at the start of a downturn.

The budget proposes making a down payment on saving for fiscal downturns by making a three percent deposit for 2014-15. Under current constitutional provisions, half goes to make a supplemental payment to pay off the Economic Recovery Bonds as described later and the other half—$1.6 billion—is deposited into the reserve fund.

Wall of Debt

The budget adopts a more aggressive pay-down of the Wall of Debt, as described further in this report. In 2011, the Wall of Debt's level of outstanding budgetary borrowing totaled $34.7 billion, which has now been reduced to less than $25 billion. The budget proposes reducing this debt by more than $11 billion this year, and fully eliminates it by 2017-18. The three key debt reduction proposals are:

- **Eliminate School Deferrals.** During the height of the recession, the state deferred almost 20 percent of annual payments to schools and community colleges, meaning that schools and colleges received one−fifth of their funds a year after they spent them. Some schools and colleges were able to borrow to manage these deferrals, while others had to implement the deferrals as cuts.

- **Economic Recovery Bonds Retirement.** Voters approved $15 billion in Economic Recovery Bonds in 2004 to cover budget deficits beginning in 2002. By making a supplemental payment of $1.6 billion this year, the state will retire the last of the bonds and finally finish paying for the 2002−03, 2003−04, and 2004−05 budgets.

- **Early Loan Payments.** The budget makes early payments on transportation loans totaling $351 million, and the Cap and Trade loan, totaling $100 million. This will enable the state to make critical investments in maintaining the state's highways and roads, and addressing climate change.

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 account for over 96 percent of General Fund revenues. For the budget year, the personal income tax is expected to generate $69.8 billion (66 percent), the sales and use tax $24.1 billion (24 percent), and the corporation tax $8.7 billion (8 percent). For the current year, all three taxes are expected to show improvements. Rapid expansion is expected to occur for the personal income tax, due largely to capital gains realizations, while the sales and use tax is expected to grow moderately. Even the corporation tax, which has been weak, is expected to recover somewhat.

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 8.5 percent for the personal income tax, 5.0 percent for the sales and use tax, and 8.9 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, as well as general economic growth.

Education

The budget proposes to continue investments in both K-12 schools and higher education. Increasing revenues in 2014-15 bring $10 billion in new Proposition 98 funding this year, and billions more in the next few years. The key changes in the education area include:

- **K-12 Schools.** Per student funding levels will increase by $3,410 through 2017-18, including an increase of more than $2,188 per student in 2014-15 over 2011-12 levels. The budget commits most new funding to districts serving disadvantaged students and corrects historical inequities in school district funding with continued implementation of the LCFF.

- **Higher Education.** The budget provides additional funding to the state's higher education system to help maintain its quality and affordability. The budget includes stable funding growth to eliminate the need for further tuition increases and intends to have community colleges and university systems work together to help ensure students complete their degrees in a timely manner.

Infrastructure

The Administration plans to release the state's five-year infrastructure plan shortly. This is the first plan since 2008. The plan is intended to focus on more than new projects and includes the estimated cost of $64.6 billion to maintain the state's existing assets. The budget includes $815 million ($800 million General Fund) to begin addressing the state's deferred maintenance projects in state parks, highways, local streets and roads, K-12 schools, community colleges, courts, prisons, state hospitals, and other state facilities. By maintaining its assets, the state will keeps its assets functioning longer and reduce the need to build more expensive new infrastructure.

Major Budget Components – Summary by Program Area

Overall Proposition 98 – K-14 Education

Prior- and Current Year Adjustments (resulting in additional one-time funds) The Governor's budget estimates that the total Proposition 98 guarantee (K-14) for 2012-13 increased by $1.8 billion, compared to the level estimated in the 2013 Budget Act. Similarly, for 2013-14, the Governor estimates an increase in the total guarantee of $1.5 billion. Both of these adjustments lead to Proposition 98 "settle-up" obligations, which result in additional one-time resources. (The Governor proposes to use these additional one-time resources to pay off deferrals – see below.) The Administration estimates that the Proposition 98 calculation for 2012-13 is a Test 1 calculation and for 2013-14 a Test 3 calculation.

Budget Year – Overall Funding Levels. The Governor's budget estimates a total Proposition 98 funding level of $61.6 billion (K-14). This is a $6.3 billion increase over the 2013-14 Proposition 98 level provided in the 2013 Budget Act. The Administration estimates that the Proposition 98 calculation for 2014-15 will be a Test 1 calculation.

Paying off Budgetary Deferrals. The Governor's budget proposes to repay all K-14 deferrals, as cited in the Governor's budget summary at a total cost of $6.4 billion. This proposal eliminates a practice used in prior budgets, in which school districts and community colleges would receive a significant portion of their funds a year after they had spent them. This practice resulted in hardships for school districts and community colleges, which would oftentimes have to borrow money to accommodate the deferrals, or cut services.

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

The Governor's budget includes a proposed Proposition 98 funding level of $54.3 billion for K-12 programs. This includes a year-to-year increase of nearly $4.3 billion in Proposition 98 funding for K-12 education, as compared to the revised Proposition 98 K-12 funding level for 2013-14. Under the Governor's proposal, ongoing K-12 Proposition 98 per pupil expenditures increase from $8,469 provided in 2013-14 to $9,194 in 2014-15. This 2014-15 proposed funding level in Proposition 98 funds for K-12 reflects a per-pupil increase of 8.6 percent, as compared to the per-pupil funding level provided in the 2013 Budget Act. The Governor's major K-12 spending proposals are identified below.

Paying off deferrals. As noted above, the Governor's budget proposes to pay off outstanding payment deferrals – a practice used in previous budgets whereby the state would delay the issuance of money to school districts for months after school districts had planned to spend it. The Governor's budget proposes to end this practice by paying off all payment deferrals, estimated at a cost of $6.4 billion for K-12 programs and community colleges. For K-12 programs, the LAO estimates the total amount of payment deferrals at $5.6 billion, all of which would be paid off in the Governor's proposed budget.

New K-12 School Finance Formula (Local Control Funding Formula). The 2013 Budget Act adopted a new way for the state to provide funding to school districts and county offices of education: the Local Control Funding Formula (LCFF). The Governor's budget proposes an increase of $4.5 billion to implement the LCFF. This investment would eliminate about 28 percent of the funding gap between the formula's 2013-14 funding level and its target at full implementation. The budget proposes to fund the formula's base grants at a rate of $7,829 per pupil, as measured by pupil average daily attendance (ADA), inclusive of cost-of-living and grade span adjustments. The 2013-14 budget funded the base grants at $7,643 per pupil ADA. Proposals to change LCFF from current law include transferring funding into the formula for two additional categorical programs (specialized secondary programs and agricultural vocational education), and creating a new continuous appropriation of LCFF funding that would bypass the annual budget process.

Enrollment and Cost-of-Living Adjustments. The Governor's proposed budget reflects an estimated decrease in student enrollment in the K-12 system. Specifically, it reflects a decrease of $214.5 million in 2013-14, as a result of a decrease in the projected average daily attendance (ADA), as compared to the 2013 Budget Act. For 2014-15, the Governor's proposed budget reflects a decrease of $42.9 million to reflect a projected decline in ADA for the budget year. (For charter schools, the Governor's proposed budget funds an estimated increase in charter school ADA – see "Other adjustments" below). The proposed budget also provides $33.3 million to support a 0.86 percent cost-of-living adjustment for categorical programs that are not included in the new LCFF. These programs include special education and child nutrition, among others. The proposed funding level for the LCFF includes cost-of-living adjustments for school districts and county offices of education.

Constitutional Amendment to create a Proposition 98 reserve. The Governor's budget proposes a constitutional amendment to increase year-to-year stability in education funding. The amendment is intended to create a mechanism to smooth out year-to-year changes in education funding, in order to prevent the damage caused by significant cuts to education. The budget summary states, "The amendment will not change the overall guaranteed level of funding for education."

Non-classroom-based independent study. The Governor's budget summary states that the Administration plans a legislative proposal regarding the use of non-classroom-based independent study, also commonly known as on-line independent study. The summary describes the legislative proposal as having the objective "to both streamline and expand the instructional opportunities available through this process." The proposal would require that independent study courses meet the following requirements: 1) be equivalent in rigor and quality to classroom-based courses; 2) contain the same number of educational minutes as classroom-based courses; 3) provide at least one meeting per week between the teacher and students; 4) maintain student-teacher ratios equivalent to that in classroom-based courses (unless a new ratio is collectively bargained); and 5) may not result in the school district or county office claiming more than one unit of ADA for each student enrolled in independent study.

Other K-12 Education Budget Proposals

K-12 School Facilities. The Governor's Budget proposes $188.1 million in one-time Proposition 98 funds for the Emergency Repair Program. In addition, the Administration proposes to continue a dialogue with the Legislature and stakeholders about the best way to fund school facilities, "including consideration of what role, if any, the state should play in the future of school facilities funding." The Administration proposes to transfer $211 million in remaining School Facility Program bond authority from specialized programs to new construction ($105.5 million) and modernization ($105.5 million) programs. The budget summary notes that approximately $163 million remains in the Seismic Mitigation program.

Proposition 39 Energy Efficiency Investments. The Governor's budget proposes to allocate $363 million in Proposition 39 energy funds available in 2014-15, as follows:

- $316 million to K-12 school districts, for energy efficiency project grants.

- $39 million to community college districts, for energy efficiency project grants.

- $5 million to the California Conservation Corps, to provide technical assistance to school districts.

- $3 million to the Workforce Investment Board, for continued implementation of job-training programs.

The Governor's budget does not propose an increase in Proposition 39 funds for revolving loans under the Energy Conservation Assistance Act.

Assessments to help implement the New Common Core Standards. The Governor proposes an increase of $46.5 million in Proposition 98 funds to implement AB 484 (Bonilla), Chapter 489, Statues of 2013. This bill created a new assessment system aligned to the new common core standards, which have been embraced by California and most other states.

Charter Schools. The Governor's budget proposes an increase of $74.3 million in Proposition 98 funds to reflect an increase in charter school ADA.

Adult Education. While the Governor's budget does not include any new proposals to adult education, the budget summary cites the reforms initiated in the 2013 Budget Act, and notes that adult education consortia plans will be completed in early 2015. The summary also cites the Administration's intent to invest in adult education in 2015-16, via a single adult education categorical program. The summary also signals the Administration's intent to continue working with the Legislature, the State Department of Education and the California Community Colleges Chancellor's Office on the work initiated in the 2013 Budget Act.

Child Care and Development

The Governor's budget includes a demonstration pilot to try to improve the outcomes for 2,000 CalWORKs families, to involve six counties over three years, providing licensed subsidized childcare and other services. The budget does not include any other major changes or proposals to preschool or childcare funding. The proposed budget includes the following minor adjustments for 2014-15:

- Stage 2 – an increase of $6.3 million General Fund (non-Proposition 98) to reflect a combination of a decrease in caseload and an increase in the cost-per-case.

- Stage 3 – an increase of $2.8 million General Fund (non-Proposition 98) to reflect a combination of a decrease in caseload and an increase in the cost-per-case.

- Federal Child Care and Development Funds – a decrease of $9.1 million to reflect a reduction in carryover funds and a decrease of $5.9 million in the base grant.

Higher Education

Multi-Year Stable Funding Plan – The Governor's budget continues to support the four-year investment plan in higher education that started in 2013-14, which assumes additional General Fund support for the University of California (UC), the California State University (CSU), California Community Colleges (CCCs) and Hastings College of the Law.

The multi-year plan assumes a five percent increase for UC and CSU in 2014-15 and a four percent increase in each of the subsequent two years. The continuation of the multi-year plan is predicated on the UC Regents and the CSU Board of Trustees adopting three-year sustainability plans that set targets for key measures, and the expectation that the universities maintain current tuition and fee levels through 2016-17.

State funding for the CCCs is projected to increase by 11.4 percent in 2014-15 and the Administration expects that community colleges funding will continue to grow significantly over the next several years, as Proposition 98 resources continue to rebound. The Governor's budget focuses this increased funding to support student success and to prioritize expanded access in districts where there is the greatest unmet need in the primary missions of the CCCs.

Promote Innovative Models of Higher Education – The budget proposes $50 million in one-time General Fund to create the Awards for Innovation in Higher Education program. Applications for awards can be submitted by a UC, CSU, community college, or a group of any of these entities. These incentive awards are proposed to recognize models of innovation in higher education that: 1) significantly increase the number of individuals in the state who earn bachelor's degrees; 2) allow students to earn bachelor's degrees that can be completed within four years of enrollment in higher education; and, 3) ease transfer through the state's education system, including by recognizing learning that has occurred across the state's education segments or elsewhere.

University of California – Specific Adjustments

General Fund Increase – As discussed above, an increase of $142.2 million General Fund pursuant to the multi-year funding plan. This funding is predicated on maintenance of current tuition levels.

Hastings College of the Law – Specific Adjustments

General Fund Increase – An increase of $1.3 million General Fund. This funding is predicated on maintenance of current tuition levels.

California State University – Specific Adjustments

General Fund Increase – As discussed above, an increase of $142.2 million General Fund pursuant to the multi-year funding plan. This funding is predicated on maintenance of current tuition levels.

Infrastructure Needs – Proposes to fund the costs of debt service from CSU's main General Fund appropriation, instead of a separate budget appropriation. Any new CSU capital expenditures will be subject to Administrative approval to ensure the funds are used for academic facilities; and there will be limits on the amount of the CSU's budget that can be spent on capital expenditures. The Governor proposed a similar approach last year that was rejected by the Legislature.

California Community Colleges – Specific Adjustments

Please see the K-12 Education section of this report for additional information on the overall K-14 Proposition 98 budget.

Implementing Statewide Performance Strategies – Proposes $1.1 million non-Proposition 98 General Fund and nine positions for the Chancellor's Office to develop leading indicators of student success and to monitor districts' performance. Further, proposes $2.5 million Proposition 98 General Fund to provide local technical assistance to support implementation of effective practices across all districts, with a focus on underperforming districts.

Investing in Student Success – Provides $200 million Proposition 98 General Fund to improve and expand student success programs and to strengthen efforts to assist underrepresented students. This includes $100 million to increase orientation, assessment, placement, counseling, and other education planning services for all matriculated students. In addition, targets $100 million to close gaps in access and achievement in underrepresented student groups, as identified in local Student Equity Plans. This funding is intended to allow colleges to better coordinate delivery of existing categorical programs.

Allocating Apportionments – Proposes $155.2 million Proposition 98 General Fund for growth in general-purpose apportionments, which represents a three percent increase in enrollment. The Governor's budget directs the Board of Governors to adopt a growth formula that gives first priority to districts identified as having the greatest unmet need in adequately serving their community's higher educational needs. All districts will receive some additional growth funding and, over time, will be fully restored to pre-recession apportionment levels.

Cost of Living Adjustment – Proposes $48.5 million for a statutory cost-of-living adjustment of 0.86 percent.

Eliminating Apportionment Deferrals – Proposes $235.6 million Proposition 98 General Fund, combined with $356.8 million Proposition 98 General Fund provided from 2012-13 and 2013-14 funds, to eliminate all remaining outstanding deferral debt owed to the CCCs. Inter-year deferrals for CCCs reached a high of $961 million in the 2011-12 fiscal year. The increase will eliminate the substantial borrowing costs borne by the districts as a result of funding deferrals, and will allow those resources to instead be used in the classroom.

Financial Stability for Apportionments – Proposes $38.4 million in 2013-14, and $35.6 million in 2014-15, in Proposition 98 General Fund by shifting a portion of the redevelopment agency revenues that are scheduled to be received in the final months of the fiscal year to the following fiscal year. Proposition 98 General Fund would be used to backfill the difference between estimated total fiscal year redevelopment agency revenues and the amount the CCCs receive through April 15th. This change is intended to allow districts to have more certainty when preparing their fiscal plans.

Investing in Deferred Maintenance and Instructional Equipment – Proposes $175 million Proposition 98 General Fund, on a one-time basis, split equally between deferred maintenance and instructional equipment purchases. These resources are intended to allow districts to protect investments previously made in facilities, and improve students' experience by replenishing and investing in new instructional equipment.

Student Financial Aid

Middle Class Scholarship Implementation – Includes $107 million General Fund to begin implementation of the Middle Class Scholarship Program.

Expand Cal Grant Renewal Award Eligibility – Includes $14.9 million General Fund to allow students who have previously been denied a Cal Grant renewal award for financial reasons (their income rose above eligibility levels) to reapply for the program no more than three academic years after receiving their original award (if their incomes fall below the income threshold in that timeframe).

Cal Grant Program Growth – Includes $3.4 million General Fund in 2013-14, and $103.3 million General Fund in 2014-15, to reflect increased participation in the Cal Grant program. Of the 2014-15 amount, $28 million is attributable to the second year of implementation of the California Dream Act.

Offset Cal Grant Costs with Federal Temporary Assistance for Needy Families (TANF) Reimbursements – Includes a decrease of $3.2 million General Fund to reflect increased TANF funds available through an interagency agreement with the Department of Social Services. This adjustment will bring the total TANF funds expended on the Cal Grant program to $544.9 million in 2014-15.

Offset Cal Grant Costs with Student Loan Operating Fund (SLOF) – Includes $60 million SLOF funds to offset Cal Grant General Fund costs.

California State Library

High-Speed Internet Access – Proposes $3.3 million General Fund to provide public libraries access to high-speed Internet to better meet the demands of today's library patrons. This includes $2.3 million to allow California's public library branches to access a statewide, high-speed Internet network, and $1 million General Fund, on a one-time basis, for grants to public libraries that require equipment upgrades to connect to a high-speed network.

Resources and the Environment

- **Cap and Trade Revenues** – Proposes to invest $850 million of Cap and Trade auction revenue proceeds to support existing and new programs, including those that meet statutory mandates for funding to low income and disadvantaged communities. Funding is proposed to be allocated, as follows: (1) $300 million for rail modernization, including $250 million for High Speed Rail; (2) $100 million to the Strategic Growth Council for sustainable communities; (3) $200 million to the Air Resources Board for low carbon transportation; (4) $140 million for energy efficiency and clean energy, including funding for water efficiency, weatherization programs and agricultural energy efficiency; (5) $50 million for fire prevention and urban forestry; (6) $30 million for waste diversion; and, (7) $30 million for wetlands and watershed restoration. The budget also proposes $5 million from the Environmental License Plate Fund for a one-time climate change assessment.

- **Drinking Water Program Reorganization** – Proposes to consolidate water regulatory agencies by shifting the Drinking Water Program from the Department of Public Health to the State Water Board.

- **Beverage Container Recycling Program Reform** – Proposes a second phase of the recycling program reform to address a structural deficit of $100 million within the Beverage Container Recycling Fund. The reform includes a three-year phase-out of processing fee subsidies, elimination of administrative fees paid to processors and recyclers, redirection of existing funds to support local recycling and fraud deterrence; and, diversification of funding for local conservation corps.

- **Water Action Plan** – Proposes investment of $619 million to address water supply and quality issues, including $8 million for groundwater management, $11 million for projects in disadvantaged communities, and $20 million for water and energy efficiency. Continues to fund flood protection and integrated regional water management programs with existing bond funding.

- **Oil Spill Response Program** – Proposes $6.7 million from the Oil Spill Prevention and Administration Fund and 39 positions to enhance inland oil spill prevention, preparedness and response capabilities, mainly from increased rail shipments.

- **State Parks Operations and Deferred Maintenance** – Proposes a one-time increase of $14 million to continue existing park service levels throughout the state. Proposes $40 million for critical infrastructure and deferred maintenance.

- **Proposition 39 Energy Efficiency Funds** – Proposes to allocate $363 million of energy efficiency funds, including $355 million for K-12 and Community Colleges, $5 million for the California Conservation Corps for continued technical assistance to K-12 school districts, and $3 million to the Workforce Investment Board for job training. (See additional information under the K-12 Education section.)

- **Coastal Commission Local Coastal Plan Funding** – Reduces funding for Local Coastal Plan upgrades. The current-year budget includes $3 million (one-time, General Fund) as part of a multi-year proposal intended to address sea level rise from climate change within local coastal plans. The proposed budget does not continue this funding.

- **California Advanced Services Fund Program Expansion** – Proposes $39 million, as required by statute, to provide broadband services to areas currently without broadband access and to build out facilities in underserved areas.

Transportation

Department of Transportation Funding – Provides for total expenditures of $10.9 billion for the department, including $9.9 billion for highway transportation. The primary sources of funding for the department are federal funds, plus state taxes on gasoline and diesel fuel, and vehicle weight fees (about $8.2 billion), with additional funds from Propositions 1B bonds (about $745 million), and reimbursements from local governments (about $1.6 billion).

Transit Funding – Provides about $373 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 $824 million in 2014-15.

Repayment of Transportation Loans – Proposes to repay $351 million of transportation funds loaned to the General Fund. Uses of the funds from the repayment include the following: $110 million for payment rehabilitation projects on the state highways, $100 million to cities and counties for preservation of local streets and roads, $100 million for traffic management mobility projects, $27 million for highway payment maintenance, and $9 million for active transportation projects.

Cap and Trade Revenues – Provides $50 million in Cap and Trade funds in the Caltrans budget for competitive grants for existing rail operators to integrate rail systems and to provide connectivity to high-speed rail. Also, proposes $100 million for the Strategic Growth Council to support implementation of SB 375 (Steinberg), Chapter 728, Statutes of 2008, for sustainable communities strategies. These strategies include projects such as, transit and transit-oriented development, that includes low-income housing, active transportation, agricultural land preservation, and planning.

High-Speed Rail – Proposes $1.3 billion ($1.1 billion in federal funds and $250 million in Cap and Trade funds) in capital outlay funding to acquire property and right-of-way access to begin construction of the first section of the high-speed rail system extending from Madera to near Bakersfield. Proposed legislation would establish an ongoing commitment of Cap and Trade revenues to the high-speed rail project. Also, the budget proposes state operations funding of $29 million from a loan from the Public Transportation Account to fund 177 state staff and various contractors to develop and implement the project. In addition, $32 million in federal funds is for local agencies to develop local/regional components of the high-speed rail system.

Department of Motor Vehicles – Provides $64.7 million to DMV to implement, beginning January 2015, SB 60 (Alejo), Chapter 524, Statutes of 2013, which requires DMV to issue a driver's license to undocumented residents who are unable to submit satisfactory proof that their presence in the United States is authorized under federal law. This is anticipated to result in 1.4 million additional people receiving drivers' licenses over the next three years. The budget assumes 822 staff will be hired by September 2014 and that five temporary offices will be established in key locations throughout the state.

California Highway Patrol – Provides $16 million for the replacement of four aircraft (two helicopters and two airplanes) for the second year of a long-term replacement plan for CHP's aging air fleet.

Health and Human Services

The Governor's budget includes a total of $118 billion ($28.8 billion General Fund and $89.2 billion other funds) for health and human services that serve low-income, vulnerable individuals and families.

Health

Department of Health Care Services (DHCS)

The budget proposes $76.1 billion ($17.2 billion General Fund) for DHCS.

Medi-Cal Program. The budget proposes total expenditures of $73.9 billion ($16.9 billion General Fund) for 2014-15. This is a 4.1 percent increase in General Fund spending from the prior year. It is projected that Medi-Cal will serve about 10.1 million Medi-Cal eligible individuals, an increase in caseload of about 10.2 percent, primarily due to the implementation of federal health care reform.

Federal Health Care Reform. ABX1 1 (Pérez) and SBX1 1 (Hernandez and Steinberg) of 2013 implemented aspects of federal health care reform and expanded Medi-Cal by:

- Simplifying eligibility, enrollment, and retention rules, making it easier to enroll and stay on Medi-Cal. This is referred to as the "mandatory expansion."
- Expanding eligibility to adults without children and parent and caretaker relatives with incomes of up to 138 percent of the federal poverty level. This is referred to as the "optional expansion."
- Increasing mental health and substance use disorder benefits available in Medi-Cal.

The budget includes $867.4 million ($404.9 million General Fund) for the mandatory expansion and $6.7 billion federal funds for the optional expansion. The federal government has committed to pay 100 percent of the costs of the optional expansion for the first three years; by 2020-21, the federal share will decrease to 90 percent and the state will pay 10 percent.

Federal health care reform is expected to increase the Medi-Cal caseload by 1.03 million in 2013-14 and 1.36 million in 2014-15.

Medi-Cal Provider Rate Reductions. AB 97 (Budget Committee), Chapter 3, Statutes of 2011, enacted Medi-Cal provider rate reductions. The budget proposes that these reductions will result in General Fund savings of $282.8 million in 2014-15, this includes $244.5 million for the ongoing savings and $38.3 million for the retroactive recoupment of these savings.

Forgive Retroactive Provider Rate Reductions. The Administration proposes to forgive retroactive provider rate reduction recoupments for certain fee-for-service providers and services (physicians/clinics, specialty drugs, dental, intermediate care facilities for the developmentally disabled, and medical transportation) for an increase of $11.6 million ($5.8 million General Fund) in 2013-14 and

$72.6 million ($36.3 million General Fund) in 2014-15. The total cost of these recoupments is $434.2 million ($217.1 million General Fund) and will be spread over the next several years. (Retroactive obligations are not proposed to be forgiven for non-specialty drugs, distinct-part nursing facilities, and durable medical equipment/medical supplies.)

The Administration intends to seek federal matching dollars to forgive these retroactive reductions. Previously, the Administration had indicated that state-only funds could be used to forgive retroactive reductions.

Coordinated Care Initiative (CCI). The Administration includes a net General Fund savings of $159.4 million in 2014-15 as a result of CCI, including the General Fund savings from the sales tax on managed care organizations. Without the tax revenue, CCI would have a General Fund cost of $172.9 million in 2014-15.

The Administration proposes the following for CCI:

- Cal MediConnect dual eligibles in Medicare fee-for-service will be passively enrolled for Medicare and Medi-Cal benefits; beginning on April 2014, in Orange, Riverside, San Bernardino, San Diego, and San Mateo counties.
- In Los Angeles County, dual eligibles may voluntarily enroll in Cal MediConnect or opt out, beginning April 2014; and the remaining dual eligibles will be passively enrolled, beginning in July 2014.
- Alameda and Santa Clara counties will passively enroll dual eligibles no sooner than July 2014.
- Trailer bill language to no longer exempt Medicare Advantage and D-SNP plans from Cal MediConnect enrollment, effective January 2015.
- Those only eligible for Medi-Cal or for partial Medicare coverage in all participating counties will have long-term supports and services included in managed care, beginning July 2014.

Background: The CCI will operate in eight counties: Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, and Santa Clara. The main components of CCI are:

- Cal MediConnect Program: A voluntary three-year demonstration (with the federal CMS) for dual eligible beneficiaries (those eligible for both Medicare and Medi-Cal) to receive coordinated medical, behavioral health, long-term institutional, and home-and community-based services through a single organized delivery system. No more than 456,000 beneficiaries would be eligible for the duals demonstration in the eight counties.

- Managed Medi-Cal Long-Term Supports and Services (MLTSS): All Medi-Cal beneficiaries, including dual eligible beneficiaries, will be required to join a Medi-Cal managed care health plan to receive their Medi-Cal benefits, including LTSS and Medicare wrap-around benefits.

Medi-Cal Pregnancy Coverage. Under current law, citizen pregnant women with incomes up to 208 percent of the federal poverty level (FPL) are eligible for limited-scope services (generally pregnancy-related services) under Medi-Cal. The Administration proposes that beneficiaries with incomes under 100 percent of FPL would receive full-scope Medi-Cal and that beneficiaries with incomes between 100 and 208 percent of FPL will receive comprehensive coverage through Covered California (the state's health benefit exchange). The Governor's budget proposes to pay for the out-of-pocket costs for these beneficiaries electing to receive coverage through Covered California, beginning in January 2015, which will result in General Fund savings of $16.6 million in 2014-15.

Drug Medi-Cal Program Integrity. The Governor's budget proposes 21 positions and $2.2 million ($1.1 million General Fund) to continue increased program integrity efforts and recertification of Drug Medi-Cal providers. This proposal is in response to program integrity concerns. Since July 2013, DHCS has temporarily suspended the certification of 177 facilities and referred 68 drug treatment providers to the Department of Justice for potential criminal prosecution.

Pediatric Dental and Vision Services Outreach. The budget proposes $17.5 million ($8.75 million federal funds and $8.75 million Proposition 10 funding provided by the California Children and Families Commission) to increase dental outreach activities for children ages zero to three years old. This outreach is intended to increase pediatric dental utilization. The method for improving the utilization and quality of pediatric vision services is still under development.

Managed Risk Medical Insurance Board (MRMIB)

The budget includes $177.6 million ($1.2 million General Fund) for programs administered by MRMIB. MRMIB currently administers the Access to Infants and Mothers Program, which provides comprehensive health care to lower middle-income pregnant women; the County Health Initiative Matching Fund Program, which provides comprehensive health benefits through county-sponsored insurance programs; and the Major Risk Medical Insurance Program, which provides health coverage for individuals with pre-existing conditions.

Elimination of MRMIB. The Administration proposes to eliminate MRMIB and transfer its programs to the Department of Health Care Services, effective July 1, 2014.

Department of Public Health (DPH)

The budget proposes $3 billion ($110.6 million General Fund) for DPH. This is a decrease of about $4.6 million General Fund compared to the Budget Act of 2013.

Drinking Water Program Reorganization. The budget proposes to transfer $200.3 million ($5 million General Fund) and 291.2 positions for the Drinking Water Program to the State Water Resources Control Board. Please see the Resources and Environment Section of this report for additional information.

Genetic Disease Screening Program. The budget proposes to implement a $45 fee increase, effective July 1, 2014, in the Prenatal Screening Program to bring the fee to $207. This fee covers the blood test for detecting birth defects during pregnancy and the follow-up services offered to women with positive screening results. The Administration proposes that the fee increase is necessary to correct for the historic overstatement of caseload and inadequate fee revenue in recent years to cover costs of the program.

Office of Statewide Health Planning and Development (OSHPD)

The budget proposes $145.7 million ($74,000 General Fund) for OSHPD.

Song-Brown Primary Care Residency Program. The budget proposes $2.84 million from the California Health Data Planning Fund per year, for three years, to fund a pilot to expand the Song-Brown program to provide grants to primary care residency programs and to expand eligibility to teaching health centers.

Department of State Hospitals (DSH)

The budget proposes $1.6 billion ($1.5 billion General Fund) for the support of DSH. The patient population is projected to reach a total of 7,214 in 2014–15. Over 90 percent of the current population comes from the criminal justice system.

***Coleman v. Brown* Lawsuit Patients** – Proposes $26.3 million General Fund to keep 137 beds active at Salinas Valley and Vacaville Psychiatric Programs to serve "Coleman" patients during the activation of the new California Health Care Facility in Stockton.

Incompetent to Stand Trial (IST) Patients – Proposes $27.8 million (General Fund) to increase bed capacity by 105 beds to address the waiting list for IST patients.

Safety and Security – Proposes $8 million (General Fund) to complete the installation and updating of the Personal Duress Alarm System (PDAS) projects. The system is currently being installed in Patton and Metropolitan State Hospitals and installation will begin at Atascadero and Coalinga in 2014. Upgrade of the PDAS at Napa State Hospital was successfully completed in November 2012.

Short-Term Housing Units – Proposes $1.5 million (General Fund) for the design and planning of specialized, short-term housing units at most state hospitals, totaling approximately 44 beds statewide.

Patient Management Unit – Proposes $1.1 million (General Fund) for the creation of a centralized patient management unit that will allow DSH to centralize the intake management of their patients. The Administration intends for this to allow them to improve their utilization of beds by directing patients to the most appropriate hospital for their needs.

State Hospital Maintenance Infrastructure Improvements – Proposes $10 million to address unidentified deferred infrastructure maintenance costs.

Human Services

Developmental Services

The Department of Developmental Services (DDS) will provide services and supports to an estimated 274,000 individuals with developmental disabilities, in the current year. Approximately 1,330 of these individuals reside in state developmental centers (DCs). The Governor proposes an overall 2014-15 budget for DDS of $5.2 billion ($2.9 billion GF). This reflects an increase of nearly 8,000 individuals served in the community and a reduction of 223 individuals residing in DCs.

- **Developmental Centers:**

  - **Master Plan:** Trailer bill language adopted last year, required the Secretary of the California Health and Human Services Agency (Secretary) to submit to the Legislature a master plan for the future of DCs, by November 15, 2013; and to submit to the Legislature, by January 10, 2014, the Administration's resulting plans to meet the needs of all current residents in DCs. The master plan, developed in consultation with a task force established by the Secretary, is expected to be submitted to the Legislature shortly, but it is unknown when the more specific plans to implement the recommendations of the master plan will be submitted.

  - **Certification Issues:** The Governor's budget includes $9.2 million ($5.1 million GF) for on-going costs to implement the Sonoma Developmental Center (SDC) Program Improvement Plan (PIP). Additionally, the Governor has submitted to the Joint Legislative Budget Committee a notification of unanticipated cost funding request from DDS for $7.2 million ($3.6 million GF) to cover current year costs. The PIP addresses quality of care deficiencies at SDC that resulted in the loss of federal certification and funding for four Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) units. The budget assumes the restoration of federal reimbursements at SDC in the budget year.

    On January 3, 2014, the state Department of Public Health announced that they had begun the process for decertifying ICF-IID units at the remaining three DCs -- Fairview, Porterville and Lanterman. The Governor's budget anticipates entering into an agreement in January specifying a path to resolve these certification issues.

- **Population Adjustments:** The budget assumes a decrease of $12.8 million ($2.8 million GF) to reflect a reduction in the number of residents at state developmental centers, excluding Lanterman.

- **Lanterman Closure Activities:** The budget proposes a net decrease of $22.7 million ($12 million GF) related to closure activities at Lanterman Developmental Center.

- **Deferred Maintenance:** The budget includes $10 million GF to address critical infrastructure deferred maintenance needs.

- **Community Services Program**

  - **Caseload and Utilization:** The Governor's budget provides a $2.4 million increase ($8.4 million GF decrease) to reflect caseload and utilization growth in the current year, including higher than anticipated enrollment in the federal Home and Community-Based waiver. For 2014-15, the budget proposes an increase of $138.6 million ($82.9 million GF).

  - **Regional Center Operations:** The Governor's budget provides a $2.1 million GF increase in regional center operations, in both the current and budget years, to correct the double-counting of savings related to the 2009-10 Early Start Eligibility savings proposal.

  - **Impacts from Other Departments:** The Governor's budget proposes a decrease of $3.1 million GF to reflect the restoration of Enteral Nutrition and partial restoration of Adult Dental Services as a Medi-Cal Optional Benefit.

  - **Labor Regulations and Minimum Wage Impacts:** The budget includes $7.5 million ($4 million GF) to make adjustments for new United States Department of Labor regulations requiring overtime compensation for service providers previously exempt, effective January 1, 2015. Additionally, the budget includes $110.1 million ($69.5 million GF), to address the impact of the increase in the state minimum wage to $9 per hour, effective July 1, 2014.

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 Governor proposes an overall 2014-15 budget of $5.5 billion in federal, state, and local funds for the program and estimates a caseload of 529,000 families (a decrease of 4 percent).

- **Parent/Child Demonstration Pilot:** The Governor's budget proposes a six-county, 2,000 family pilot project over three years for low-income families to connect children with licensed child care. The budget projects a $9.9 million GF cost in 2014-15 and $115.4 million GF total over three years, and assumes the first cohort of families to enroll in March 2015, and the second cohort in 2016.

- **Maximum Aid Payment Levels:** The Governor's budget assumes a 5 percent increase in Maximum Aid Payment Levels, effective March 1, 2014, and estimates an annual cost of $168 million to be funded by 1991 Realignment growth funds and a $6.3 million GF augmentation.

In-Home Supportive Services (IHSS)

The IHSS program provides personal care and domestic services to approximately 450,000 low-income individuals who are aged, blind, or have disabilities. Over the last several years, the enacted budgets have included major reductions and changes to the IHSS program, including an 8 percent reduction, from July 1, 2013, to June 30, 2014, in authorized hours of service to each IHSS recipient, and, beginning July 1, 2014, a 7 percent reduction in authorized hours. The budget includes $2 billion GF (a 6.4 percent increase) and estimates a 453,417 person caseload in 2014-15.

- **Overtime compensation:** The Governor's budget recognizes the U.S. Department of Labor's new Fair Labor Standards Act regulations, effective January 1, 2015, that require overtime pay for domestic workers and for activities that were not previously eligible for compensation, such as travel time between multiple recipients, wait time associated with medical accompaniment, and time spent in mandatory provider training. The budget proposes to prohibit providers from working overtime, except for documented emergency circumstances, and will create a Provider Backup System to assist recipients in obtaining a provider if their regular provider exceeds the number of authorized hours. The budget assumes that implementation of new federal requirements will cost $208.9 million ($99.1 million GF) in 2014-15 and $327.9 million ($153.1 million GF) annually thereafter.

- The Governor's budget also makes changes to the anticipated schedule 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 is 1.3 million recipients. The Governor's budget reflects an estimated cost-of-living increase of 1.5 percent in 2014 and 0.6 percent in 2015 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. The budget includes $2.8 billion GF for the SSI/SSP program.

- **Community Care Licensing:** The Governor's budget includes $7.5 million ($5.8 million GF) and 71.5 positions in 2014-15 for quality enhancement and program improvement measures. The funds will allow the Community Care Licensing Division to inspect a licensed residential facility at least once every five years, as statutorily required, increase staff training, and create a specialized complaint hotline. The budget assumes these changes to be funded, in part, by a proposed 10 percent increase in licensing fees.

- **State Hearings Division:** The Governor's budget includes $9.8 million ($1.3 million GF) and 63 two-year limited-term positions in 2014-15 to address anticipated workload impact from the Affordable Care Act implementation.

Local Government

- **Redevelopment.** As part of the 2011-12 budget, local redevelopment agencies (RDAs) were dissolved. The adopted legislation allowed for continued payment of obligations secured by the property tax increment, but redirected "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. In addition, flurry of lawsuits and the general complications involved in eliminating this $5 billion program add to the uncertainty. In 2011-12 and 2012-13 combined, approximately $2.2 billion was returned to K‑14 schools. The Governor's budget anticipates Proposition 98 General Fund savings resulting from the dissolution of RDAs will be $1.1 billion in 2013-14. For 2014‑15, Proposition 98 General Funding savings are expected to be $785 million. On an ongoing basis, Proposition 98 General Fund savings are estimated to be $1 billion annually. Under certain conditions, funds above this amount will increase available resources for K‑14 schools.

- **Economic Development.** Local governments have a number of different tools available to them for local economic development efforts. In some respects, however, the elimination of RDAs does leave them without the flexibility that is important for addressing various local needs. One underutilized financing method is the Infrastructure Financing District (IFD). IFDs are empowered to use tax increment financing to finance tax allocation bonds, the proceeds from which are used for local development. Cities, counties, and special districts have the option to participate in IFDs while schools cannot. IFDs require a two-thirds vote by the affected electorate to be created and are limited in the types of projects that they may generally fund.

The budget proposes expanding the tax increment financing tool utilized by IFDs, for a broader array of uses than that which is currently authorized under law. The budget proposal includes:

- Broadening the types of projects that IFDs can fund.
- Allowing cities or counties that meet specified benchmarks to create these new IFDs, and to issue related debt, subject to receiving 55 percent voter approval.
- Permitting new IFD project areas to overlap with the project areas of the former RDAs, while strictly limiting the available funding in those areas to dollars available after payment on all of the former RDA's approved obligations.
- Maintaining the current IFD prohibition on the diversion of property tax revenues from K-14 schools, which will ensure any usage will have no state General Fund impact.
- Requiring entities that seek to establish an IFD to gain the approval of the county, cities, and special districts that would contribute their revenue.

If the establishing city or county formerly operated an RDA, the expanded IFD tool would be available to them only if they meet various benchmarks, including: receipt of a Finding of Completion from Finance, compliance with all State Controller's Office RDA audit findings, and the conclusion of any outstanding legal issues with the state.

- **State-County Assessor's Partnership.** The budget proposes to reconstitute, on a limited basis, a State-County Assessors' Partnership Agreement Program to enhance local property assessment efforts. The program would begin on a three-year pilot basis, funded at $7.5 million per year, and to be administered by the Department of Finance. The program would be limited to nine county assessors' offices that will be competitively selected. Both local governments and the state (through a reduction in the General Fund Prop 98 obligation) would benefit from improved property tax collections. The state funded a similar program until 2000-06, when it was eliminated as a savings measure.

General Government

- **California Department of Veterans Affairs (CDVA)** – Proposes a $34 million increase in General Fund to complete the activation of the state Veterans Homes located in Redding and Fresno.

- **Office of Emergency Services (OES)** – Proposes a $2.7 million increase in order to relocate public safety communications equipment and operations that are currently housed at Red Mountain to three new communications sites.

- **Department of General Services (DGS)** – Proposes a $2.5 million increase in General Fund to support the development of a long-range planning study for the Sacramento Region in order to address ongoing infrastructure and space needs.

- **California Department of Business Oversight (DBO)** – Proposes a $2.7 million increase in special funds in order to support 19 positions in 2014-15 to establish cyclical examinations of broker-dealers and investment advisors. In 2015-16, support will increase to $5.2 million and 36 positions for continued support of cyclical examinations of broker-dealers and investment advisors.

- **Department of Technology (IT)** – Proposes a $6.7 expenditure from the Technology Services Revolving Fund to design, construct, and install a new uninterruptable power supply system, cooling components and associated equipment at one of the two state-owned data centers. The budget also proposes a $684,000 increase in expenditures to support a two-year pilot project that would fund five limited-term positions within the Office of Information Security in order to audit state departments' compliance with State and Federal Information Technology security policies.

- **Financial Information Systems of California (FI$Cal) –** Proposes a $4.3 million increase in 2014-15 due to escalating project scope. The Department of General Services (DGS) financial system was originally scheduled to be integrated within the FI$Cal system in 2014. Due to a need to replace the antiquated DGS financial system prior to integrating with FI$Cal, the cost of the project will increase and the integration will be delayed to a later date.

- **State Controller's Office (SCO) –** Proposes a $6.5 million ($3.6 million General Fund, $2.9 million other funds) to address ongoing litigation efforts related to the currently suspended effort to update the state's payroll system.

- **Department of Consumer Affairs (DCA)** – Proposes a $12.4 million increase in special funds in order to support 90 enforcement related positions and $466,000 special funds to support 11 positions related to licensing workload.

- **Unemployment Insurance (UI)** – Includes a decrease of $251.8 million in 2013‑14, and a decrease of $3.2 billion in 2014‑15 for UI benefit payments administered by the Employment Development Department (EDD) based on current economic conditions and the expiration of the federal benefits extension program, which impacts approximately 222,000 Californians. The Governor's budget also includes a decrease of $142.6 million in 2013‑14 and an increase of $177.5 million in 2014‑15 for Disability Insurance benefit payments.

- **UI Program Administration** – Includes: 1) $38 million from the Contingent Fund; 2) an increase in withholding penalties deposited in the Contingent Fund from 10 percent to 15 percent effective July 1, 2014, resulting in increased revenue of $10 million ($25 million annually after 3 years); and, 3) a one‑year suspension of the transfer of personal income tax withholding penalties to the General Fund, retaining approximately $16 million for the program. These measures return service levels for EDD's administration of the UI program back to those achieved in 2012‑13 and allow the department to retain staff and continue overtime to process new and continued claims.

- **Workforce Investment Act (WIA)** – Includes an increase of $11.8 million in federal funds in 2013‑14 for the Governor's discretionary WIA programs and rapid response activities.

- **Process Safety Management Unit Expansion (Refinery Inspections)** – Includes an increase of $2.4 million Occupational Safety and Health Fund to enforce workplace health and safety regulations in 15 refineries and over 1,600 other facilities that handle hazardous chemicals. This expands the Department of Industrial Relation's existing Process Safety Management Unit to 26 positions. These staff will significantly increase the number of refinery inspections, as well as the time spent conducting each inspection. Refinery inspections will be funded from a new regulatory fee, based on the amount of crude oil being processed at each refinery.

- **Public Works/Prevailing Wage Consolidation** – Includes multiple adjustments to consolidate all public works and prevailing wage enforcement activities within a single unit, supported by a new registration fee on contractors who choose to work on public works projects. The fee will support an $11.4 million program with 83 positions. The new fee will eliminate the program's reliance on the General Fund and bond funds tied to public works projects, which have resulted in funding challenges in the past. These funding changes, along with programmatic efficiencies realized through the consolidation, will provide the program with a stable funding source to support prevailing wage determinations, monitoring, and enforcement throughout the state. This represents an increase of more than 20 positions compared to prior enforcement levels.

- **Employee Compensation** – Includes $173.1 million ($82.4 million General Fund) to fund collective bargaining contract agreement "triggers" for employee salary increases. A final determination on whether the "triggers" will go into effect in 2014-15 will be made at the May Revision, based on the latest revenue projections and updated expenditure information.

  Additionally, The Governor's budget includes $98.6 million ($40.3 million General Fund) to extend the same general salary increases negotiated for rank and file members to unrepresented state managers and supervisors, to avoid salary compaction issues. Managers and supervisors associated with Bargaining Unit 5 – California Association of Highway Patrolmen and Bargaining Unit 6 – California Correctional Peace Officers Association will receive the salary adjustment extended to their rank and file counterparts.

- **Employee Retirement** – As a result of the Public Employees' Pension Reform Act of 2013, the Governor's budget estimates that the state will contribute an additional $67.1 million during 2013-14, and $108.4 million in 2014-15, toward the state's unfunded liability. The Budget estimates approximately $4 billion in total funding for state employee pensions in 2014-15.

- **Workers' Compensation** – Proposes $81.1 million ($80.7 million General Fund) to augment the budgets of the California Department of Corrections and Rehabilitation and the Department of Forestry and Fire Protection for workers' compensation costs.

- **Bond Debt Service –** General Fund debt service expenditures, after various other funding offsets, will increase by $416.5 million (7.5 percent), to a total of

$6 billion, over the current year expenditures. This increase is comprised of $382.2 million for General Obligation (GO) debt service ($5.3 billion total), and $34.3 million for lease-revenue bonds ($673.7 million total). The increase is attributed to recent bond sales and the planned issuance of additional bonds over the next year.

- **California Five-Year Infrastructure Plan –** The Five-Year Infrastructure Plan is being released with the budget. The Plan outlines the Administration's infrastructure priorities for the next five years for the major state infrastructure programs, including high-speed rail and other transportation, state institutions, judicial branch, natural resources, and education. The Plan only proposes limited, new lease-revenue bond authorizations. The $815 million ($800 million General Fund) package makes the most significant investments in highway and local streets and roads maintenance projects, schools and community colleges, and state parks.

- **Cashflow Borrowing –** Includes $120 million General Fund for interest costs associated with cashflow borrowing. This includes $60 million for special fund borrowing and $60 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.

- **Budgetary Loans from Special Funds** – Includes $54 million for interest on budgetary loans. The Governor indicates that at the end of 2013-14, special fund budgetary loans will total $3.9 billion, which will drop to $2.9 billion by 2014-15.

- **Franchise Tax Board (FTB) –** Calls for $75.1 million and 71 positions to continue implementation of the Enterprise Data to Revenue (EDR) Project to facilitate the collection of personal and corporation income taxes. 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, the budget calls for $7.7 million for the Accounts Receivable Management Program (ARMP), which will provide 101 limited-term positions and generate $108 million in General Fund revenues in the budget year. The accounts receivable inventory has accumulated during periods of staffing reductions and furloughs.

Corrections and Judiciary

California Department of Corrections and Rehabilitation (CDCR) – Proposes total funding of $9.8 billion ($9.5 billion General Fund and $320 million other funds) in 2014-15.

CDCR Population – The 2013 Budget Act projected an adult inmate average daily population of 128,885 in the current year. The current year adult inmate population is now projected to exceed Budget Act projections by 6,101 inmates, a 4.7 percent increase, for a total population of 134,986. The budget year adult inmate population is projected to be 137,788, a 6.9 percent increase of 8,908 inmates. The current projections also reflect an increase in the parolee population of 3,439 in the current year compared to Budget Act projections, for a total average daily population of 45,934. The parolee population is projected to be 36,652 in 2014‑15, a decrease of 5,843.

CDCR, Division of Juvenile Justice (DJJ) Population – The DJJ's average daily ward population is increasing in the current year and decreasing in 2014-15, when compared to 2013 Budget Act projections. Specifically, the ward population is projected to increase by 32 in 2013-14, for a total population of 711; and decrease by 34 in 2014-15, for a total population of 645. The ward population has decreased significantly in recent years, due primarily to fewer parole violators being housed by DJJ, as a result of AB 1628 (Budget Committee), Chapter 729, Statutes of 2010, which shifted supervision responsibility for wards released from DJJ to the counties, beginning in January 2011; and SB 1021 (Budget and Fiscal Review Committee), Chapter 41, Statutes of 2012, which mandated the discharge of all remaining juvenile parolees by December 31, 2012.

Court Ordered Prison Population Cap – Assumes the Federal Courts will grant California a two-year extension on meeting the court imposed population cap currently set at 137.5 percent of system-wide design capacity. Based on this assumption, the Governor's budget reflects total expenditures of $228 million from the $315 million (General Fund) appropriated in AB 105 (Steinberg and Huff), Chapter 310, Statutes of 2013. The proposed plan would set aside $81.1 million for use toward recidivism reduction efforts, as follows:

- $11.8 million to expand substance use disorder treatment to ten additional state prisons.

- $9.7 million to expand substance use and cognitive behavioral treatment to in-state contracted facilities.

- $11.3 million to increase the number of slots in the Integrated Services for Mentally Ill Parolees program from 600 to 900.

- $8.3 million for the design and planning necessary to convert a 600 bed facility in Stockton into a reentry hub over the next two years.

- $40 million to support state reentry programs in the community, either through programs provided in jails or for services provided within communities.

The proposed budget also states the intent of the Administration to immediately begin implementing measures required by the federal court pertaining to expanded medical parole, elderly parole, and credit enhancements.

Expansion of Correctional Officer Training – Includes $61.7 million (General Fund) to temporarily expand the capacity of the Correctional Officer Training Academy from 720 to 3,400 cadets. The Administration contends that this increased cadet need is driven primarily by correctional officer retirements and other attrition.

Enhanced Drug and Contraband Interdiction Program – Proposes $14 million (General Fund) to support the establishment of an enhanced drug and contraband interdiction program. The funding will allow for an increase in the number of passive search dogs and the equipment necessary to search prisoners and visitors. The proposed program does not include the searching of guards or staff at the prisons.

CDCR Workers' Compensation – Provides an increase of $75 million (General Fund) to address increasing workers' compensation costs.

Prison Maintenance Infrastructure Improvements – Proposes $20 million to address unidentified deferred infrastructure maintenance costs.

CDCR Legal Services – Proposes $1.4 million (General Fund) in support of Department of Justice legal services rendered on behalf of the CDCR.

Local Jail Construction – Includes $500 million in lease-revenue bond financing for the construction of jail facilities in order to improve treatment space in local jails. This would bring the total state spending on local jail construction, since 2007, to $2.2 billion. The Governor's proposal would require a 10 percent funding match from participating counties.

Changes to Realignment – Proposes legislation to require that any county jail felony sentence be a split sentence, unless the court finds it to be in the interests of justice to impose a straight sentence.

Proposes that sentences over 10 years be served in state prison. The Administration specifies that this proposed change is only to be implemented if the Administration is successful in its efforts to meet its court-ordered population cap. (Preliminary estimates suggest that this would be approximately 300 offenders annually.)

Board of State and Community Corrections (BSCC) – Proposes total funding of $134.2 million ($44.3 million General Fund) for the BSCC.

Local Law Enforcement – Includes $27.5 million (General Fund) for cities in support of frontline law enforcement efforts.

Judicial Branch – Proposes total funding of $3.3 billion ($1.3 billion General Fund) for the Judicial Branch, of which $2.5 billion is provided in support of trial court operations.

Local Trial Court Funding – Provides $100 million (General Fund) in on-going additional funding to support trial court operations.

Judicial Council Funding – Provides $5 million (General Fund) in on-going additional funding to support the state judiciary.

The 2014-15 Budget:

Overview of the Governor's Budget

MAC TAYLOR • LEGISLATIVE ANALYST • JANUARY 13, 2014

LAO

TABLE OF CONTENTS

LEGISLATIVE ANALYST'S OFFICE

Legislative Analyst

Mac Taylor

State and Local Finance

Jason Sisney
Marianne O'Malley

Chas Alamo
Justin Garosi
Seth Kerstein
Ryan Miller[a]
Nick Schroeder
Brian Uhler
Brian Weatherford

Corrections, Transportation, and Environment

Anthony Simbol
Brian Brown
Drew Soderborg

Ashley Ames
Aaron Edwards
Anton Favorini-Csorba
Jeremy Fraysse
Helen Kerstein
Sarah Larson
Anita Lee
Lia Moore
Jessica Digiambattista Peters
Tiffany Roberts

Administration and Information Services

Larry Castro
Sarah Kleinberg
Karry Dennis-Fowler

Michael Greer
Vu Chu
Douglas Dixon
Sandi Harvey

[a] Overview coordinator.

Education

Jennifer Kuhn

Edgar Cabral
Carolyn Chu
Natasha Collins
Rachel Ehlers
Paul Golaszewski
Judy Heiman
Kenneth Kapphahn
Jameel Naqvi
Paul Steenhausen

Health and Human Services

Mark C. Newton
Shawn Martin

Ross Brown
Amber Didier
Rashi Kesarwani
Lourdes Morales
Ginni Bella-Navarre
Felix Su
Ryan Woolsey

Support

Izet Arriaga
Anthony Lucero
Tina McGee
Sarah Scanlon
Jim Stahley
Jim Will

EXECUTIVE SUMMARY

The Governor's Budget Proposal

Proposes $2.3 Billion Reserve. On January 9, 2014, the Governor presented a budget package that included $151 billion in spending from the General Fund and special funds, an $11 billion increase over the revised 2013-14 level. The Governor proposes a $2.3 billion reserve at the end of 2014-15—comprised of $1.6 billion in the rainy-day reserve created by Proposition 58 (2004) and $693 million in the General Fund's traditional reserve. Recent, sharp increases in personal income tax (PIT) collections—driven largely by soaring stock prices in 2013—have improved the state's budget condition significantly.

Major Features of the Governor's Budget. The budget package uses much of the large projected growth in the Proposition 98 budget to pay down $6.2 billion in school and community colleges deferrals. Outside of Proposition 98, the budget accelerates $1.6 billion in payments for the state's prior deficit financing bonds. In addition, the Governor proposes a rainy-day fund measure for the November 2014 ballot that would base deposits on capital gains related revenues—the state's principal source of revenue volatility. The Governor's budget includes a plan for allocating $850 million in cap-and-trade auction revenues and proposes $618 million to address the state's water challenges. Further, the budget includes $815 million for deferred maintenance infrastructure projects.

LAO Comments

Governor's Budget Would Continue California's Fiscal Progress. California has made substantial progress in recent years in addressing its prior, persistent state budgetary problems. This progress has been facilitated by a recovering economy, a stock market that has been soaring recently, increased revenues from the temporary taxes of Proposition 30, and the Legislature's recent decisions to make few new ongoing spending commitments outside of Proposition 98. The proposal continues the Governor's focus on paying down the "wall of debt," a selection of budgetary liabilities the state incurred in addressing its past budget problems. The Governor's emphasis on debt repayment is a prudent one. Overall, the Governor's proposal would place California on an even stronger fiscal footing, continuing California's budgetary progress.

Addressing Some of California's Biggest Budgetary Issues. The Governor's proposal for a new rainy-day fund requirement emphasizes the importance of regular state contributions to a larger budget reserve. So does ACA 4, the measure currently scheduled for the November 2014 statewide ballot. In general, setting aside money for a rainy day is exactly what the state should be doing when revenues are soaring, as they are now. In this report, we discuss issues the Legislature will want to consider for these and other rainy-day fund alternatives. With regard to another difficult budgetary issue for California—addressing the large unfunded liabilities of the state's teachers' retirement system—we suggest that the state set aside funds beginning this year in anticipation of a future long-term funding plan.

OVERVIEW

The Governor's Budget Proposal

On January 9, 2014, the Governor presented his 2014-15 budget proposal to the Legislature. As displayed in Figure 1, the Governor's spending plan includes $151 billion in spending from the General Fund and special funds combined. This reflects an $11 billion—or 8 percent—increase over 2013-14 revised levels. Recent, sharp increases in personal income tax collections—driven largely by soaring stock prices in 2013—have improved the state's budget condition significantly.

Administration's Budget Forecast

Improved General Fund Condition. Figure 2 displays the administration's projection of the General Fund condition. The June 2013 spending plan assumed that 2013-14 would end with a $1.1 billion reserve. The Governor's budget now estimates a $3 billion reserve for the state at the end of 2013-14. The $1.9 billion increase in the 2013-14 reserve is largely explained by:

- ***Higher 2011-12, 2012-13, and 2013-14 Revenues.*** Over 2012-13 and 2013-14 combined, the administration now estimates General Fund revenues and net transfers to be $4.8 billion higher than budget act estimates. In addition, there is a $558 million upward fund balance

Figure 1

Governor's Budget Expenditures

(Dollars in Millions)

Fund Type	2012-13 Revised	2013-14 Revised	2014-15 Proposed	Change From 2013-14 Amount	Change From 2013-14 Percent
General Fund[a]	$96,562	$98,463	$106,793	$8,331	8.5%
Special funds	37,724	41,153	43,979	2,826	6.9
Budget Totals	**$134,286**	**$139,616**	**$150,772**	**$11,156**	**8.0%**
Selected bond funds	$6,715	$8,181	$4,166	-$4,015	-49.1%
Federal funds	70,431	85,803	84,562	-1,241	-1.4

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

Figure 2

Governor's Budget General Fund Condition

Includes Education Protection Account (In Millions)

	2012-13	2013-14	2014-15
Prior-year fund balance[a]	-$1,100	$2,254	$3,938
Revenues and transfers	99,915	100,147	106,094[b]
Total resources available	$98,816	$102,401	$110,032
Expenditures	$96,562	$98,463	$106,793[c]
Ending fund balance	$2,254	$3,938	$3,239
Encumbrances	$955	$955	$955
Reserve[d]	**$1,299**	**$2,983**	**$2,284**
Budget Stabilization Account	—	—	$1,591
Special Fund for Economic Uncertainties[d]	$1,299	$2,983	693

[a] The *2014-15 Governor's Budget Summary*, as released on January 9, 2014, included an $832 million net increase in the 2012-13 entering fund balance, compared to data in the state's June 2013 enacted budget plan. The number listed on this line for 2012-13 reflects a $274 million downward adjustment related to personal income tax accruals for 2011-12 and prior years, reflecting an error identified by the administration subsequent to the release of the Governor's budget.

[b] Amount differs from that in the *2014-15 Governor's Budget Summary*. To improve the comparability with prior-year figures, the number listed here includes all revenues, including those transferred to the Budget Stabilization Account, resulting in $1.6 billion higher revenues than shown in administration totals.

[c] Includes $1.6 billion to accelerate the retirement of economic recovery bonds.

[d] Lower than displayed in the *2014-15 Governor's Budget Summary* by $274 million due to the downward adjustment described in footnote a.

adjustment for 2011-12 and prior years mainly related to revenue accruals.

- ***Higher General Fund Proposition 98 Spending.*** The administration's estimated revenue gains are in large part offset by $3.6 billion in increased General Fund spending on schools and community colleges in 2012-13 and 2013-14. In addition, the administration has revised its non-Proposition 98 spending estimates for 2012-13 and 2013-14—changes that, on net, improve the budget condition by a small amount.

Governor Proposes $2.3 Billion Reserve at End of 2014-15. The Governor's budget plan includes General Fund spending in 2014-15 that exceeds revenues by about $700 million. The budget, however, includes several one-time spending items, including a $1.6 billion one-time supplemental payment to retire the state's outstanding economic recovery bonds (ERBs). The Governor can trigger this supplemental payment under Proposition 58 (2004), the state's existing rainy-day fund requirement. (The supplemental payment will result in an early retirement of the ERBs, generating General Fund savings from expiration of the so-called "triple flip" in 2015-16—about one year earlier than otherwise would be the case.) The Governor proposes the state end 2014-15 with a total General Fund reserve of $2.3 billion—$700 million below the revised reserve level at the end of 2013-14. The 2014-15 reserve is a combination of $1.6 billion in the Proposition 58 rainy-day fund (known as the Budget Stabilization Account [BSA]) and $693 million in the General Fund's traditional reserve, the Special Fund for Economic Uncertainties (SFEU).

Major Features of the Governor's Budget

Figure 3 displays the major features of the Governor's budget proposal. In recent years, the primary focus of the budget process has been on the General Fund. Until the 2013-14 budget deliberations, the state had faced a multibillion dollar General Fund shortfall in nearly every year over the preceding decade. Recently, however, the need for these actions has diminished, and this year the state is faced with choices on how to allocate several billion dollars of surplus General Fund resources. The Governor's budget reflects this shift in focus away from the General Fund, as many of his major proposals are for special fund programs. Below, we describe the major proposals in the Governor's budget plan.

Proposes $2.3 Billion Reserve. For the first time since 2007-08, the Governor's budget reflects his intent to transfer funds to the BSA. (Under Proposition 58, the Governor determines whether the scheduled BSA transfer occurs annually.) Specifically, the budget plan shifts 3 percent ($3.2 billion) of General Fund revenues to this rainy-day fund. Half of these funds must go to accelerate repayment of the ERBs, which were used to finance state budget deficits of the early 2000s.

Includes New Rainy-Day Fund Constitutional Proposal. The Governor's budget package proposes to replace ACA 4—the rainy-day fund measure currently scheduled for the November 2014 ballot—with an alternative measure. Specifically, the measure would base the required deposits into the rainy-day fund on projections of capital gains-related PIT—the state's principal source of revenue volatility. In addition, the proposal would create a Proposition 98 reserve to attempt to reduce volatility within the Proposition 98 budget.

Pays Down State Debts. The Governor's proposal reflects his continued focus on repaying items on the wall of debt. As discussed above, half of the transfer to the BSA will be used to accelerate the pay down of the ERBs. The Governor plans to use much of the large growth in Proposition 98 funding to pay off the remaining school and community college deferrals ($6.2 billion). The Proposition 98 package also includes $188 million for the Emergency Repair Program (ERP). Additionally, the plan provides funds to pay off $1.6 billion in special fund loans in 2013-14 and 2014-15 combined, including a $328 million Highway Users Tax Account loan and $100 million of the loan from the Greenhouse Gas (GHG)

Figure 3

Major Features of the Governor's Budget

Reserve/Rainy-Day Fund

- End 2014-15 with $2.3 billion reserve (including $1.6 billion in Proposition 58 reserve).
- Create new rainy-day fund mechanism to replace existing Proposition 58 reserve with new Proposition 98 reserve.

Paying Down State Debts (One-Time Costs)

- Accelerate pay down of economic recovery bonds by about one year ($1.6 billion General Fund).
- Pay off remaining school and community college deferrals ($6.2 billion Proposition 98 funds).
- Repay $1.6 billion in special fund loans in 2013-14 and 2014-15 combined.
- Provide $188 million for school repairs.

Education

- Provide additional $4.5 billion for K-12 Local Control Funding Formula.
- Increase funding for community college student support ($200 million).
- Provide 3 percent increase for community college enrollment growth ($155 million).
- Provide unallocated base augmentations to UC and CSU ($142 million each).
- Create $50 million grant program for universities and community colleges to change service delivery.
- Shift debt-service payments into CSU's budget.

Health and Human Services

- Exempt certain Medi-Cal providers from recoupment of prior-year payment reductions previously enjoined.
- Restrict overtime for IHSS workers in response to new federal regulations.

Infrastructure

- Deliver to Legislature first five-year infrastructure plan since January 2008.
- Provide $815 million in one-time funds (from General Fund and other funds) for deferred maintenance projects.
- Authorize $500 million in lease-revenue bond authority for jail construction.

Cap-and-Trade

- Allocate $850 million in cap-and-trade auction revenues to various programs, including: $250 million for construction of the high-speed rail system and $200 million for low-emission vehicle program.

Water

- Propose $618 million plan (almost all from special funds) for various water-related programs, including protecting groundwater basins, augmenting local water supplies, and improving flood protection.
- Transfer safe drinking water program from Department of Public Health to State Water Resources Control Board.

Judiciary and Criminal Justice

- Provide $105 million ongoing increase to judicial branch.
- Assume two-year extension of court-ordered population cap.

Other Programs

- Assume that most state employees receive at least 2 percent pay increase in 2014-15 ($173 million all funds).

Reduction Fund. (As described later, the latter two repayments are related to the Governor's infrastructure and cap-and-trade proposals.)

Includes \$11.8 Billion for Proposition 98 Above* 2013-14 Budget Ac*t Levels. The Governor's budget includes \$11.8 billion in Proposition 98 spending increases—\$7.6 billion attributable to 2014-15, \$3.7 billion attributable to 2012-13 and 2013-14, and \$503 million for earlier years. Of the \$11.8 billion, \$6.8 billion is designated for one-time purposes and \$5 billion for ongoing purposes. Most of the one-time funding is allocated for paying off the school and community college deferrals (\$6.2 billion). Of the ongoing funding, \$4.5 billion is for the school district Local Control Funding Formula (LCFF).

Proposes Increased General Purpose Funding for Universities. The Governor proposes unallocated base budget increases of \$142 million each for University of California (UC) and California State University (CSU) in 2014-15. These increases represent the second annual installment in a four-year funding plan proposed by the Governor last year. The Governor conditions his proposed annual funding increases for the universities on their maintaining tuition at current levels. Similar to last year, the Governor does not propose enrollment targets or enrollment growth funding for the universities.

Infrastructure Proposals Include \$815 Million for Deferred Maintenance. According to the *Governor's Budget Summary*, the administration intends to deliver to the Legislature the first five-year infrastructure plan since 2008. The budget plan includes major proposals related to infrastructure, including \$815 million (mostly from special funds) for deferred maintenance projects. In addition, the budget proposes to shift \$211 million in remaining bond authority from various school facility programs, such as seismic mitigation, to new school construction and school modernization. Similar to last year, the Governor proposes to shift debt-service payments into CSU's main appropriation. The Governor's budget plan also proposes \$500 million in lease-revenue bond authority to help counties construct and modify jail facilities.

Proposes \$850 Million Cap-and-Trade Spending Plan. In 2006, legislation was enacted to reduce GHG emissions statewide to 1990 levels by 2020. Among these efforts, the state's cap-and-trade program places a "cap" on aggregate GHG emissions from entities responsible for roughly 85 percent of the state's GHG emissions. The Governor's budget includes a plan for allocating \$850 million in cap-and-trade auction revenues, including \$250 million for the state's high-speed rail project.

Includes \$618 Million Plan for Water Projects. In October 2013, the administration released a draft plan to address water challenges facing the state. These challenges include limited and uncertain water supplies, poor quality of surface water and groundwater, impaired ecosystems, and high flood risk. The Governor's budget package includes \$618 million to implement some aspects of the plan.

The Administration's Multiyear Forecast

Forecasts Balanced Budgets Through 2017-18. 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 2014-15 budget plan. It projects that General Fund revenues will annually exceed expenditures after 2014-15, resulting in an operating surplus of \$1.7 billion in 2015-16, growing to \$2.3 billion in 2017-18. Compared to our November forecast, these operating surpluses are much lower. This disparity results in large part from a few billion dollars in each year for wall of debt payments that are not included in our forecast. Even with these payments, the administration forecasts that 2017-18 would end with an $8.3 billion reserve—$4.6 billion in the BSA and $3.7 billion in the SFEU. Consistent with standard forecasting conventions—including our office's—the administration's multiyear forecast implicitly assumes continuation of the current economic expansion for several years.

LAO Comments

Governor's Budget Would Continue California's Fiscal Progress. California has made substantial progress in recent years in addressing its prior, persistent state budgetary problems. This progress has been facilitated by a recovering economy, a stock market that has been soaring recently, increased revenues from the temporary taxes of Proposition 30, and the state's recent decisions to make relatively few new non-Proposition 98 spending commitments. Overall, the Governor's proposal would place California on an even stronger fiscal footing and continue California's fiscal progress. By allowing deposits to the state's existing Proposition 58 rainy-day fund to resume, the state can begin to build a strong precedent for accumulating reserves during good revenue times. The Governor's planned early repayment of the state's deficit bonds would free up sales tax resources now dedicated to bond repayment to support the General Fund beginning in 2015-16 or so. The Governor also prudently proposes to continue paying down special fund loans and other wall of debt items, including his plan to pay off all school payment deferrals from Proposition 98 funds. Finally, the Governor proposes limited new spending outside of Proposition 98, some of which is one-time spending commitments such as his deferred maintenance proposal.

Governor Prudently Prioritizes Debt Repayments. In crafting his 2014-15 budget proposal, the Governor started with a possible surplus comparable in size to the one we estimated in our November 2013 fiscal forecast. (While the administration's revenue estimates are somewhat lower, so are its Proposition 98 and some other spending estimates.) The Governor prioritized making wall of debt repayments in his proposal. In the budget summary, the administration estimates that the Governor's plan would reduce the wall of debt by $11.8 billion in 2014-15. These reductions can be broken into three categories: (1) ERB wall of debt costs that are mandatory, which are about $2 billion in 2014-15; (2) Proposition 98 wall of debt reductions of about $6.7 billion—principally the Governor's choice to propose pay downs of school payment deferrals (to be paid from the overall pot of state funds required to be provided to schools); and (3) the remaining $3 billion or so of wall of debt repayments in the Governor's plan. This $3 billion consists mainly of the Governor's planned $1.6 billion payment to retire the remaining ERBs one year early and his proposed $1 billion of payments to pay off past loans from the state's special funds. While the Governor has the authority under Proposition 58 to trigger the accelerated ERB repayment, this decision and at least some of his proposed special fund loan repayments represent choices that he made in designing his budget proposal. In general, we think the Governor's focus on debt repayments is a prudent one. The Legislature, however, has the ability to amend the Governor's special fund loan repayment plan by adding different special fund loan repayments, deleting others, changing proposed repayment amounts, or adopting broader changes to fees and expenditures of the special funds involved.

Goals of Governor's Rainy-Day Proposal Are the Right Ones. As described in the "Rainy-Day Fund" section of this report, regularly contributing to a larger rainy-day fund is exactly the direction the state should be taking at a time when revenues are soaring. The Governor's proposal would base deposits into the rainy-day fund on capital gains related revenues—the principal source of state revenue volatility. The state's experience with constitutional formulas, however, suggests that any formula-based proposal merits careful legislative consideration. In the "Rainy-Day Fund" section of this report, we discuss some of the factors the Legislature may wish to consider in weighing a constitutional rainy-day fund requirement.

Governor's Overall Proposition 98 Plan Reasonable. We believe the Governor's Proposition 98 plan provides a reasonable mix of one-time and ongoing spending. By retiring the $6.2 billion in outstanding K-14 deferrals, the Governor's plan would eliminate the largest component of the school and community college wall of debt by the end of 2014-15. In addition to reducing outstanding one-time Proposition 98 obligations significantly, the Governor's plan also would increase ongoing programmatic spending significantly by augmenting both the LCFF and community college programs. The mix of one-time and ongoing spending is particularly important in 2014-15 given the minimum guarantee likely will be very sensitive to volatility in General Fund revenues, with estimates of the guarantee potentially swinging widely over the coming months.

Governor's Higher Education Proposals—Similar Concerns as Last Year. The Governor's higher education budget plan is very similar to last year, with the continuation of most of his proposals relating to unallocated base budget increases; no specified expectations with regards to operations, facilities, or performance; and no enrollment expectations. As with last year, we remain concerned that his plan would lead to less responsiveness from the segments in meeting state priorities as well as diminished state guidance and oversight.

Focus on Deferred Maintenance Positive. As described earlier, the Governor's budget proposes $815 million for deferred maintenance projects. We believe that it is important for the state to begin to address its accumulated deferred maintenance needs. While deferring annual maintenance lowers costs in the short run, it often results in substantial costs over the long run. The Governor's plan is a positive first step towards dealing with an important and often ignored program.

Issues With Other Infrastructure Proposals. The Governor's budget contains several infrastructure ideas and proposals, including ones relating to school facility funding, CSU debt service, and county jail construction. With regards to rethinking the financing of school facilities, the Legislature would have many issues to consider—from differences in local revenue-raising ability among districts to the distribution of any state funds among districts, the stability of that funding, and the incentives provided for districts to build and maintain facilities cost-effectively. Regarding the Governor's CSU debt-service proposal, we are concerned that the approach diminishes the Legislature's oversight over the university's use of state funds. And with respect to the Governor's proposal for $500 million in bond authority for county jail construction, we suggest that the Legislature seek from the administration additional information on county jail needs and other issues in considering the proposal.

Cap-and-Trade Proposal Unlikely to Maximize Emission Reductions. The Governor's budget proposes a plan for using $850 million in auction revenues generated from the cap-and-trade program for various projects to GHG emissions. Most notably, the plan includes $250 million for the state's high-speed rail project. As discussed later in this report, we are concerned that the Governor's proposal likely would not maximize the reduction of GHG emissions.

Governor's Integrated Approach for Water Has Merit. The Governor's budget proposes $618 million to begin implementing a plan to address water challenges facing the state. We find that the Governor's integrated approach has merit, though we lay out some policy considerations and funding issues that the Legislature may want to consider in weighing the Governor's proposal.

Setting Aside Some Money for CalSTRS Now Would Be Smart. The *Governor's Budget Summary* expressed an interest in working with school districts and teachers over the coming year to reach agreement on a long-term California State Teachers' Retirement System (CalSTRS) funding plan that would fully fund the system over a 30-year period. We agree with the Governor regarding the key goal of a shared responsibility to achieve a fully-funded, sustainable teachers' pension system within about 30 years. In the meantime, however, we suggest that the state set aside some money during the 2014-15 budget process—when the state is experiencing a significant influx of revenues—in anticipation of the state's adoption of a long-term CalSTRS funding plan.

Planning for Possibility of Even Higher Revenue Estimates in May. In May, when the Governor presents his revised budget plan to the Legislature, both the administration and our office will release new economic and revenue estimates. Given recent economic and tax collection data, however, there is a significant possibility that 2013-14 and perhaps 2014-15 revenue estimates will rise by a few billion dollars. The state's recent revenue gains are good news for state finances. These gains reflect the state's continuing economic recovery, which seems to be accelerating somewhat. Nevertheless, a significant portion of the recent revenue surge probably results from capital gains-related PIT caused by large increases in stock prices throughout 2013. The Governor is prudent to warn Californians that this revenue surge may prove short-lived.

When a similar revenue surge materialized in the late 1990s, we now know that state leaders made spending and revenue commitments that contributed to the state's financial problems throughout the last decade. We advise the Legislature to avoid making similar mistakes this year. The Governor's plan contains a number of features that would help improve the state's fiscal footing, including an emphasis on debt repayments and an effort to improve the state's rainy-day fund requirements. By making relatively few ongoing new non-Proposition 98 spending commitments, the Governor is attempting to minimize, as much as possible, future budget pressures that could result from making such new commitments today.

In the event that revenue projections increase between now and May, the Legislature would face important decisions regarding how to allocate additional revenues. Much of any such revenue increases could be required to be spent on schools and community colleges under Proposition 98. After addressing these requirements, we believe the Legislature should give highest priority to increasing the size of the Governor's proposed reserves and setting aside additional funds in anticipation of making bigger payments on the state's key retirement liabilities (including payments to address CalSTRS' unfunded obligations). In order to keep the state on a sound fiscal footing, we advise the Legislature to make only limited and targeted ongoing program commitments from additional revenues that may be identified this spring.

ECONOMY AND REVENUES

Administration's Economic Forecast

Recovery Expected to Accelerate Somewhat. The administration's *2014-15 Governor's Budget* economic forecast assumes that the current moderate economic recovery will accelerate in 2014, leading to broad-based improvements in both the U.S. and California economies over the next two years. This forecast incorporates the negative impact of the recent federal government shutdown—which caused most economists to lower expectations for 2013 economic growth—but assumes these effects were short-lived and therefore will not linger into 2014. The administration expects the U.S. economy (as expressed by real gross domestic product [GDP]) to expand 2.5 percent in 2014, accelerating to 3.1 percent growth in 2015. These growth rates are on par with rates seen typically during a mature economic expansion, reflecting the consensus outlook that U.S. economic growth is returning to more normal levels. Figure 4 summarizes the administration's economic forecast for 2013 and 2014 and compares it with other recent estimates, including those from our office.

Recent Economic Improvements. In order to meet the Governor's January 10 budget deadline, administration officials finalize some of their work on this economic forecast by mid-December. Economic data from December and January, including a strongly positive revision to GDP during the period coinciding with the federal government shutdown, suggest the U.S. economy may be performing somewhat stronger than previously estimated. This strength is reflected in the most recent economic forecast included in Figure 4 from IHS Economics (an economics advisory firm), which indicates the U.S. economy, as measured by real GDP, performed better in 2013 than either our office or the administration estimated when completing our most recent forecasts.

Figure 4

Comparing Administration's Economic Forecast With Recent Forecasts

	2013				2014			
	2013-14 Budget Act	LAO November 2013	DOF January 2014	IHS Economics January 2014	*2013-14 Budget Act*	LAO November 2013	DOF January 2014	IHS Economics January 2014
United States								
Percent change in:								
Real gross domestic product	2.0%	1.5%	1.7%	1.9%	2.8%	2.5%	2.5%	2.7%
Personal Income	2.8	2.8	2.8	2.9	5.1	4.7	4.6	4.6
Employment	1.5	1.6	1.6	1.6	1.6	1.7	1.6	1.7
California								
Percent change in:								
Personal income	2.2%	2.1%	2.6%	NA	5.7%	5.4%	4.6%	NA
Employment	2.1	1.7	2.1	NA	2.4	2.2	2.3	NA
Unemployment rate	9.4	8.9	8.9	NA	8.6	7.8	7.9	NA
Housing permits (thousands)	82	88	87	NA	121	120	114	NA

NA = Not applicable.

Federal Actions No Longer Seem a Significant Threat to Growth in 2014. The partial shutdown of federal government operations in October 2013 and uncertainty about whether Congress would increase the federal government's so-called "debt ceiling" likely slowed economic growth somewhat in the final quarter of 2013. These risks—along with the automatic spending cuts known as sequestration and the Federal Reserve's gradual tightening of monetary policy—constituted a threat to consumer, business, and investor confidence that could have slowed the modest recovery. Fortunately, these risks now appear to be fading for the following reasons: (1) the government shutdown does not seem to have affected economic prospects, (2) the debt ceiling was extended until early 2014, and debate on the issue appears less contentious than it was in 2013, (3) Congress passed a bipartisan budget agreement to soften the sequestration spending cuts, and (4) financial markets have reacted calmly to date upon announcement by the Federal Reserve that it would begin "tapering," the gradual elimination of its unconventional bond purchase program.

Administration's Revenue Forecast

As shown in Figure 5, the administration's new revenue forecast projects the General Fund will book $100.1 billion of revenues and transfers in 2013-14 and $106.1 billion in 2014-15. (Administration summaries show estimated 2014-15 revenues of $104.5 billion. This is reduced by the amount of the Governor's planned $1.6 billion transfer to the BSA, the state's existing Proposition 58 rainy-day fund. We display all General Fund revenues in our summaries so that figures are more comparable to those of prior years.) Both Figure 5 and Figure 6 (see next page) show how several key revenue metrics have been revised above levels in the state's 2013-14 budget act (passed in June 2013) in both our office's November 2013 revenue projections and the administration's revised January 2014 projections.

Key Points

Revenue Forecast Now Significantly Above Budget Act Projections. As shown in Figure 6, the administration has increased its revenue forecast

Figure 5

Comparing Administration's General Fund Revenue Forecast With Prior Forecasts[a]

General Fund and Education Protection Account Combined (In Millions)

	2013-14			2014-15		
	2013-14 Budget Act	LAO November 2013	DOF January 2014	*2013-14 Budget Act*	LAO November 2013	DOF January 2014
Personal income tax	$60,827	$66,002	$64,287	$67,132	$71,363	$69,764
Sales and use tax	22,983	22,809	22,920	24,702	23,561	24,071
Corporation tax	8,508	8,278	7,971	9,095	8,851	8,682
Subtotals, "Big Three" Taxes	($92,318)	($97,089)	($95,178)	($100,929)	($103,775)	($102,517)
Insurance Tax	$2,200	$2,163	$2,143	$2,265	$2,343	$2,297
Other revenue	2,249	2,254	2,480	1,858	1,874	2,046
Transfers and loans[b]	331	342	346	-385	-375	-765
Total Revenues and Transfers	**$97,098**	**$101,847**	**$100,147**	**$104,667**	**$107,617**	**$106,094**

[a] The Department of Finance (DOF) Governor's budget forecast updated revenues for prior years as well, 2011-12 and 2012-13, that are not shown here. These updates increase available General Fund revenue from those years by a combined $2.3 billion above the *2013-14 Budget Act* assumptions.

[b] Does not include transfer of revenues from General Fund to Budget Stabilization Account to improve comparability of totals with those of prior years.

compared to the forecast used in the state's 2013-14 budget plan. For the four fiscal years of 2011-12 through 2014-15 combined, the administration's forecast of total General Fund revenues and transfers is now $6.7 billion higher than last year's budget act forecast. About one-half of this increase ($3 billion) is the result of the administration's new higher revenue and transfer estimates for 2013-14. Also included in the $6.7 billion total is $536 million of higher PIT and corporation tax (CT) revenue accruals and adjustments for 2011-12 and prior years, which the administration reports as an increase to the beginning 2012-13 General Fund balance. Compared to the administration's budget act projections, the new revenue estimates include a net amount of $300 million more of transfers out of the General Fund across the four fiscal years—largely accelerated special fund loan repayments proposed by the Governor in his 2014-15 budget plan.

Higher Estimates Due Largely to Higher PIT Projections. Across the four fiscal years, the Governor's budget forecast for PIT revenue is $7.6 billion above the *2013-14 Budget Act* estimate, as shown in Figure 6. This total consists of higher estimates of $56 million in 2011-12 and prior years, $1.4 billion in 2012-13, $3.5 billion in 2013-14, and $2.6 billion in 2014-15. The improvement in the administration's PIT revenue estimates is offset somewhat by lower estimates of CT revenue (a combined $517 million across the four fiscal years) and sales and use taxes ($452 million over the period).

Personal Income Tax

PIT Revenue Depends on Volatile Capital Gains. The PIT is the state's largest revenue source, accounting for two-thirds of General Fund revenue in 2014-15 in the administration's projections. In addition to traditional sources of income such as hourly wages and salaries, the

Figure 6

Change From *2013-14 Budget Act* Revenue Projections to Those in Recent State Revenue Forecasts

General Fund and Education Protection Account Combined (In Billions)

	2011-12 and Prior Years	2012-13	2013-14	2014-15	Change From *2013-14 Budget Act*—All Four Years Combined
Personal Income Tax (PIT)					
LAO November 2013 forecast	-$0.5	$1.1	$5.2	$4.2	**$10.1**
Administration January 2014 forecast	0.1	1.4	3.5	2.6	**7.6**
"Big Three" PIT, Sales, and Corporation Taxes Combined					
LAO November 2013 forecast	—	$1.5	$4.8	$2.8	**$9.2**
Administration January 2014 forecast	$0.5	1.6	2.9	1.6	**6.6**
Total Revenues and Transfers					
LAO November 2013 forecast	—	$1.6	$4.7	$3.0	**$9.4**
Administration January 2014 forecast[a]	$0.5	1.7	3.0	1.4	**6.7**

[a] Unlike the LAO November 2013 forecast, reflects Governor's proposals for accelerated loan repayments to certain state special funds in 2014-15 and other adjustments, which result in a net amount of $300 million more transfers out of the General Fund for the four fiscal years combined. Like the LAO November 2013 forecast, the amounts displayed in this line do not reflect the Governor's planned transfer of 2014-15 revenues to the Budget Stabilization Account.

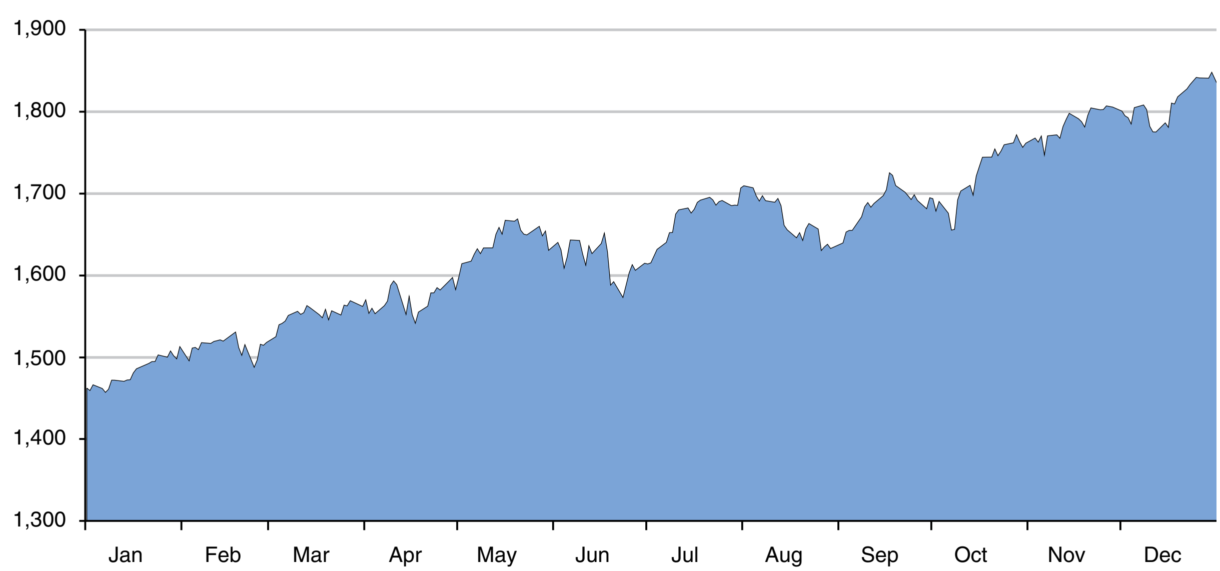
tax is paid on realized capital gains, principally from the sale of stocks, bonds, and real estate. These types of assets are concentrated among high-income taxpayers in the state's top marginal income tax brackets. The 1 percent of taxpayers with the most income typically have paid around 40 percent of PIT in recent years (rising to nearly 50 percent on occasion), a large portion of which is in the form of capital gains taxes. In addition to its concentration, capital gains are determined largely by sometimes turbulent and unpredictable stock prices. In the space of five years, for example, tax agency data shows that estimated PIT revenues from realized capital gains peaked at $10.9 billion in 2007, fell to $2.3 billion in 2009, and returned to $4.2 billion in 2011. Actual data on capital gains realizations and taxes lags by around a year and a half, meaning that 2012 data will become available this year.

Recent Forecasts Account for 2013 Stock Gains. Figure 7 shows the upward trend of U.S. stock prices during 2013, as measured by the S&P 500 stock index. Both the administration's revised PIT forecast and our office's November 2013 forecast attempt to account for this development in their estimates of capital gains income. The administration's upward PIT revenue adjustments in 2013-14 and 2014-15 result primarily from higher capital gains estimates.

Recent Data Suggest Potentially Higher PIT Revenue. Many high-income taxpayers make estimated payments throughout the year as their income materializes. December and January are important months for these payments, as year-end payments are due January 15th. December estimated payments—as well as PIT withholding—were stronger than we expected. In the next few days, we will have more information about January estimated payments. Based on recent

Figure 7

S&P 500 Index Rose Notably During 2013



tax collection trends, we would not be surprised at all if actual PIT revenues for 2013-14 exceeded the administration's revised projections by a few billion dollars. This assessment definitely could change in the coming months if positive trends in stock prices were to change or if there were negative surprises in state tax collections between now and April. Nevertheless, we advise state leaders to plan for the significant possibility that revenue estimates for 2013-14 and perhaps 2014-15 will be higher when they are revised in mid-May.

GOVERNOR'S MAJOR PROPOSALS

Rainy-Day Fund

State Has a Volatile Revenue System. Principally due to revenues from capital gains—paid mostly from the state's highest-income taxpayers—the state's revenue structure is volatile. In many years, the normal volatility of capital gains can result in annual revenues being a few billion above or below ours or the administration's revenue forecasts. While our volatile revenue structure promotes strong growth in revenues over the longer term, its inherent uncertainty complicates budgetary planning. One of the most important tools the state can use to reduce budgetary volatility is its rainy-day reserve. Specifically, by setting aside revenues when times are good, the state can: (1) avoid ongoing spending commitments that cannot be sustained over time and (2) build up a reserve to cushion the impact of the next economic turndown.

State Constitution Contains Rainy-Day Fund Requirement. Proposition 58 (2004) created the state's rainy-day fund, known as the BSA. Each year, Proposition 58 requires that 3 percent of estimated General Fund revenues be deposited into the BSA. Until the state's prior deficit financing bonds are repaid, half of the annual deposit goes to accelerating the repayment of those bonds. The deposits continue until the BSA reaches either $8 billion or 5 percent of General Fund revenues, whichever is greater. Proposition 58 authorizes the Governor to suspend or reduce the amount of the deposit by executive order. The Legislature can transfer up to the entire balance of the BSA back to the General Fund by majority vote.

State's Experience With Proposition 58. The state deposited funds into the BSA twice—in 2006-07 and 2007-08, for a total rainy-day fund of $1.5 billion—but the fund was emptied when revenues plummeted during the financial crisis. Since 2007-08, governors have suspended the BSA deposit each year.

ACA 4 Rainy-Day Fund Measure Scheduled for November 2014 Ballot. In 2010, the Legislature voted to place ACA 4 before voters. Assembly Constitutional Amendment 4 aims to increase the maximum size of the state rainy-day fund—to 10 percent of estimated General Fund revenues—when state revenues are experiencing strong growth and to limit the amount that can be withdrawn from the fund in any single year. These changes would tend to further mitigate budgetary volatility in the future. In addition, in certain circumstances, some of the funds transferred to the rainy-day fund could be used for one-time infrastructure-related purposes and for paying down other liabilities.

Deposits to Rainy-Day Fund Under ACA 4. Assembly Constitutional Amendment 4 includes two requirements for making deposits to the rainy-day fund. First, the measure continues the current practice of requiring a deposit equal to 3 percent of estimated General Fund revenues each

September. Second, ACA 4 requires another deposit in May when the state is experiencing particularly strong revenue growth. Specifically, the May deposit would equal the amount by which annual estimated General Fund revenues were above (1) the historical trend of General Fund revenues or (2) the prior year's General Fund expenditures adjusted for change in population and cost of living, whichever is less. The historical trend of General Fund revenues would be calculated each year by the Director of Finance. Specifically, the measure requires the calculation to be based on a linear regression—a statistical analysis technique—that involves adjustments to exclude the revenue effects of changes in tax policy that have been in effect for less than 20 years.

Governor's Proposal

Budget Proposes to Replace ACA 4 With Alternate Measure. The Governor's budget proposes a rainy-day fund that aims to reduce budgetary volatility by basing the size of a required deposit on capital gains-related revenues—the principal source of state revenue volatility. Our comments are based on the general description in the *Governor's Budget Summary* and our discussions with administration staff. Specifically, the Governor's proposal:

- ***Increases the Size of Rainy-Day Fund.*** The Governor's proposal increases the size of the rainy-day fund to 10 percent of estimated General Fund revenues. This larger reserve would provide greater protection against unexpected revenue shortfalls.

- ***Amount of Deposit Based on Capital Gains Revenues.*** Compared with ACA 4, the Governor's proposal uses a different method for determining the size of the annual required deposit. Specifically, we understand the Governor's proposal would require certain projected capital gains income taxes exceeding 6.5 percent of annual General Fund revenues to be deposited to the rainy-day fund. Deposits would be "trued up" over the next two years as more capital gains and other formula data emerges.

- ***Creates a Proposition 98 Reserve.*** The Governor proposes that a portion of a required rainy-day fund deposit go into a Proposition 98 reserve (essentially, as we think of it, a dedicated reserve within the rainy-day fund). This portion would be determined by calculating the part of the increase in the Proposition 98 minimum guarantee caused by capital gains revenues over the 6.5 percent threshold described above. The Proposition 98 reserve deposit would count toward meeting the minimum guarantee in that year, but as the deposit would be held in reserve, total appropriations to schools and community colleges would be less than the minimum guarantee in the years when deposits are made. In a subsequent year, when year-to-year growth in the guarantee is insufficient to fund specified growth and cost-of-living adjustments (COLA), funds from the Proposition 98 reserve would be distributed to schools and community colleges. In this instance, the Proposition 98 reserve distributions would provide schools and colleges with funding above the minimum guarantee in some of the more difficult fiscal years. Because the minimum guarantee can be highly sensitive to changes in General Fund revenues, in some years with significant capital gains, most or all of the proposed rainy-day fund deposits under the Governor's plan would go to the Proposition 98 reserve—meaning those funds would remain unavailable for non-Proposition 98 spending in the future.

- ***Limits Withdrawals.*** For any portion of the rainy-day fund outside of the Proposition 98 reserve, the Governor's plan would limit the amount that can be withdrawn in the first year of a revenue downturn. Specifically, the state would be limited to withdrawing half of that part of the rainy-day fund in the first year of a downturn. For the Proposition 98 reserve itself, in certain instances, we understand that the Governor's plan would allow the full amount to be withdrawn if needed to provide specified growth and COLA adjustments to schools and community colleges.

- ***Allows Funds to Be Used to Pay Down Various Liabilities.*** As described in the *Governor's Budget Summary*, the proposal allows the amount otherwise required to be transferred to the rainy-day fund to instead be used to pay down various budgetary liabilities, such as those on the Governor's wall of debt.

LAO Comments

Goals of Both ACA 4 and Governor's Proposal Are the Right Ones. Assembly Constitutional Amendment 4 and the Governor's proposal both provide mechanisms to "take money off the table" during good times in order to build larger rainy-day reserves. By doing so, either plan could reduce budgetary volatility, resulting in more predictable funding for state and local programs. The measures seek to make contributing to a rainy-day fund a regular feature of the budget process. We believe this is precisely the direction the state should be taking to improve its budgeting practices—particularly at a time when state revenues are soaring due in large part to rising stock prices.

State's History With Constitutional Budgetary Formulas. California's state budget system is already very complex. Formula-driven ballot measures have added considerably to this complexity. Proposition 98, as currently administered, is understood by a small number of insiders. The Gann limit, as amended by Proposition 111, has seldom played a significant role in the state budget process, and its detailed estimates—listed in obscure appendices of annual administration budget documents—are difficult to fathom. Given this experience, writing additional budgetary formulas into the Constitution could diminish the public's already limited understanding of the state's budget system.

Legislature Should Consider Formulas Carefully. As is likely to be the case with any rainy-day fund formula to be written into the State Constitution, both ACA 4 and the Governor's proposal probably would produce unforeseen or unintended consequences for the state in the future. As described earlier, we understand the Governor's proposal would require certain projected capital gains taxes exceeding 6.5 percent of annual General Fund revenues to be deposited to the rainy-day fund. As income distributions change in the future and as stock prices and capital gains grow or decline over time, this constitutional threshold could result in a stronger or weaker rainy-day fund requirement—in general, meaning less or more flexibility for the Legislature and the Governor to address their budget priorities during some periods of time. In the average and median fiscal year since the mid-1990s, capital gains taxes have made up around 7 percent of General Fund revenues. While 6.5 percent, therefore, currently represents something like a "normal year" for capital gains, that may not be the case over time. Similarly, ACA 4 contains a linear regression calculation that requires many adjustments and assumptions to be made to account for tax policy changes over the prior 20 years. We have concerns about the workability and reliability of this calculation. Given these concerns, we advise the Legislature to consider these proposed formulas carefully.

Formula-Based Decisions Often Made Using Imperfect Information. Various rainy-day fund proposals of recent years seem to assume that the data necessary to compute their formulas exists, is knowable with some certainty at a given point in time, and is not subject to interpretation. This is often not the case. For example, revenues for a given fiscal year remain uncertain for about two years, complicating calculations required by ACA 4. In addition, by May when the Legislature and Governor would finalize the estimate of capital gains and the amount of the deposit under the Governor's proposal, the state would have no hard data on capital gains taxes for the fiscal year just ending and imperfect information for the year before that. Moreover, projections of future capital gains taxes are well known to be unreliable—a point the Governor has made forcefully during the past year. As such, locking a reserve formula into the Constitution based on capital gains projections should be considered carefully by the Legislature.

Concerns Regarding Possible Shift of Power to the Executive Branch. Under ACA 4 and the Governor's measure, the amount of the deposits would be dependent on various estimates. Assembly Constitutional Amendment 4 contains formulas explicitly required to be compiled by the executive branch. While we understand the estimates in the Governor's proposal would be subject to legislative review, future governors may well premise their approval of state budget bills on legislative agreement to their administrations' formula calculations. In such a scenario, the Legislature would see more of its powers shifted to the executive branch.

Both Measures' Effectiveness Likely Affected by Proposition 98 Interactions. Both ACA 4 and the Governor's measure make choices regarding how Proposition 98 interacts with the non-Proposition 98 side of the budget. For example, some large influxes of revenues can result in little growth in the state's rainy-day fund under ACA 4 due to Proposition 98. Under the Governor's measure, in a similar year of revenue growth, nearly all of the revenues set aside for rainy-day fund purposes may sometimes go to the Proposition 98 reserve.

How Should the Legislature Proceed?

Possible Alternative Approaches. Despite our concerns, both ACA 4 and the Governor's proposal foster a critical debate. Both aim to address one of the state's most challenging budget problems—revenue volatility. While we think that both ACA 4 and the Governor's proposal have meritorious features, other alternatives could be considered by the Legislature. If the Legislature wishes to place before voters a revised constitutional rainy-day fund requirement, the measure could focus on simple, incremental changes to the Proposition 58 requirement. Below, we list some options that the Legislature may wish to consider in this regard.

- ***Increase Size of Reserve.*** Increasing the size of the Proposition 58 reserve, the BSA, would provide the state greater protection against unexpected revenue shortfalls.

- ***Limit Amount of Withdrawals.*** Limiting the amount that can be withdrawn from the BSA in any single year could improve the state's ability to mitigate budgetary shortfalls in multiyear recessions, but would diminish the ability to cover a significant budget shortfall in any single fiscal year.

- ***Limit Frequency of Withdrawals.*** Limiting the frequency of withdrawals to a specified number of years in any decade could increase the likelihood that the rainy-day fund would be used only when needed most.

- ***Limit Frequency of Suspensions.*** Limiting the frequency of BSA suspensions or reductions to a specified number of years in any decade could encourage more consistent rainy-day fund deposits.

- ***Consider Balance Between Proposition 98 and Other Expenditures.*** In amending Proposition 58—or in considering any rainy-day fund proposal—the Legislature will have to consider the extent to which the Proposition 98 and non-Proposition 98 sides of the budget, respectively, are constrained in periods when the rainy-day fund is being filled and aided when budgetary trends are weak.

- ***Ensure Reserve Deposit Plans Consistent With Annual Budget Agreements.*** Proposition 58 currently requires the Governor to decide whether to suspend or reduce scheduled transfers to the BSA no later than June 1. Yet, the Legislature passes the annual budget on June 15, and the Governor signs the budget plan on or before July 1. Proposition 58 could be amended to allow the Governor to alter his initial June 1 determination on or before July 1 to ensure the state's rainy-day fund deposit plan is compatible with the budget plan adopted by the Legislature.

California Can Build Tradition of Sound Fiscal Stewardship. Assembly Constitutional Amendment 4 and the Governor's proposal should lead to an important budgetary discussion by lawmakers. Regardless of the Legislature's decision about a possible constitutional ballot measure, decisions made in this year's budget process can begin a new tradition of setting aside revenues when times are good to provide a cushion for when revenues decline. The Governor's budget proposal to reinstate the annual deposit to the BSA, for example, could create a strong precedent for accumulating reserves during good revenue times. Further, the proposal is evidence that the Proposition 58 mechanism can work. If revenue estimates rise even more between January and May, the Legislature and the Governor have the chance to build an even larger reserve than the Governor proposes this year. Through actions such as these, the state can establish a tradition of sound fiscal stewardship—with or without any proposed constitutional change.

CalSTRS

Longstanding Funding Problems. CalSTRS has not been appropriately funded for much of its 100-year history. Simply put, CalSTRS is not funded enough to ensure its solvency over the long term. Moreover, state law does not even make clear who is responsible for providing more funding to the system: teachers, districts, or the state. The basic pension math is clear—CalSTRS must receive more money. In our view, now is the time for action to *begin* addressing this very difficult problem.

30-Year, Full-Funding Plan Should Be Focus Now. We agree with the Governor that the key goal of the state should be developing a plan of shared responsibility to achieve a fully-funded, sustainable teachers' pension system within about 30 years. The CalSTRS board has stated that this is the "definitive approach" to addressing the system's funding problem. This will be a very expensive proposition, potentially requiring around $5 billion per year initially (growing over time) in extra resources from some combination of the state, districts, and teachers. This amount will remain substantial over the long term regardless of the fact that stock prices have been growing recently.

Setting Aside Some Money Now Would Be Smart. The Governor suggests that state officials and the education community attempt to come to agreement on how the state, districts, and teachers respectively will fund CalSTRS over the long term. In the meantime, however, a portion of the state's 2014-15 budget reserve could be set aside in anticipation of making the first deposit to CalSTRS after development of a new long-term funding plan over the next year or two. In any event, the responsibility to adopt a solution will in the end rest squarely with the Legislature and the Governor.

Over the Long Term, the State's Role Should Change. The Governor's budget summary comments that the state's long-term role as a direct contributor to CalSTRS should be evaluated. We agree. Employers and employees should be partners in defined benefit pension systems, and the state is not the employer of California's public school teachers. In our November 2011 publication on the Governor's initial pension proposal, we noted that the state can—and probably should—play a key role in addressing the large unfunded liability that exists for past and current teachers' benefits. We also have suggested that the state create a plan for *future* teachers' benefits to be paid completely by districts and teachers over the long term.

Proposition 98

Proposition 98 funds K-12 education, the California Community Colleges (CCC), preschool, and various other state education programs. The Governor's budget includes $11.8 billion in Proposition 98 spending increases. Of that amount, $7.6 billion is designated as 2014-15 Proposition 98 spending, $3.7 billion is additional funding attributable to 2012-13 and 2013-14, and $503 million is attributable to earlier years. Of the $11.8 billion, $6.8 billion is designated for one-time purposes and $5 billion for ongoing purposes. Under the Governor's budget, ongoing K-12 per-pupil funding would increase from $7,936 in 2013-14 to $8,724 in 2014-15—an increase of $788 (10 percent).

Changes to the Minimum Guarantee

2012-13 Minimum Guarantee Up $1.9 Billion. As Figure 8 shows, the administration's revised estimate of the 2012-13 minimum guarantee is $58.3 billion, a $1.9 billion increase from the estimate made at the time the 2013-14 budget plan was enacted. Of the increase in the minimum guarantee, roughly $1.8 billion is due to General Fund revenues being $1.7 billion higher than assumed in the 2013-14 budget plan, and the remainder is due to an increase in baseline property tax revenues. (The 2012-13 minimum guarantee is a "Test 1" year, in which increases in property tax revenues result in higher funding for schools

Figure 8

Increase in 2012-13 and 2013-14 Proposition 98 Minimum Guarantees

(In Millions)

	2012-13			2013-14		
	Budgeted	**Revised**	**Change**	**Budgeted**	**Revised**	**Change**
Minimum Guarantee						
General Fund	$40,454	$42,207	$1,752	$39,055	$40,948	$1,893
Local property tax	16,011	16,135	124	16,226	15,866	-361
Totals	**$56,465**	**$58,342**	**$1,877**	**$55,281**	**$56,813**	**$1,532**

and community colleges.) Though the Governor's estimate of the minimum guarantee has increased, his estimate of 2012-13 Proposition 98 spending is $130 million lower, primarily due to lower-than-expected student attendance. The higher minimum guarantee combined with lower-than-expected costs create a total "settle-up" obligation of $2 billion.

2013-14 Minimum Guarantee Up $1.5 Billion. The administration's revised estimate of the 2013-14 minimum guarantee is $56.8 billion, a $1.5 billion increase from the amount assumed in the 2013-14 budget plan. This increase is due to the higher 2012-13 minimum guarantee and higher year-to-year growth in per capita General Fund revenues, offset slightly by lower-than-anticipated growth in student attendance. Though the minimum guarantee is up $1.5 billion, the state's General Fund Proposition 98 requirement is up by $1.9 billion due to estimates of local property tax revenues decreasing by $361 million. The Governor also has a revised estimate of 2013-14 spending, which is down $150 million primarily due to lower-than-expected student attendance. The higher minimum guarantee combined with lower-than-expected costs creates a 2013-14 settle-up obligation of $1.7 billion.

2014-15 Minimum Guarantee $4.7 Billion Above Revised 2013-14 Level. As Figure 9 shows, the Governor's budget proposes $61.6 billion in total Proposition 98 funding for 2014-15. This is $4.7 billion higher than the revised 2013-14 spending level. The increase is driven by strong growth in General Fund revenue and increases in property tax revenues. (Test 1 is operative in 2014-15, such that marginal increases in property tax revenues—except for RDA asset revenues—are resulting in a higher Proposition 98 minimum guarantee.)

Wall of Debt Proposal

One of the largest components of the Governor's budget plan is his proposal to retire all wall of debt obligations, including school and community college obligations, by the end of 2017-18. The state currently has a total of

Figure 9

Proposition 98 Funding

(Dollars in Millions)

	2012-13 Revised	2013-14 Revised	2014-15 Proposed	Change From 2013-14 Amount	Change From 2013-14 Percent
Preschool	$481	$507	$509	$2	—
K-12 Education					
General Fund	$37,740	$36,361	$40,079	$3,718	10%
Local property tax revenue	13,895	13,633	14,171	537	4
Subtotals	($51,634)	($49,995)	($54,250)	($4,255)	(9%)
California Community Colleges					
General Fund	$3,908	$4,001	$4,396	$395	10%
Local property tax revenue	2,241	2,232	2,326	94	4
Subtotals	($6,149)	($6,233)	($6,723)	($489)	(8%)
Other Agencies	$78	$78	$77	-$1	-1%
Totals	**$58,342**	**$56,813**	**$61,559**	**$4,746**	**8%**
General Fund	$42,207	$40,948	$45,062	$4,115	10%
Local property tax revenue	16,135	15,866	16,497	631	4

$11.5 billion in such outstanding school and community college obligations—$6.2 billion in deferrals (late payments), $4.5 billion in unpaid mandate claims, $462 million for ERP, and $410 million for the Quality Education Investment Act (QEIA). (The state also has a $1.5 billion outstanding Proposition 98 settle-up obligation, which can be used to pay off the obligations mentioned above.) We discuss the Governor's plan for retiring these obligations below.

Retires All School and Community College Deferrals by End of 2014-15. The Governor proposes to pay down all $6.2 billion in outstanding school and community college deferrals by the end of 2014-15. As Figure 10 shows, the Governor designates Proposition 98 funding from 2012-13, 2013-14, and 2014-15 to pay down these deferrals. Under the Governor's plan, all higher Proposition 98 spending proposed in 2012-13 and 2013-14 is used for deferral pay downs. About one-third of the new spending proposed for 2014-15 is for deferral pay downs.

Makes Final $410 Million QEIA Payment. QEIA provides funding to low-performing schools for various improvement activities and to community colleges for career technical education. Through the QEIA program, the state is providing additional funds to schools and community colleges as part of a Proposition 98 settle-up agreement relating to 2004-05 and 2005-06. Although statute requires a $410 million payment to fully retire the state's 2004-05 and 2005-06 settle-up obligations, the estimated costs of the QEIA program in 2014-15 are $316 million. (Fewer schools are now participating in the program.) The Governor proposes to redirect the $94 million in freed-up funds to the ERP (as discussed further below).

Provides $188 Million for ERP. The ERP was created in 2004 through legislation associated with the *Williams* settlement and is intended to provide low-performing schools with a total of $800 million for emergency facility repairs. Of the $188 million proposed for ERP in 2014-15, $94 million is being redirected from free-up QEIA funds (mentioned above) and $94 million is coming from unspent prior-year Proposition 98 funds. Under the Governor's proposal, the state would have $274 million in outstanding ERP obligations at the end of 2014-15.

Retires Remaining Wall of Debt Obligations by End of 2017-18. The Governor proposes to retire all remaining wall of debt obligations in the following three years, with all obligations paid off by 2017-18. In 2015-16, the Governor would provide $1.5 billion to retire the state's outstanding Proposition 98 settle-up obligation. Because settle-up payments can be provided to schools and community colleges for any purpose, the Governor proposes to dedicate these settle-up funds for repaying the remaining $274 million owed for ERP and paying off $1.2 billion in outstanding mandate claims. The remaining $3.2 billion in mandate-claim payments would be spread across 2016-17 and 2017-18.

Other Major Proposition 98 Proposals

Figure 11 (see next page) shows all major changes to Proposition 98 spending in 2014-15. As the figure shows, the budget provides $7.6 billion in

Figure 10

Governor Proposes to Pay Down All Outstanding K-14 Deferrals

(In Millions)

	K-12	CCC	Totals
Pay down scored to:			
2012-13	$1,813	$194	$2,007
2013-14	1,520	163	1,683
2014-15	2,238	236	2,474
Total Proposed Deferral Pay Down	**$5,571**	**$592**	**$6,164**

policy-related spending increases. Of this amount, $5.2 billion reflects program augmentations and $2.5 billion is for paying down the last of school ($2.2 billion) and community college ($236 million) deferrals. As shown in the figure, the largest programmatic augmentation is for the school district LCFF. We discuss this and other notable proposals below. For community colleges, we discuss the Governor's Student Success and Support Program (SSSP) proposal later in the "Higher Education" section of this report and the Governor's $175 million maintenance-related proposal later in the "Infrastructure" section.

Provides $4.5 Billion for LCFF Increases. The proposed $4.5 billion increase in LCFF funding reflects an 11 percent year-to-year increase and is estimated to close 28 percent of the remaining gap between school districts' 2013-14 funding levels and the LCFF full implementation rates. Under the Governor's proposal, we estimate the 2014-15 per pupil LCFF funding level would be approximately 80 percent of the full implementation rates. The Governor also proposes to add two categorical programs to the LCFF—Specialized Secondary Programs ($4.8 million) and agricultural education grants ($4.1 million). Under the Governor's proposal, school districts receiving funding for these two programs in 2013-14 would have those funds count towards their LCFF targets beginning in 2014-15. (No change would be made to the LCFF target rates.) The currently required categorical activities would be left to districts' discretion. The Governor's plan also provides county offices of education (COEs) with an additional $26 million in LCFF funding. The administration projects that this increase will be sufficient to provide COEs their full LCFF target rates in the budget year.

Proposes New Automated Budget Formula for LCFF Funding. The Governor proposes statutory language requiring that a specified percentage of annual Proposition 98 funding automatically be dedicated to LCFF each year (the exact percentage has yet to be determined). Under current law, prior-year LCFF appropriations are continuously appropriated—that is, these appropriations are automatically made to school districts, even without an approved state budget. Increases in LCFF funding, however, are made at the discretion of the Legislature and must be approved in the annual budget.

Figure 11

Increases in 2014-15 Proposition 98 Spending

(In Millions)

Accounting Adjustments	
Remove prior-year one-time actions	-$2,423
Fund QEIA program outside of Proposition 98	-361
Adjust energy efficiency funds	-101
Subtotal	(-$2,885)
Policy Changes	
Fund increase in school district LCFF	$4,472
Pay down remaining deferrals (one-time)	2,474
Augment CCC Student Success and Support Program	200
Augment CCC maintenance and instructional equipment (one-time)	175
Fund 3 percent CCC enrollment growth	155
Provide 0.86 percent COLA to select K-14 programs	82
Increase funding for K-12 pupil testing	46
Fund increase in COE LCFF	26
Other changes	1
Subtotal	**($7,631)**
Total Changes	$4,746

QEIA = Quality Education Investment Act; LCFF = Local Control Funding Formula; CCC = California Community Colleges; COLA = cost-of-living adjustment; and COE = county office of education.

Under the Governor's proposal, the Legislature effectively would have no role in making this key determination moving forward.

Other Changes to Existing Programs. The Governor's budget plan includes several other notable changes. The budget provides $82 million to fund a 0.86 percent COLA for most K-12 categorical programs and community college apportionments. The Governor also provides a $46 million increase for pupil testing to reflect the higher cost of administering new standardized tests aligned to the Common Core State Standards. The budget also reflects a $101 million reduction in funding for Proposition 39 energy projects. (The Governor estimates that the amount of corporate tax revenues deposited into the Clean Energy Job Creation Fund in 2014-15 will be $101 million lower than assumed in the 2013-14 budget plan, thus requiring a corresponding reduction in funding.) To accommodate the reduction, the Governor provides no additional funding in 2014-15 for the revolving loan program ($28 million savings) and reduces school and community college grants by $65 million and $8 million, respectively. The Governor also proposes to add three mandates—Uniform Complaint Procedures, Public Contracts, and Charter Schools IV—to the Mandate Block Grant. Given none of the three mandates is relatively costly, the Governor's plan does not provide an associated increase in block grant funding.

Proposes Simplification of Rules for Independent Study. To facilitate the use of online instruction, the Governor proposes to create a simplified independent study program for grades 9-12. Current independent study programs require that each student assignment within a course be translated into an equivalent number of classroom hours for purposes of generating funding. Under the Governor's proposal, independent study programs alternatively could choose to translate each course into an equivalent number of hours for purposes of generating funding. The Governor also proposes to allow student-teacher ratios in these courses to exceed limits established by current law, provided these changes are collectively bargained by local education agencies.

Governor's Overall Proposition 98 Plan Reasonable

Plan Contains Prudent Mix of One-Time and Ongoing Spending. We believe the Governor's Proposition 98 plan provides a reasonable mix of programmatic funding increases and pay downs of outstanding obligations. By retiring the $6.2 billion in outstanding K-14 deferrals, the plan would eliminate the largest component of the school and community college wall of debt. Dedicating a substantial amount of new funding to one-time purposes also helps the state minimize any future disruption in school funding as a result of revenue volatility or an economic slowdown. Though a significant amount of funding is dedicated to one-time purposes in the Governor's plan, his plan also significantly increases LCFF funding and provides a variety of community college augmentations, thereby building up ongoing programmatic support.

2014-15 Minimum Guarantee Very Sensitive to Changes in General Fund Revenues. Because 2014-15 is a Test 1 year in which a relatively large maintenance factor payment is required, marginal increases or decreases in General Fund revenues can result in dollar-for-dollar changes in the minimum guarantee. (As we've previously discussed, this is driven by the state's approach to paying maintenance factor in Test 1 years.) As a result, estimates of the 2014-15 minimum guarantee will be highly sensitive to changes in General Fund revenues and could experience large swings over the coming months. This volatility and associated swings in the guarantee makes a prudent mix of one-time and ongoing support particularly important.

Concerns With Proposal to Automate Future LCFF Funding Increases. Though we believe the Governor's overall Proposition 98 plan is reasonable, we have concerns with his proposal to set in statute the specific share of Proposition 98 funding that would be dedicated to LCFF each year moving forward. Though we believe the bulk of future K-12 funding increases should be dedicated to funding LCFF, we are concerned that such an approach would remove the Legislature's discretion to appropriate funding and make key budget decisions. Given the considerable loss of associated legislative authority and discretion, we recommend the Legislature reject this proposal.

Higher Education

California's publicly funded higher education system consists of UC, CSU, CCC, Hastings College of the Law (Hastings), the California Student Aid Commission (CSAC), and the California Institute for Regenerative Medicine (CIRM). As shown in Figure 12, the Governor's budget provides $13 billion in General Fund support for higher education in 2014-15. This is $1.2 billion (10 percent) more than the revised current-year level.

Major Higher Education Proposals

The majority of the new funding is for base increases at the universities, increases in apportionment funding and two categorical programs at the community colleges, repaying bonds that support CIRM research, as well as increased participation in Cal Grants and implementation of the new Middle Class Scholarship program.

Proposes Increase in General Purpose Funding for Universities. The Governor proposes unallocated base budget increases of $142 million each for UC and CSU in 2014-15. These increases represent the second annual installment in a four-year funding plan proposed by the Governor last year. Under this plan, the universities, which received 5 percent base funding increases in the current year, would receive the proposed 5 percent increase in 2014-15, followed by 4 percent increases

Figure 12

Higher Education General Fund Support

(Dollars in Millions)

	2012-13 Actual	2013-14 Revised	2014-15 Proposed	Change From 2013-14	
				Amount	Percent
University of California	$2,566	$2,844	$2,987	$142	5%
California State University[a]	2,473	2,789	2,966	177	6
California Community Colleges[b]	4,269	4,390	4,828	438	10
California Student Aid Commission[c]	1,559	1,682	1,904	222	13
California Institute for Regenerative Medicine	53	97	284	187	193
Hastings College of the Law	9	10	11	1	13
Awards for Innovation in Higher Education	—	—	50	50	N/A
Debt-service obligations[d]	(1,027)	(1,027)	(1,255)	(228)	(22)
Totals	**$10,930**	**$11,812**	**$13,030**	**$1,218**	**10%**

[a] Includes health benefit costs for CSU retired annuitants.
[b] Includes Quality Education Investment Act funds.
[c] Includes federal Temporary Assistance for Needy Families funds and monies from the Student Loan Operating Fund—both of which directly offset General Fund expenditures for Cal Grants.
[d] Amounts, which include debt service on general obligation, lease-revenue, and UC general revenue bonds, are shown for reference only, as they already are reflected in the lines above.

in each of the subsequent two years. (The increases for both universities are based on 5 percent of UC's support budget, resulting in an increase of 5.6 percent for CSU.) About $10 million of CSU's increase is related to a new proposed process for funding capital projects (discussed later in the "Infrastructure" section of this report).

No Enrollment Targets for Universities. Similar to last year, the Governor does not propose enrollment targets or enrollment growth funding for the universities. The Governor's budget documents show resident enrollment flat in the budget year at UC, growing by 2 percent at CSU, and decreasing by 8 percent at Hastings. (The administration indicates these enrollment levels are shown for "display purposes only and do not constitute an enrollment plan.")

Assumes No Tuition Increases. Although the Governor acknowledges in his budget summary that college is relatively affordable for California's public-college students (due to high public subsidies, relatively low tuition and fees, and robust financial aid programs), he conditions his proposed annual funding increases for the universities on their maintaining tuition at current levels. Under his plan, tuition levels, which have not increased since 2011-12, would remain flat through 2016-17.

Requires UC and CSU to Adopt Sustainability Plans. The Governor proposes budget language requiring the UC and CSU governing boards to adopt three-year sustainability plans by November 30, 2014. Under this proposal, the universities would project expenditures for each year from 2015-16 through 2017-18 and describe changes needed to ensure expenditures do not exceed available resources (based on General Fund and tuition assumptions provided by the Department of Finance [DOF]). The segments also would project resident and nonresident enrollment for each of the three years and set performance targets for the outcome measures approved in last year's budget. (Under current law, UC and CSU are required to report annually by March 1 on a specified set of performance measures.)

Significantly Increases CCC Funding. In addition to paying off CCC deferrals (discussed earlier in the Proposition 98 section of this report), the Governor provides significant programmatic increases to the CCC system. These augmentations include $200 million for the Student Success and Support categorical program (discussed in more detail below), $175 million (one-time) for deferred maintenance and instructional support (discussed later in the "Infrastructure" section of this report), $155 million for 3 percent enrollment growth (an additional 34,000 full-time equivalent students), and $48 million to provide a 0.86 percent COLA to apportionments.

Proposes Major Augmentation for CCC Categorical Program. The Governor provides a $200 million augmentation to CCC's SSSP (formerly known as matriculation), which represents a tripling of current-year funding for the categorical program. The SSSP funds assessment and orientation services for new students, as well as academic counseling for both new and continuing students. Of the $200 million, $100 million would be allocated to districts in support of all CCC students (using a formula based on student enrollment). The remaining $100 million would be allocated to districts specifically to target "high need" CCC students. The Chancellor's Office would be tasked with defining what constitutes high need as well as with developing a methodology for allocating these monies to districts. The Governor's intent is for districts to provide additional services—beyond the base services provided under SSSP—so as to reduce student achievement gaps (related to students' gender, ethnic/racial group, or disability). The Governor's budget also expresses a desire for districts to improve coordination of SSSP with CCC categorical programs that serve similar students and also would permit districts to reallocate up to 25 percent of funds from three CCC categorical programs to other programs that serve high-need students.

Proposes New Innovation Awards. Also included in the Governor's budget is one-time funding of $50 million for awards to encourage innovation at UC, CSU, and CCC campuses. Proposed budget language defines three state priorities: (1) significantly increasing bachelor's degree attainment in the state, (2) shortening time to degree, and (3) easing transfer across segments. Campuses, both individually and in groups, could apply for awards to implement innovative higher education models that achieve these priorities. A committee of five Governor's appointees representing DOF and the segments' governing boards (including the State Board of Education) and two legislative appointees selected by the Assembly Speaker and Senate Rules Committee would make award decisions. The committee would look for proposals that reduce the costs of instruction; involve collaboration across campuses, segments, and educational levels; are replicable; and show commitment from campus officials and stakeholders.

Funds Implementation of Middle Class Scholarship Program. The budget provides $107 million for the first year of scholarship awards under this new program, as approved in last year's budget legislation. Students at UC and CSU with family incomes up to $100,000 qualify for awards that cover 40 percent of their systemwide tuition (when combined with all other public financial aid). Awards decrease in size for students with family incomes between $100,000 and $150,000, such that a student with a family income of $150,000 qualifies for an award covering 10 percent of tuition. The legislation directs CSAC to reduce award amounts for all students proportionately if the appropriation is insufficient to provide full awards to all eligible applicants. The commission will make a preliminary determination about whether awards will need to be prorated in April, after receiving the universities' estimates of qualifying students.

Funds Cal Grant Participation Growth. The budget also provides $103 million for increased participation in Cal Grants. A portion of this growth is due to a surge in new awards in the current year, which increases renewals in the budget year. (The budget does not assume additional growth in the number of new awards for 2014-15.) In addition, the second cohort of Dream Act students accounts for about one-quarter of the increase.

Mixed Review of Governor's Proposals

Below, we provide our initial assessment of the Governor's higher education proposals.

Does Not Link University Funding to State Priorities. Although the Governor enumerates several higher education priorities in his budget documents (for example, reducing the cost of education and improving affordability, timely completion rates, and program quality), his funding plan includes large unallocated increases tied only to maintaining flat tuition levels. The budget requires the universities to set performance goals, but does not establish state performance expectations or link the universities' funding to meeting these expectations. This approach diminishes the Legislature's role in key policy decisions and allows the universities to pursue their own interests rather than the broader public interest. The state could connect university funding with state priorities in a variety of ways. For example, the state could allocate new funding for specific purposes such as a COLA, maintenance projects, or pension obligations. It also could use the performance results the universities are required to report in March to inform funding decisions—including the allocation of new funding among the segments—rather than committing in advance to specified annual augmentations.

Tuition Freeze Likely to Increase Future Volatility. We remain concerned that locking in tuition and fee levels for a total of six years, as proposed by the Governor, could lead to larger increases and greater tuition volatility for future students. A tuition policy that allows for moderate increases and provides a rational basis for allocating costs between state and students is more likely to serve the state's interests in the long run.

Sustainability Reports Could Help Inform Budget Discussions. By requiring UC and CSU to develop an expenditure plan and performance goals based on the administration's estimate of available resources, the expenditure plans could help clarify the trade-offs involved in the funding levels included in the Governor's budget. We would emphasize, however, that these reports should be treated as only a starting point for discussion because they would reflect only the administration's resource proposals and the segments' own performance targets. The Legislature may have different ideas regarding how much to invest in higher education (both through state appropriations and tuition policies) and what outcomes to expect from the universities.

Information to Date Suggests Governor's CCC Enrollment Growth Proposal May Be Too High. We have concerns that the Governor may be providing too much funding for CCC enrollment growth. After several years of strong demand for a CCC education during the recent recession, a number of districts throughout the state have indicated that they are having difficulty achieving their enrollment targets. In 2012-13, more than a dozen districts failed to meet their enrollment targets. By late February, the CCC Chancellor's Office will have updated information from districts regarding whether districts are on track to meet their targets in the current year. The Legislature will need to carefully assess these data to evaluate the merit of the Governor's enrollment growth proposal. If it decides the entire $155 million for enrollment growth is not justified, the Legislature could use any associated freed-up funds for other Proposition 98 priorities.

Governor's Focus on CCC Support Program Is Laudable but Fails to Fully Address Student Needs. Over the past several years, a number of reports have highlighted the relatively low success rates of CCC students. For example, the Institute for Higher Education Leadership and Policy has found that only about one-third of CCC students who seek to transfer or graduate with an associate degree or certificate actually do so. As a result of data such as these, the Legislature has shown a strong interest in improving student outcomes and, through recent legislation and budget actions, has identified SSSP as a key priority. Given these factors, the Governor's focus on student success is reasonable. We have concerns, however, that the Governor's emphasis on SSSP is too narrowly focused. As state and national research has shown, students often need a variety of support to succeed. Different types of students may need different support services and many students need multiple types of support that extend beyond undergoing initial assessment and meeting with an academic counselor. For example, a student with a learning disability (such as dyslexia) may require specialized assistance. A financially needy and academically underprepared student may need access to financial aid advising and intensive tutoring in basic skills (remedial) coursework. By placing the entire $200 million augmentation in SSSP, however, the Governor limits the ability of districts to provide a fuller range of effective services to students. We recommend the Legislature consider a more comprehensive approach that spreads funds across support programs (including SSSP, Disabled Student Programs and Services, and Student

Success for Basic Skills Students), or gives districts more flexibility to allocate resources as they see fit (such as by combining categorical program funding into a block grant).

Concerns About Innovation Awards. The Governor's proposed innovation award program could result in some confusion about the state's higher education priorities. Last year, the Governor signed SB 195 (Liu), which set three broad state goals for higher education that differ somewhat from the state priorities the Governor proposes. In addition, the Governor indicates that the award program builds on last year's efforts to expand the use of technology to remove course bottlenecks and reduce the costs of education. However, the results of those efforts are not yet clear, and it appears premature to fund a new award program before giving the existing efforts time to show results. Finally, we are concerned that earmarking a relatively small amount of one-time funding for campuses to address state priorities could send a poor message and encourage business-as-usual with the bulk of the state's higher education investment.

Health and Human Services

Implementation of the Patient Protection and Affordable Care Act (ACA)

Budget Assumes Significant Fiscal Effects Associated With ACA Implementation. The budget assumes a couple of major fiscal effects associated with various ACA-related provisions that were enacted as part of the 2013-14 budget. For example, the budget assumes about $400 million in net General Fund costs in 2014-15 largely associated with implementation of simplified Medi-Cal eligibility and enrollment processes that are expected to increase enrollment among individuals who are eligible for the program—often referred to as the "mandatory" Medi-Cal expansion. In addition, the budget assumes General Fund savings of $300 million in 2013-14 and $900 million in 2014-15 from implementation of the optional Medi-Cal expansion. These savings are realized through changes to 1991 health realignment that were authorized as part of the 2013-14 budget and result in lower state General Fund costs in the California Work Opportunity and Responsibility to Kids (CalWORKs) budget.

Estimates Are Subject to Substantial Uncertainty, but Additional Data Should Be Available in Coming Months. Our office's November 2013 report, *The 2014-15 Budget: California's Fiscal Outlook*, assumed about $350 million in costs for the mandatory expansion in 2014-15, and $930 million in savings related to changes to 1991 realignment and the Medi-Cal expansion in 2014-15. The fiscal estimates included in the Governor's budget are similar to our office's most recent estimates. However, both our recent estimates and the Governor's budget estimates are subject to considerable uncertainty and are based on limited data. As the Medi-Cal expansion was implemented beginning January 1, 2014, more reliable estimates should be available in a few months, after more data are collected and analyzed and the effects of ACA implementation are better understood.

Status of Medi-Cal Provider Payment Reductions

Budget Proposes to Forgive Retroactive Recoupment of Payment Reductions for Some Medi-Cal Providers. In 2011, budget-related legislation authorized reductions in certain Medi-Cal provider payments by up to 10 percent. Until recently, federal court injunctions prevented the state from implementing many of these reductions. In June 2013, the injunctions were lifted, giving the state authority to (1) apply the reductions to current and future payments to providers on an *ongoing* basis, and (2) *retroactively* recoup the reductions from past payments that were made to providers during the period in which the injunctions were in effect. Since the 2013-14 budget was enacted, several types of providers have been exempted from the *ongoing* payment reduction through either an administrative decision by the Department of Health Care Services or recently enacted legislation.

The Governor's budget proposes to exempt certain (but not all) classes of providers and services from the *retroactive* recoupments, and includes $36 million in increased General Fund expenditures associated with this proposal. Because the recoupments are otherwise scheduled to take place over several years, the total General Fund cost of the proposal over this multiyear period is estimated to be $218 million. The administration has stated that while federal approval is required to implement this proposal, no statutory changes are necessary.

Achieve Savings From Provider Reductions Prospectively. The budget assumes that the state will continue to implement reductions to payments to providers and services that have not been legislatively or administratively exempted from *ongoing* reductions. The budget assumes that these *ongoing* reductions will result in General Fund savings of $245 million in 2014-15.

CalWORKs

Parent/Child Engagement Demonstration Pilot. The Governor's CalWORKs proposal includes a three-year demonstration project that would provide intensive case management, life skills and work readiness training, and licensed child care to a limited number of CalWORKs families that face the highest barriers to employment and may not be fully participating in the CalWORKs program. This demonstration project would operate in six counties (yet to be determined) with a cost of $9.9 million (General Fund) in 2014-15 and a total estimated cost of $115 million (General Fund) over the duration of the demonstration.

Grant Increase. The Governor's proposal also includes full-year funding for a 5 percent increase to CalWORKs cash grants that was approved as part of the 2013-14 budget package and is scheduled to go into effect in March 2014. As provided in the 2013-14 budget package, this grant increase is to be funded with certain funds redirected from 1991 realignment growth revenues, with the General Fund making up the difference if the redirected funds are insufficient. The Governor's proposal assumes that the full-year cost of the grant increase in 2014-15 is $168 million and that most of this amount will be paid for with the redirected funds. The General Fund will cover a shortfall estimated to be $6.3 million. The estimated amount of redirected funds available to pay for this grant increase is preliminary and is likely to be updated, along with the amount of any General Fund contribution, as part of the Governor's May Revision.

Developmental Services

Provides Funding for Sonoma Developmental Center to Meet Federal Requirements. The budget proposes $5.1 million from the General Fund ($9.2 million total funds) for improvements needed at the Sonoma Developmental Center to comply with federal certification requirements for receipt of federal funds. While three other developmental centers were recently found to be out of compliance with federal certification requirements, the budget does not propose additional funds to address these federal certification issues. The Governor's budget summary document notes that a plan to resolve the certification issues at these three centers is currently under development. (This plan will dictate the funding requirements to address the certification issues.)

In-Home Supportive Services (IHSS)

Restricts Overtime for IHSS Providers in Light of New Federal Labor Regulations. The budget includes $99 million from the General Fund ($209 million total funds) in response to new federal labor regulations (effective January 1, 2015) impacting IHSS providers (and other home care workers). In accordance with the federal regulations, the proposal provides funding for certain work activities that were previously ineligible for compensation, such as wait time during doctor's appointments. The new federal regulations also require overtime pay for home care workers (which would include IHSS providers). In response to this new regulation, the budget proposes to restrict providers from working overtime and require IHSS recipients in need of additional assistance to utilize a "Provider Backup System" to identify another provider to perform the assistance. After 2014-15, it is estimated that the annual full-year cost of this proposal will be $153 million General Fund ($328 million total funds).

Infrastructure

According to the *Governor's Budget Summary*, the administration intends to release soon a statewide five-year infrastructure plan—a required annual document that was last provided in 2008. In addition, the Governor's proposed budget includes several major proposals related to infrastructure. We discuss these specific proposals below.

Deferred Maintenance

Proposes One-Time Funding for Deferred Maintenance. The Governor's budget identifies state infrastructure deferred maintenance needs of $64.6 billion, most of which are related to the state's transportation system. The budget proposes one-time spending of $815 million from various fund sources to begin to address these needs (see Figure 13). Of this spending, $337 million is proposed to repay a General Fund loan from the Highway Users Tax Account, with the monies allocated for state highway pavement rehabilitation and maintenance, traffic management mobility, and local streets and roads projects. Additionally, the budget includes $188 million for the K-12 Schools Emergency Repair Program and $175 million for community colleges (to be split equally between maintenance projects and instructional support, such as replacement of library materials and classroom projectors). The Governor also includes a total of $100 million from the General Fund to help support the maintenance needs of nine departments. Finally, the budget proposes $15 million from the State Court Facilities Construction Fund to address maintenance projects within the courts.

Focus on Deferred Maintenance Is Positive. We believe that it is appropriate for the state to address its accumulated deferred maintenance as proposed by the Governor. When repairs to key building and infrastructure components are put off, facilities can eventually require more expensive investments, such as emergency repairs (when systems break down), capital improvements (such as major rehabilitation), or replacement. As a result, while deferring annual maintenance needs avoids expenses in the short run, it often results in substantial additional costs in the long run. While the Governor's proposal does not address all of the state's significant deferred maintenance needs, we think it is a commendable first step towards dealing with an important and often ignored problem.

Proposal Raises Questions for Legislative Consideration. As it evaluates the specifics of the Governor's deferred maintenance proposal, the Legislature will want to consider the following issues.

- ***Amount and Allocation of Deferred Maintenance Funding to Departments.*** The Legislature will want to consider whether the total level of funding proposed is the appropriate amount to dedicate to deferred maintenance given the state's needs, as well as whether the proposed distribution among departments is consistent with legislative priorities.

- ***Prioritization and Accountability of Projects Within Departments.*** The Legislature may want to provide guidance on the priorities for spending these deferred maintenance dollars. For example, it may wish to emphasize projects that address fire, life and safety issues, reduce state liability, and prevent higher future state costs. The Legislature may also wish to consider whether projects should be required to address deferred maintenance only, rather than using funds for other purposes such as instructional support for community colleges, which, while potentially worthy, do not directly address the condition of the state's existing facilities.

- ***Appropriate Funding Sources.*** The Legislature may wish to consider the appropriate funding sources for deferred maintenance. There may be some programs where there could be a role for alternative or additional funding for deferred maintenance from other sources, such as bond funds, private donations, or user fees. Identifying such sources would increase the number of projects that could be completed or reduce the amount of General Fund dollars that are required.

- ***Prevention of Future Deferred Maintenance.*** Providing one-time funding, regardless of size, is only a short-term response to the problem. Ideally, there should be no deferred maintenance. As such, the Legislature may want departments to describe what specific factors led to its deferred maintenance problem—for instance, insufficient maintenance funding

Figure 13

Administration's Deferred Maintenance Proposal

(In Millions)

Department/Program	Proposed Amount	Fund Source
Caltrans	$337	General Fund[a]
K-12 Schools Emergency Repair Program	188	General Fund[b]
California Community Colleges	175	General Fund[c]
Parks and Recreation	40	General Fund
Corrections and Rehabilitation	20	General Fund
Judicial Branch	15	State Court Facilities Construction Fund
Developmental Services	10	General Fund
State Hospitals	10	General Fund
General Services	7	General Fund
State Special Schools	5	General Fund
Forestry and Fire Protection	3	General Fund
Military	3	General Fund
Food and Agriculture	2	General Fund
Total	**$815**	

[a] To repay Highway Users Tax Account loan.
[b] Consists of $94 million in prior-year unspent Proposition 98 funds and $94 million in funding attributable to a 2005-06 Proposition 98 settle-up obligation.
[c] Counts toward 2014-15 Proposition 98 minimum guarantee.

in the base budget or diversion of funds provided for maintenance to other areas of operations. This information could assist the Legislature in crafting policies to address underlying problems and to ensure that, over time, appropriate ongoing maintenance is sustained and deferred maintenance is eliminated.

School Facility Funding

Governor Seeks Conversation on School Facility Funding. In his budget summary, the Governor notes that most state bond funding for new school construction and school modernization has been depleted. He proposes to shift $211 million in remaining bond authority from four targeted school facility programs to these two school facility programs. He also seeks "to continue a dialogue on the future of school facilities funding, including what role, if any, the state should play." If the state decides to continue funding school facilities, the Governor suggests that any future program: (1) not rely too heavily on state bonds, (2) be easy to administer, and (3) provide incentives for districts to use "modern educational delivery methods."

Several Major Issues for Legislature to Consider. The Governor questions whether the state should continue its traditional role in funding school facilities but does not elaborate on what factors to consider in making this determination. Some factors to consider include the availability of funding at the local level for facilities and differences in local revenue-raising capacity among districts. If the Legislature were to decide to continue to fund school facilities, then it would need to consider whether to continue using state bonds or move to another financing mechanism, such as an annual per-student grant. If the Legislature were to authorize a new bond-funded program, it would need to determine the associated eligibility criteria, application process, and cost-sharing requirements between the state and districts. Alternatively, if the Legislature were to adopt a per-student grant, it would need to consider whether the grant should be weighted or uniform, as well as whether the grant could be integrated into the LCFF. In all these cases, the Legislature also would need to consider whether to make payments for facilities from within Proposition 98.

CSU Capital Outlay Process

Proposes New Capital Outlay Process for CSU. Similar to the new capital outlay process approved for UC last year, the Governor proposes to shift debt service payments into CSU's main appropriation. Moving forward, CSU would be responsible for funding debt service from within this main appropriation. Under the proposal, the university would issue its own revenue bonds for various types of capital projects and could restructure its existing lease-revenue bond debt. The university would notify the Joint Legislative Budget Committee of project proposals and submit them to DOF for approval.

Issues for Legislative Consideration. The administration indicates that the main purpose of this change is to compel CSU to weigh operations and infrastructure requirements and determine the best allocation of resources between them. We are concerned, however, that the Governor's approach diminishes the Legislature's oversight over the university's use of state funds. In addition, this approach presupposes that a particular amount of debt service funding—in this case, the 2013-14 amount for general obligation bond debt service and the estimated 2014-15 amount for lease-revenue debt service—is an appropriate amount upon which to base ongoing needs, yet the administration offers no evidence to this effect.

Jail Construction

Governor Proposes an Additional $500 Million for Jail Construction. Since 2007, the Legislature has approved two measures authorizing a total of $1.7 billion in lease-revenue bonds to fund the construction and modification of county jails. Chapter 7, Statutes of 2007 (AB 900, Solorio), provided $1.2 billion to help counties address jail overcrowding. Chapter 42, Statutes of 2012 (SB 1022, Committee on Budget and Fiscal Review), authorized an additional $500 million to help counties construct and modify jails to accommodate longer-term inmates who have been shifted to county responsibility under the 2011 realignment of lower-level offenders. The Governor's budget for 2014-15 proposes that another $500 million in lease-revenue bonds be authorized to support the construction of jail facilities. Under the proposal, counties would be subject to a 10 percent match requirement.

LAO Comments. The administration has not yet provided an analysis of county jail needs or other rationale for why the level of funding proposed is needed for jail projects or what criteria would be used to award the lease-revenue funding. For example, it is not clear whether funding would be awarded in a manner to alleviate crowding or to build additional facility space for programs, such as substance abuse treatment classes. Without such information, it will be difficult for the Legislature to assess whether the additional funding will be allocated in a manner that is cost effective and in line with state priorities.

Resources and Environmental Protection

Cap-and-Trade Expenditure Plan

Background. The Global Warming Solutions Act of 2006 (Chapter 488, Statutes of 2006 [AB 32, Núñez/Pavley]), commonly referred to as AB 32, established the goal of reducing GHG emissions statewide to 1990 levels by 2020. In order to help achieve this goal, the California Air Resources Board (ARB) adopted a regulation that establishes a cap-and-trade program that places a "cap" on aggregate GHG emissions from entities responsible for roughly 85 percent of the state's GHG emissions. To implement the cap-and-trade program, ARB allocates a certain number of carbon allowances equal to the cap. Each allowance equals one ton of carbon dioxide equivalent. The ARB provides some allowances for free, while making others available for purchase at auctions. Once the allowances have been allocated, entities can then "trade" (buy and sell on the open market) the allowances in order to obtain enough to cover their total emissions for a given period of time.

To date, ARB has conducted five auctions since November of 2012, which have generated a total of $532 million in state revenue. Future quarterly auctions are expected to raise additional revenue. The *2013-14 Budget Act* authorizes the Director of Finance to loan $500 million in cap-and-trade auction revenue to the General Fund.

Governor's Proposal. The Governor's budget proposes to spend $850 million from cap-and-trade auction revenue in 2014-15 on various activities such as energy efficiency projects, low-emission vehicle rebates, and the state's high-speed rail project. Figure 14 (see next page) provides a list of the proposed programs and funding levels. The Governor's budget also includes a partial repayment of $100 million of the 2013-14 budget loan to the General Fund.

Proposal Unlikely to Maximize GHG Emission Reductions. In order to minimize the economic impact of cap-and-trade, it is important that auction revenues be invested in a way that maximizes GHG emission reductions. Maximizing emission reductions (specifically in the capped sectors) reduces competition for allowances, thereby putting downward pressure on the price of allowances. This, in turn, reduces the overall cost for covered entities to comply with AB 32 and the potential negative economic impacts of the program on consumers, businesses, and ratepayers. It is, however, unclear to what extent the complement of activities proposed by the Governor maximizes GHG emission reductions. For example, a GHG emission analysis completed by the High Speed Rail Authority (HSRA) indicates that once the high-speed rail system is operational in 2022, it would contribute a relatively minor amount of GHG emission reductions to the state. Moreover, the construction of the project would actually produce additional emissions (though HSRA will try to offset these emissions). Despite these findings, roughly 30 percent of the funding in the Governor's proposal goes to the high-speed rail project. Compared to a different mix of investments that could be made with the cap-and-trade revenue, the Governor's proposal is unlikely to maximize GHG emission reductions. Therefore, the Legislature will need to consider the most effective use of the cap-and-trade auction revenue.

Certain Aspects of Proposal Could Be Legally Risky. The Legislature will also want to consider the potential legal risks associated with some of the activities that the Governor proposes to fund with cap-and-trade auction revenue. Based on an opinion that we received from Legislative Counsel, the revenues generated from ARB's cap-and-trade auctions are considered "mitigation fee" revenues. Thus, the use of these revenues are subject to certain legal criteria. Specifically, we are advised that their use is subject to the so-called Sinclair nexus test. This test requires that a clear nexus must exist between an activity for which a mitigation fee is used and the adverse effects related to the activity on which that fee is levied. Given this legal requirement, the administration's proposal to fund activities (such as high-speed rail) could be legally risky. While the high-speed rail project could eventually help reduce GHG emissions somewhat in the very long run, it would not help achieve AB 32's primary goal of reducing GHG emissions by 2020.

Water Action Plan

Proposal. In October 2013, the administration released a draft Water Action Plan that intends to address multiple water challenges facing the state, including limited and uncertain water supplies,

Figure 14

Governor's 2014-15 Cap-and-Trade Expenditure Plan

(In Millions)

Department	Activity	Amount
High-Speed Rail Authority	Rail planning, land acquisition, and construction	$250
Air Resources Board	Low-emission vehicle rebates	200
Strategic Growth Council	Transit oriented development grants	100
Community Services and Development	Low-Income Home Energy Assistance Program	80
Caltrans	Intercity rail grants	50
Forestry and Fire Protection	Fire prevention and urban forestry	50
Fish and Wildlife	Water Action Plan—wetlands restoration	30
CalRecycle	Waste diversion	30
General Services	Energy efficiency upgrades in state buildings	20
Food and Agriculture	Reducing agricultural waste	20
Water Resources	Water Action Plan—water use efficiency	20
Total		**$850**

poor quality of surface water and groundwater, impaired ecosystems, and high risk of flooding. As shown in Figure 15, the Governor's budget proposes $618 million (mostly bond funding) to begin implementing some aspects of the plan. Significant components include (1) $473 million in one-time bond funds for the Integrated Regional Water Management (IRWM) program, which provides grants for various water stakeholders to collaborate by funding projects that meet multiple goals; (2) $77 million in one-time bond funds for flood control planning and projects; and (3) $50 million in cap-and-trade auction revenues for projects intended to have both water and climate benefits. In addition, the budget proposes transferring drinking water regulation and financial assistance responsibilities from the Department of Public Health to the State Water Resources Control Board (SWRCB) in order to improve water policy coordination and efficiency.

Integrated Approach in Water Action Plan Has Merit. Traditionally, individual areas of water policy have been treated as largely unconnected, with responsibilities spread across numerous departments. Considering the diverse areas of water policy together in a consolidated manner would be a more effective approach, particularly since these areas are highly interconnected. For example, unsustainable groundwater use can cause water quality problems and damage nearby levees. We find that the Governor's plan would move the state towards a more integrated approach in several ways, including his proposals to (1) transfer drinking water responsibilities to SWRCB, which could allow for a more integrated approach to water quality and improve program efficiency; (2) expand monitoring of both the quality and storage capacity of the state's groundwater, which could increase integration in groundwater management policy; and (3) fund IRWM projects. In addition, there may be benefits to considering water and climate policy

Figure 15

Budget Proposal for Water Action Plan Addresses Multiple Water Issues

(In Millions)

Activity	Department	Amount	Fund Source
IRWM grants	DWR	$473	Proposition 84 bond
Flood protection	DWR	77	Proposition 1E bond
Wetlands and watersheds restoration	DFW	30	Cap-and-trade auction revenues
Water quality grants for disadvantaged communities	SWRCB	11	Various special funds
State Water Project energy efficiency	DWR	10	Cap-and-trade auction revenues
Water use efficiency project grants	DWR	10	Cap-and-trade auction revenues
Groundwater monitoring and management	SWRCB, DWR	8	General Fund, Waste Discharge Permit Fund
Salton Sea restoration maintenance	DFW	—[a]	Salton Sea Restoration Fund
Drinking Water Program transfer[b]	SWRCB	-1	Propositions 50 and 84 bonds
Total		**$618**	

[a] Proposal totals $400,000.

[b] Included in Water Action Plan but proposed separately in budget.

IRWM = Integrated Regional Water Management; DWR = Department of Water Resources; DFW = Department of Fish and Wildlife; SWRCB = State Water Resources Control Board.

in conjunction. For example, increasing water use efficiency can reduce energy use and associated GHG emissions because California's water delivery and treatment systems are highly energy intensive. Because of the potential for such "co-benefits," considering resources policies together in an integrated manner has the potential to reduce the cost of meeting various environmental goals.

Significant Policy Implications. The Water Action Plan lays out a broad approach to water policy in California over the next five years. As such, the Legislature will want to consider whether the policy objectives and strategies included in the Water Action Plan are consistent with legislative priorities before deciding whether to approve the specific funding proposals in the Governor's budget. This includes consideration of policy questions related to (1) the most appropriate level of state oversight and regulation of groundwater use; (2) whether the Bay Delta Conservation Plan—included in the Water Action Plan, but not funded in the Governor's budget proposal for 2014-15—is the desired approach to improve water supply reliability and enhance the ecosystem in the Sacramento-San Joaquin Delta; and (3) what policy tools the state should use to help develop local water supplies.

Implementation Strategy and Priorities. The budget proposal does not include funding for all activities described in the Water Action Plan. In proposing the specific expenditures above, the administration has implicitly identified certain activities as priorities and as needing to be implemented in the near term. If the overall direction of the plan is consistent with the Legislature's policy objectives, the Legislature may want to ask the administration (1) for a long-term implementation and expenditure plan that describes how the plan will be carried out over the next several years and (2) why these specific expenditures were prioritized for 2014-15 over other elements of the plan.

Considering Appropriate Funding Sources. Nearly 90 percent of the expenditures proposed for 2014-15 are supported by one-time bond funds. However, unappropriated bond funding is limited and is likely to be exhausted in the next few years. Accordingly, implementing the Water Action Plan in future years would require new funding sources. The plan describes a need to identify long-term funding sources for many of these programs and includes some specific funding recommendations. However, the budget does not propose any specific new funding sources. The Legislature may also wish to consider whether any future water bonds, including the one currently scheduled for the November 2014 ballot, and the Water Action Plan are consistent with each other. Finally, the Legislature may want to consider whether some activities should be funded by other sources, such as user fees or charges on polluters.

Judicial and Criminal Justice

Trial Court Funding

Background. Over the past few years, the judicial branch utilized a number of one-time solutions (such as the use of trial court reserves) to offset ongoing reductions to the trial courts and mitigate the impact of these reductions on court users. In addition, trial courts partially accommodated their ongoing reductions by implementing operational actions, such as leaving vacancies open, closing courtrooms and courthouses, and reducing clerk office hours. Some of these operational actions resulted in reduced access to court services, longer wait times, and increased backlogs in court workload.

Proposal. The Governor's budget provides an ongoing General Fund augmentation of $100 million to support trial court operations. (The budget also proposes a $5 million augmentation to support state level court and

Judicial Council operations.) The budget requires that the allocation to the trial courts be based on the new workload-driven funding formula recently adopted by the Judicial Council. However, the trial courts would have flexibility in spending these funds.

Funding May Not Significantly Increase Level of Court Services. While the Governor's budget provides an additional $100 million in ongoing General Fund support for trial court operations, these funds may not result in a substantial restoration of access to court services. First, as indicated above, the Governor's proposal does not include a list of priorities or requirements for the use of the funds, such as requiring that they be used to increase public access to trial court services. Second, approximately $200 million in one-time solutions previously used to offset ongoing reductions from prior years will no longer be available in 2014-15. Thus, trial courts will need to take actions to absorb this on an ongoing basis, which could include further operational reductions. In addition, the trial courts indicate that they will face increased cost pressures in 2014-15, particularly for increased pension and benefit costs totaling an estimated $65 million.

In view of the above, it is possible that the increased funding proposed in the Governor's budget will only minimize further reductions of court services. We also note that the impact of the proposed funding increase will vary across courts. This is because there are differences in (1) the cost increases faced by each court, (2) the specific operational choices each court has made over the past few years to address their share of the ongoing reductions, and (3) how the new funding formula impacts each court.

Meeting Court-Ordered Prison Population Cap

Background. In September 2013, the Legislature passed and the Governor signed Chapter 310, Statutes of 2013 (SB 105, Steinberg), to address the federal three-judge panel order requiring the state to reduce the prison population to no more than 137.5 percent of design capacity by December 31, 2013. Chapter 310 provides the California Department of Corrections and Rehabilitation (CDCR) with an additional $315 million in General Fund support in 2013-14 and authorizes the department to enter into contracts to secure a sufficient amount of inmate housing to meet the court order and to avoid the early release of inmates which might otherwise be necessary to comply with the order. The measure also requires that if the federal court modifies its order capping the prison population, a share of the $315 million appropriation in Chapter 310 would be deposited into a newly established Recidivism Reduction Fund.

On September 24, 2013, the three-judge panel issued an order directing the state to meet with inmate attorneys to discuss how to implement a long-term overcrowding solution. The order also prohibits the state from entering into any new contracts for out-of-state housing without an order of the court. A subsequent order moved back the deadline for meeting the population cap to April 18, 2014.

Governor's Proposal. Although the state has yet to come to an agreement with inmate attorneys on how to implement a long-term overcrowding solution, the Governor's budget assumes that such an agreement will include a two-year extension of the deadline to April 18, 2016. The budget assumes that the extension will reduce planned expenditures on contract beds by $87.2 million in 2013-14. Based on the requirements specified in Chapter 310, the budget reflects a deposit of $81.1 million to the Recidivism Reduction Fund for expenditure in 2014-15. Of this amount, the administration proposes using $32.8 million to expand inmate and parolee treatment programs. The remainder of the funds would help expand CDCR's capacity: (1) $8.3 million to fund the design of a project to renovate a former youth correctional facility into a 600-bed reentry facility and (2) $40 million to purchase space in community reentry facilities for offenders within one year of release. The administration also proposes various changes intended to reduce the inmate population. These actions include (1) streamlining the parole process, (2) expanding medical parole and instituting elderly parole, and (3) implementing various credit enhancements.

The budget also includes $497 million to house about 17,700 inmates in out-of-state and in-state contract beds in 2014-15. This represents an increase of $97 million and 4,700 contract beds above the 2013-14 level. In the event that the federal court does not extend the deadline as assumed in the Governor's budget, the administration indicates that it will further expand the use of out-of-state contract beds in 2013-14 and reevaluate its proposed expenditures from the Recidivism Reduction Fund.

LAO Comments. The administration's proposals raises several issues for legislative consideration. First, it will be important for the Legislature to evaluate the cost-effectiveness of the proposed expenditures from the Recidivism Reduction Fund—that is, how each proposed expenditure reduces the prison population and helps the state comply with the population limit. It will also be important for the administration to provide details on how each proposal would be implemented, such as how the proposed community reentry facilities would be operated and how inmates would be selected to be placed in the limited space available at such facilities.

As discussed above, the administration's proposal to comply with the prison population cap—if it is not extended by the federal court—would rely on the increased use of out-of-state contract beds. However, the state is currently prohibited from entering into any new contracts for out-of-state housing without an order from the court. It is unclear if and when the federal court would grant such authorization.

LAO Publications

The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656. This report and others, as well as an e-mail subscription service, are available on the LAO's website at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.