OVERVIEW OF THE 2013-14 BUDGET BILL

Senate Bill 65

As Introduced January 10, 2013

Senate Committee on Budget and Fiscal Review

Senator Mark Leno, Chair

February 2013

California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

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February 4, 2013

Dear Colleague:

I am pleased to forward a copy of the *Overview of the 2013-14 Budget Bill*, which has been prepared by the staff of the Senate Budget and Fiscal Review Committee. The document is intended to highlight the Governor's major proposals and provide additional information and framework to support the review of these proposals. This document, as well as further analysis by the Legislative Analyst's Office, will provide the basis for budget hearings throughout the spring.

In the first section, we provide an overview of the state's fiscal condition and the Governor's fiscal proposals. The next section, entitled "Major Issues," is organized by budget subcommittee. For each major issue, this report provides background, an explanation of the Governor's proposals, and important issues to consider.

In the Appendix, we include supplementary fiscal documents from the Department of Finance. Also included are a working timeline for completing the 2013-14 budget and a list of budget committee consultants and their respective areas of responsibility.

If you have questions, please do not hesitate to contact me or the committee staff.

Sincerely,

MARK LENO
Chair

TABLE OF CONTENTS

Budget Overview

OVERALL BUDGET PROPOSAL:

The Governor has proposed a budget for 2013-14 which is essentially balanced with respect to revenues and expenditures, and includes several additional measures that would build a reserve of approximately $1.0 billion. The Governor's Budget also includes the continuation of established efforts to pay down budgetary debt from past years. Consecutive years of forecasted budget shortfalls of roughly $20 billion have been addressed through significant spending reductions—largely in the areas of corrections, health and human services and education—and increased revenues approved by the voters. As a result, the General Fund is expected to end the current year essentially balanced (with a narrow reserve of $167 million), with the proposed 2013-14 budget incorporating a reserve of approximately $1 billion. The budget includes a total of $99.3 billion in General Fund revenues and other available resources and $97.7 billion in General Fund expenditures. Overall, General Fund spending in 2013-14 is expected to grow by approximately 5 percent from the current year, largely as a result of increased expenditures in education and health care. To provide some context, state budget expenditures peaked in 2007-08 with General Fund spending of about $103.0 billion. As a share of the state economy, General Fund spending is at its lowest level since 1972-73.

OVERVIEW OF GOVERNOR'S BUDGET PROPOSAL:

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

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

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

As an integral part of the proposal, the budget includes measures that would result in establishing a modest reserve for economic uncertainties. The proposed budget components that account for the approximately $1.0 billion reserve are:

- Suspending four local government requirements that have been newly identified as mandates for a savings of $104 million.
- Using 2012-13 funds appropriated above the Proposition 98 minimum guarantee to prepay obligations to schools under previous court decisions for a savings of $172 million.
- Continuing to use miscellaneous state highway account revenues to pay for transportation bond debt service for savings of $67 million.
- Extending the hospital quality assurance fee for additional resources of $310 million.
- Extending the gross premiums tax on Medi-Cal managed health care plans for additional resources of $364 million.

PERSPECTIVE ON PRIOR BUDGETS:

The Governor's Budget ends a string of successive years with multi-billion dollar deficits. As a result of the Legislature's efforts and the voters' approval of temporary taxes, the state is fiscally on the firmest footing it has been on in years. Measures taken to close the budget gap have been significant and the effect on General Fund spending has reflected the severe economic and fiscal constraints. General Fund spending peaked in 2007-08 at $103.0 billion, dropping to $90.4 billion in 2008-09 and to $86.4 billion in 2011-12. The current year represents the first increase in General Fund spending since the recession began. While the trough of the national business cycle actually occurred in June 2009, clearly the fiscal impacts on the state of the steep economic decline have continued to linger.

The budget crisis, from which the state is just now beginning to emerge, began in full-force in 2008 with the rapid drop in economic activity and the subsequent onset of the recession. This led to sharp declines in revenue—especially from economically sensitive components—and escalating expenditure demands for particular programs and services. Prior budget decisions, including permanent tax reductions, left the state facing budgetary obstacles with reduced fiscal flexibility coupled with pressures to adopt one-time solutions to address ongoing structural imbalances.

Before 2008, there was some evidence of possible budget stress; in the fall of 2006, the LAO raised concerns regarding the state's structural balance in the out-years. Even so, the state's General Fund was expected to end the 2006-07 budget year with a reserve of $3.1 billion. Based on continuing revenue improvements at the time—especially stronger than expected investment income—this actually represented an increase of about $1.0 billion from the estimated reserve in the 2006 Budget Act. The LAO did raise concerns regarding the outlook for the 2007-08 budget year, indicating that operating expenditures would outstrip operating revenues by roughly $5.5 billion.

By the fall of 2007, there was additional deterioration in the state's budget situation. The economy was beginning to soften somewhat, leading to modest revenue declines. A leveling off in the rapid run-up property taxes led to increasing General Fund expenditures on K-14 education. When the 2007 Budget Act was adopted in August, the focus was on closing a modest budget gap and retaining a $4.1 billion reserve which was then forecasted. However, by the fall of 2007, the budget situation had deteriorated by about $6.0 billion and a current year deficit of $1.9 billion was expected. The outlook for 2008-09 budget year was even worse; the LAO indicated an operating shortfall of $8.0 billion and multi-billion dollar shortfalls thereafter.

When the 2008 Budget Act was adopted in September, the prior year 2007-08 shortfall and the budget had been addressed largely through a series of one-time measures. The 2008 Budget Act incorporated a reserve of $1.7 billion for 2008-09. Within weeks of the budget passing, however, national financial and credit markets virtually collapsed, leading to substantial declines in state revenues. By the fall of 2008, LAO forecasted a current year shortfall of $8.4 billion, representing a precipitous reversal of $10.0 billion from the time the budget was adopted in September, and reflective of the free-fall in the state and national economies. Furthermore, the LAO indicated a $19.4 billion deficit for 2009-10, for a massive combined two-year deficit of $27.8 billion. Absent corrective action, huge shortfalls in the out-years were also forecasted.

The Budget Act of 2009 was comprised of multiple legislative actions throughout the year. Revisions were made to the 2008-09 budget year as well, with major temporary tax increases and significant cuts affecting most state-funded programs. At the time of the July 2009 revisions to the Budget Act, the plan incorporated a $500 million reserve at the conclusion of the 2009-10 budget year and deficit in 2010-11 of $7.4 billion. However, by the Fall of 2009, the situation had continued to deteriorate, and LAO forecasted a current year deficit of $6.3 billion coupled with a $14.4 billion shortfall in 2010-11, for a two-year budget gap of $20.7 billion.

The Legislature adopted the 2010 Budget Act in October 2010 with an estimated reserve for the 2010-11 budget year of $1.3 billion and predicated on the receipt of $3.5 billion in federal funds. In its fall 2010 analysis, LAO assumed these additional federal dollars would not be received and also incorporated other erosions in savings and or revenues in projecting a shortfall in 2010-11 of $6.1 billion. In addition, the slow economic recovery and the temporary nature of some of the budget-balancing measures meant that the state would show an additional shortfall in 2011-12 of approximately $19.2 billion. Despite the still substantial budget deficits, this was actually the first time since the downturn began that the estimates for the out-year deficit had declined from the prior year's estimated shortfall.

By the following year, adopted on-going budget solutions were taking hold in a substantial manner. Still, in the Fall of 2011, the LAO indicated a shortfall of $3.0 billion 2011-12, as opposed to a surplus of $500 million incorporated in the 2011 Budget Act. This prognosis was the result of additional declines in prior year revenues, continuing economic softness in the current year, and the inability to realize certain savings as a result of court decisions. The 2011 Budget Act incorporated a series of trigger cuts that would occur if revenues did not reach a certain level. Even with the assumed trigger cuts, it was seen that the state would still face a 2011-12 shortfall of $3.0 billion coupled with a 2012-13 operating shortfall of $9.8 billion. The state ended the 2011-12 budget year with a deficit of $3.6 billion.

CURRENT-YEAR BUDGET UPDATE:

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

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

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

The 2012-13 Budget was predicated on the passage of the Governor's tax proposal placed before the voters in November. The measure, as approved, raises tax rates for the personal income tax and the sales and use tax on a temporary basis. The measures are fully described in the section "Revenues and Taxes." The Governor's Budget assumes that the current budget will remain balanced by a narrow margin of $167 million, as opposed to the roughly $950 million reserve adopted in the budget. This modest deterioration was due to erosion of some of the solutions adopted with respect to programmatic reductions, a lower increase in property tax related revenues and assets that offset General Fund K-12 expenditures, and other miscellaneous factors including reductions in certain revenue sources.

In November 2012, the LAO indicated that the state would end 2012-13 with a deficit of roughly $950 million and 2013-14 with a shortfall of $940 million, for a combined deficit of approximately $1.9 billion. This contrasts somewhat with the Governor's budget plan that would result in an essentially balanced budget at the conclusion of 2013-14 (not including the $1.0 billion proposed reserve.) The difference in the Administration's and LAO's numbers are relatively minor (especially compared to previous budget years) and largely stem from the Administration's higher revenue estimates for PIT, higher savings estimates for K-12 education, and lower loan repayment amounts to special funds.

PROPOSED EXPENDITURES BY PROGRAM AREA:

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

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

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

SUBCOMMITTEE NO. 1

EDUCATION

K-12

Higher Education

K-12 Finance – Local Control Funding Formula

BACKGROUND:

Current K-12 School Finance System. The state currently appropriates more than **$47 billion** annually to public schools. Of this amount, **$33 billion** (about 70 percent) is distributed to schools through revenue limit apportionments and most of the remaining **$14 billion** (about 30 percent) is distributed through different categorical program allocations.

Revenue limits provide basic apportionments to schools on a per pupil basis. Revenue limits provide discretionary (unrestricted) funding to schools that can be used for general education purposes.

Categorical programs provide individualized funding streams for specialized (restricted) purposes. There are currently about 60 different state categorical programs, each with its own funding allocation and program requirements.

Recent Categorical Funding and Flexibility. As a means of meeting education budget shortfalls, state budgets have granted K-12 schools substantial funding flexibility since 2008-09. Currently, the state allows K-12 schools to use about **$4.4 billion** in categorical funds "for any educational purpose". This flexibility has been granted to **38 categorical programs** for a seven year period ending in 2014-15. Funding for these individual programs continues – reflecting overall reductions of nearly 20 percent – that will also continue through the end of 2014-15.

District allocations for categorical programs in the flexibility program are based generally upon the proportion of state funding the district received for each program in 2008-09. Under current law, these district proportions will continue through 2014-15, with no adjustments for enrollment (growth or decline). Under this scenario, declining enrollment districts benefit financially from higher funding proportions for up to seven years and growing districts lose since they retain lower funding proportions for up to seven years.

Governor Proposed Weighted Pupil Formula in 2012-13 Reflecting Warren Institute Brief. Last year, the Governor proposed a new K-12 finance formula – known as the Weighted Pupil Formula. The new formula was based upon a modified version of the formula recommended by an issue brief published by the Warren Institute in 2008.[1] The Weighted Pupil Formula included two key features recommended by the Warren Institute brief: (1) base funding and (2) supplemental funding for low-income students and English learners. The Legislature did not adopt the Governor's new formula last year.

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[1] Alan Bersin, Michael W. Kirst, and Goodwin Liu. *Getting Beyond the Facts: Reforming California School Finance*, The Chief Justice Earl Warren Institute on Race, Ethnicity & Diversity, University of California, Berkeley Law School, April 2008.

GOVERNOR'S PROPOSAL:

Problems with Existing School Finance System. According to the Governor's State of the State message, California's public school finance system is **"overly complex, bureaucratically driven, and deeply inequitable."**

The Governor's Budget Summary makes strong statements about the current K-12 finance system. Per the Governor, the current funding system is a "relic of the past, where program allocations have been frozen and no longer reflect changing student needs." There are many different funding streams, each with their own allocation formula and spending restrictions. The system is also state-driven in that it requires local districts to perform certain activities that interfere with ability of local officials to best meet the needs of students.

The Governor also states that scholarly research and practical experience indicate that low-income students and English language learners come to school with unique challenges and often require supplemental instruction and support services to be successful in school.

Lastly, the Governor believes that the current school finance system provides few incentives for school districts to offer innovative educational programs that increase student success.

In proposing a new finance system for K-12 schools, the Governor has developed specific goals to:

- Increase local controls and reduce state bureaucracy.
- Ensure that student needs drive the allocation of resources.
- Increase transparency in school funding, empowering parents and local communities to access information in a more user-friendly manner and enhance their ability to engage in local school matters.
- Ensure sufficient flexibility and accountability at the local level so those closest to the students can make the decisions.

Governor's Overall Funding Flexibility and Accountability Plan. To remedy problems with the existing school finance system, the Governor proposes a new K-12 school finance system – the Local Control Funding Formula – beginning in 2013-14. The new funding formula provides significant and permanent additional flexibility to local districts by consolidating the vast majority of state categorical programs and revenue limit apportionments into a single source of funding. Notably, the Governor proposes an additional **$1.6 billion** in Proposition 98 funding to begin implementation of the new formula in 2013-14.

The formula will distribute these combined resources to schools using base grants and funding supplements that account for the variability in costs of educating specific student populations, thereby ensuring that funds will continue to be targeted to districts with large populations of educationally disadvantaged pupils.

The funding formula will be phased in over a period of seven years, estimated to be completed by 2019-20, and will provide an additional **$15 billion, plus COLA,** to K-12 schools districts, county offices of education, and charter schools statewide over the 2012-13 funding levels.

This new funding formula is coupled with a newly-proposed system of accountability that will accompany implementation of the new funding formula in 2013-14. While details are not fully known, the Governor proposes a new accountability system "to focus on core requirements and outcomes expected of schools to better integrate accountability with the local school district budget process." The new system also maintains academic performance and federal accountability requirements, as well as fiscal and budgetary controls.

Specific Features of the Governor's Local Control Funding Formula & Appropriations.

The Governor proposes an increase of **$1.6 billion** to implement a new **Local Control Funding Formula** for school districts, county offices of education, and charter schools beginning in 2013-14. The formula would be phased in over a seven year period, estimated to be completed by 2019-20, with an estimated **$15 billion, plus COLA,** in new Proposition 98 funding for K-12 schools.

The proposed Local Control Funding Formula collapses K-12 revenue limit apportionments and most of the nearly 60 state categorical programs into one formula accompanied by new accountability requirements. Major features of the new formula are summarized below:

- **Base Grants.** The new formula establishes a base funding grant "target" for each school district, county office of education, and charter school based upon grade span funding levels multiplied by the number of students – measured by student average daily attendance (ADA), as follows:

  $**6,342** for grades K-3
  $6,437 for grades 4-6
  $6,628 for grades 7-8
  $7,680 for grades 9-12

  The Governor also proposes two special grade span adjustments -- an additional 11.2 percent class size reduction adjustment for grades K-3, and an additional 2.8 percent career technical education adjustment for grades 9-12.[2]

- **Supplemental Grants.** The formula also provides additional funding for educationally disadvantaged pupils based upon a percentage of base grant funding. Specifically, school districts, county offices of education, and charter schools receive an additional **35 percent** in base grant funding for low-income students, English learner students, and students residing in

[2] Qualifications for additional class size reduction and career technical education adjustments are not fully known at this time. To date, the Administration has indicated that in future years, districts would have to maintain class sizes of 24 or fewer students in order to qualify for K-3 grade span adjustment, unless other agreements were collectively bargained at the local level.

foster care. (These are unduplicated pupil counts so students are not counted more than once.)

School districts and county offices of education with larger proportions of disadvantaged pupils receive supplemental "concentration" grants. More precisely, per pupil amounts would increase another **35 percent** above base grant funding for unduplicated counts of educationally disadvantaged students that exceed 50 percent of the total district enrollment. Charter schools are also eligible for concentration grants but must not exceed proportions of disadvantaged students for the districts where they reside.

Supplemental and concentration grant calculations are applied to base grants by grade span, but do not include special grade span adjustments for class size reduction and career technical education.

- **New Target Funding Levels & Growth.** Under the Governor's plan, a new unique "target" funding grant would be established for districts, county offices, and charter schools reflecting base grants (including basic and special grade spans adjustment) and supplemental grants (including concentration grants). In allocating an estimated $15 billion in new funding over the next seven years; districts further from the target level would receive a larger share of new funds and districts with funding above the targeted level would receive no additional funds. Each district below the target would receive same proportional amount.

- **Cost-of-Living Adjustments (COLAs).** The Governor's proposes $15 billion to implement the new formula over seven years. This figure would increase based upon annual COLA adjustments, which will be provided to target grant for each district, county office, and charter school target grant during (and after) this timespan. COLAs would not be provided for the Targeted Instructional Improvement Grants (TIIG) and Home-to-School (HTS) programs, but would be provided to other separate categorical programs currently subject to annual statutory COLAs.

- **Hold Harmless Provisions.** The Governor proposes to hold districts harmless from any loss of per pupil funding beginning in 2013-14. So no district will experience a loss in funding below their 2012-13 level as a result of the new formula.

- **Restoration of Revenue Limit Losses.** The Governor proposes to begin restoration of recent revenue limit reductions and foregone COLAs by eliminating current "deficit factors" and providing $15 billion, plus COLAs, to phase in the new formula by 2019-20. This is accomplished by building the new targets based on the average "undeficited" revenue limit rates ($6,816 per student).

  Since deficit factors are restored on the statewide average through the base grant structure, there will be some variability in what increases each district, county office or charter school receives through the new formula compared to repayments under the current revenue limit system.

- **Flexibility Provisions.** Funding for all of the programs that will be replaced by the Governor's new formula will immediately be made completely flexible for use in supporting any locally determined educational purpose. As such, the Governor proposes to eliminate most of the programmatic and compliance requirements for programs under the existing finance system. (Many of these current statutory requirements are already on hold as a result of categorical flexibility granted to about 40 state categorical programs from 2008-09 through 2014-15.)

- **Categorical Program "Add-Ons".** The Governor proposes to exclude two categorical programs – TIIG and HTS Transportation – from the new formula. Districts that currently receive funding for these programs would continue to receive funding as a permanent "add-on" to the new formula. The Governor's plan "locks" funding in at existing allocations, but makes funds flexible so districts can use funds for any educational purpose.

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

- **County Funding.** The Governor's plan includes a new two-part funding formula for county offices of education. The first part would provide a per-student allocation for students educated in county-operated alternative schools, including court schools. The second part would provide funding for general operations and support for school districts and would be allocated based upon the number of students and number of districts in the county.

- **Accountability System.** The Governor proposes a new accountability system to accompany the new funding formula in 2013-14. The new plan requires that all school districts produce and adopt a Local Control and Accountability Plan concurrent and aligned with each district's annual budget and spending plan. Plans are required to address how districts will use state funding received through the new funding formula toward improvement in the following categories:

    - Basic conditions for student achievement, including qualified teachers, sufficient instructional material, and school facilities in good repair.
    - Programs or instruction that benefit low-income students and English language learners.
    - Implementation of Common Core content standards and progress toward college and career readiness, as measured by the Academic Performance Index, graduation, completion of college preparatory classes, and career technical education.

    While the Governor's proposal would eliminate the programmatic and compliance requirements associated with current funding streams rolled into the new formula, the proposal would retain federal accountability requirements, academic performance requirements, as well as fiscal and budgetary controls.

Education Programs Included in New Formula. The Governor's Local Control Funding Formula proposal consolidates revenue limit apportionments and more than 40 of the state's categorical programs in 2013-14, as reflected in the table below.

In summary, the new formula would encompass a total of about **$40.4 billion** in existing K-12 funding in 2012-13, including **$32.9 billion** in revenue limit entitlements and **$7.5 billion** in categorical funding.

The additional **$1.6 billion** proposed by the Governor for growth, brings total funding for the new formula to **$42.0 billion** in 2013-14.

K-12 Programs Included in the Local Control Funding Formula
(Dollars in Thousands)

Item	Program	2012-13	Item	Program	2012-13
			208	Civic Education	200
104	Summer School Programs	336,246	209	Teacher Dismissal Apportionments	38
105	ROC/Ps	384,708	211	Charter Schools Block Grant	211,583
107	County Office Oversight	4,370	211	Charter EIA	123,956
108	Grade 7-12 Counseling	167,056	212	Charter Start Up	20,015
119	Foster Youth Programs	15,096	227	Community Based English Tutoring	40,082
122	Specialized Secondary Program Grants	4,892	228	School Safety Block Grant	79,932
124	Gifted and Talented	44,225	232	High School Class Size Reduction	78,950
128	Economic Impact Aid	944,447	682	Statutory K-3 CSR	1,270,000
137	Professional Development Institutes for Math and English	45,476	240	Advanced Placement Grant Programs	2,443
144	Principal Training	3,928	242	Student Leadership/CA Association of Student Councils	26
156	Adult Education	634,805	243	Pupil Retention Block Grant	76,675
158	Adults in Correctional Facilities	14,967	244	Teacher Credentialing Block Grant	90,404
166	Partnership Academies	21,428	245	Professional Development Block Grant	218,380
167	Agricultural Vocational Education	4,134	266	County Office (Williams)	8,016
181	Educational Technology	14,073	247	School and Library Improvement Block Grant	370,000
188	Deferred Maintenance	250,826	248	School Safety Competitive Grant	14,349
189	Instructional Materials Block Grant	333,689	260	Physical Education Block Grant	33,519
190	Community Day Schools	41,685			
193	Staff Development	25,957	265	Arts and Music Block Grant	87,987
195	National Board Certification	2,405	267	Certificated Staff Mentoring	8,583
198	California School Age Families Education Program	46,419	268	Oral Health Assessments	3,527
204	California High School Exit Exam	58,322	6360-101	Alternative Credentialing	26,191
				Subtotal, Categorical Programs	$6,164,010
			111	Home to School –Add On	495,991
			246	TIIG—Add On	855,131
				Subtotal, Categorical Add-Ons	$1,346,243
				Subtotal, Categorical Programs	**$7,515,132**
				Subtotal, Revenue Limit Apportionments	**$32,929,583**
				TOTAL	**$40,444,715**

Programs Excluded from the New Formula.

The Governor proposes to exclude a total of **12 categorical programs** – accounting for about **$4.9 billion** in state funding -- from the Local Control Funding Formula. These programs, which would be retained as separate categorical programs subject to program requirements and funding allocations, are listed in the table below.

K-12 Categorical Programs Excluded from the Local Control Funding Formula		
Budget Item	**Program**	**2012-13**
107	County Office of Education Oversight	4,799
113	Student Assessments Programs	$72,688
150	American Indian Early Education Programs	540
151	Indian Education Centers	4,006
161	Special Education	3,314,927
182	K12 Internet Access	8,340
196	State Preschool Program (Part Day/Part Year Preschool)	480,761
201	Child Nutrition	1,017
203	Child Nutrition	156,673
220	Charter School Facility Grants	92,031
295	Mandates Block Grant	166,609
649	After-School Education and Safety Services (Proposition 49)	546,965
	Subtotal	**$4,849,356**

The Governor would exclude some categorical programs from the new funding formula for some specific purposes, such as meeting federal maintenance of effort (MOE) requirements. Two large programs – special education (the largest by far) and child nutrition – are excluded for this purpose.

Another large program, the After School Education Safety program, is excluded because it was authorized by a state ballot measure – Proposition 49.

The state preschool program, which provides education programs for low-income three and four-year olds, is excluded by the Governor because it is not a K-12 program.

Most – but not all – other programs appear excluded because they are considered state-level programs or projects, such as student assessments, fiscal and program oversight, and shared technology.

Another large categorical program excluded from the Governor's weighted pupil formula is the Quality Education Investment Act (QEIA). This program is not reflected on the Governor's list of excluded programs, probably because it is a limited-term program.

The Governor's proposal involves state funded programs only, and therefore does not include $**6.9 billion** in funding for more than 20 federal programs for K-12 schools in 2012-13.

Impact of New Funding Formula on Local Educational Agencies (LEAs).

The Administration has indicated it will release data in the next few weeks that will identify funding levels for school districts, county offices, and charter schools under the Governor's proposed Local Control Funding Formula.

While the specific impact of the new formula is not yet known, there will likely be some districts who earn more and some districts that earn less than they would have under existing formulas, although all districts are held harmless from any loss of funding below 2012-13 per pupil funding rates. In general, districts with larger numbers and concentrations of educationally disadvantaged pupils will receive more supplemental funds, while those districts with fewer disadvantaged pupils will not receive comparable supplements.

Governor's Related K-12 Budget Proposals.

Adult Education and Apprenticeship Realignment. The Budget proposes to consolidate administration of Adult Education and Apprenticeship programs within the California Community Colleges. Currently Adult Education programs are funded and administered by both K-12 school districts and community colleges. The Governor proposes to eliminate this bifurcated system and create a more accountable and centralized adult education learning system within the community colleges.

The Budget proposes **$315.7 million** in Proposition 98 funding for community colleges for this purpose in 2013-14. Of this amount, **$300 million** is new Proposition 98 funding and **$15.7 million** is shifted from the K-12 Apprenticeship Program. The Budget proposes to allocate funding for the consolidated program through a new Adult Education Block Grant based upon the number of adults served.

(The Governor's Adult Education proposal is included as a separate topic in this report.)

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

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

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

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

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

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

- Eliminating the integration of federal funds in the state's AB 602 calculation and treating both funding streams separately to remove unnecessary complications in the formula and help equalize funding among special education local plan areas.
- Consolidating funding for several special education program add-ons into the base AB 602 formula calculation, while collapsing another 15 special education add-on programs into 12 based on similar activities.

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

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

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

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

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

ISSUES TO CONSIDER:

Governor's Plan to Streamline School Fina nce Syste m is Very Positive Overall. The Governor's plan clearly simplifies an overly complicated and confusing K-12 finance system. Additionally, the Governor's plan substantially reinvests state categorical funding based upon student needs. In so doing, the plan eliminates illogical and inequitable funding allocations which characterize the state's current funding system for K-12 schools.

According to the LAO, the Governor's proposal to restructure the way the state allocates K–12 funding has many strong components. Most importantly, it would replace a complicated, top–down system with one that is more transparent, better linked with student costs, and locally driven. It also would transition gradually to the new system, ensuring that the vast majority of districts receive funding increases in 2013–14 and the coming years, while simultaneously making progress towards a more rational distribution of funds.

Though the Governor's overall school finance plan has considerable merit, the LAO believes the Legislature could strengthen it by making a few modifications. A couple of these recommendations are highlighted in the following sections.

Governor's Plan Builds Upon Research and Input from Stakeholders. There is broad based consensus among the research community that the K-12 system is deeply flawed. Most notably, the "Getting Down to Facts" studies and reports from the Governor's Committee on Education Excellence, both published in 2007, identify major problems with the existing system.

The proposed Local Control Funding Formula replaces the Weighted Pupil Formula proposed by the Governor last year, but includes some similar and some new features based upon input from education stakeholders.

As originally proposed last year, the Weighted Pupil Formula was based upon a modified version of the formula recommended by an issue brief published by the Warren Institute in 2008.[3] The Governor's new Local Control Funding Formula includes two components recommended by the Warren Institute brief: (1) base funding and (2) supplemental funding for low-income students and English learners. While not specifically recommended, the Warren Institute brief contemplated grade span adjustments for base grants, which are also reflected in the Governor's Local Control Funding Formula.

Administration Views Accountability as Critical Companion to Local Funding Flexibility, But Current Concept Needs Strengthening. The Governor's new funding formula is coupled with a newly-proposed system of accountability that will accompany implementation of the new funding formula in 2013-14. While details are not fully known, the Governor appears focused more on a locally-based system that tracks core requirements (access to qualified teachers, adequate textbooks, facilities in good repair, specialized instruction/programs for low-income students and English language learners, access to Common Core standards), as well as student and school outcomes. The Governor also proposes to maintain academic performance and federal accountability requirements, as well as fiscal and budgetary controls currently in place. However, under the Governor's plan, it is not clear what role the state or counties, if any, would play in monitoring, supporting, and assuring the basic conditions of education and strong academic outcomes for students statewide. This will be an important issue for the Legislature to consider.

[3] Alan Bersin, Michael W. Kirst, and Goodwin Liu. *Getting Beyond the Facts: Reforming California School Finance,* The Chief Justice Earl Warren Institute on Race, Ethnicity & Diversity, University of California, Berkeley Law School, April 2008.

Governor Estimates $15 Billion in Additional Proposition 98 Funding over the Next Seven Years to Grow the New Formula. The LAO's November forecast projected a more robust economy beginning in 2013-14 and beyond, that would provide notable growth for the Proposition 98 guarantee. More recently, the LAO has indicated that the Governor's plan would notably improve the outlook for schools for four years following 2013-14. The Governor's plan for rolling out the new formula depends upon healthy Proposition 98 revenues.

Governor's Holds Schools Harmless from Per Pupil Funding Losses and Eventually Restores Revenue Limit Funding Lost Since 2007-08. The Governor proposes to hold districts harmless from the loss of per pupil funding beginning in 2013-14, so no district will experience a loss in total per pupil funding as the new formula is implemented. In addition, the Governor proposes to begin restoration of revenue limit cuts and foregone COLA since 2007-08. This is accomplished by building restoration of "undeficited" revenue limits into the new statewide average base grant of $6,816 per student. However, since deficit factors are restored on the statewide average through the base grant structure, there will be some variability in what increases each district, county office or charter school receives through the new formula compared to repayments under the current revenue limit system. Are there still districts that will lose funding over the next seven years?

Cost-of-Living Adjustments (COLAs) Resumed and Applied to All Funding within the New Formula Beginning in 2013-14. COLAs have not been provided in recent years for revenue limits and categorical programs as required by statute. The Governor proposes funding to provide a 1.65 percent COLA in 2013-14 – as a part of the $1.6 billion in new funding -- for all funding in the new formula. While COLAs have not been funded in recent years, under current law they are required for revenue limits and <u>some</u> categorical programs. The Governor proposes to apply to all funding in the new formula – except the TIIG and HTS categorical program "add-ons" -- which may reflect a larger base and additional COLA for schools.

Administration Says Poverty Measures Not Perfect, But May Be Best Available. The Governor's proposal would use the number of pupils reported by schools as eligible for free- or reduced-price meals (FRPM) as the measure of economic disadvantage. Given the importance of the poverty factor, is this an accurate measure? Have other options been explored, such as Title I census data? What are the limitations of census data, for example does it prevent calculation of unduplicated counts of educationally disadvantaged students? What about other census data in California – is it available by district? Does the addition of students residing in foster care in any way strengthen free- and reduced-price meal counts? How many districts utilize direct certification of free- and reduced-price lunches?

Governor's Plan Limits Timeframe for English Learner-Only Counts in Determining Supplemental Funding. The Governor's proposal adds a new element with regard to English learner student counts under the new formula for purposes of supplemental and concentration grant funding. The Governor's plan continues to use the number of pupils identified by schools as "English learners" as the measure for English learner pupils. However, the Governor now proposes to authorize supplemental and concentration grant funding for an English learner for up to five years. The Administration estimates that approximately 75 percent of English learner pupils statewide are low-income under the Governor's proposal. Since English learner pupils who remain low-income or reside in foster care will continue to be counted, this time limit appears to limit counts for English learner-only students. That said, what is the Governor's rationale for the new time limits for English learners? Additionally, what is known about the percentage of English learner students who are not low-income?

Substantial Overlap of Educationally Disadvantaged Students Counts Used for Supplemental Funding. The Governor's proposal utilizes unduplicated student counts – including low-income students, English learner students and students in foster care – as the basis of supplemental and concentration funding under the new formula. The Governor has added students residing in foster care to supplemental counts to the new formula proposal this year. However, because all students residing in foster care also qualify for free- and reduced-price lunch, by definition, there should be no increase in unduplicated student counts. As mentioned above there is significant overlap between low-income and English learner student counts, with only 25 percent of English learners who do not also qualify as low-income. Last year the Administration estimated that 60 percent of students statewide would be included in the unduplicated, counts of disadvantaged students. Is this figure still accurate?

Not Clear Yet How Governor's Plan Assures Supplemental Funding is Used for Benefit of Students that Generate Funding. Per the Administration, the Governor's school finance proposals are intended to empower local school officials to determine the best use of scarce resources. In so doing, the Governor proposes to eliminate most of the program and funding requirements for most categorical funds, including statute for many needs-based programs. Given the historic under-performance of low-income students, English learner students, and students in foster care, are there funding requirements under current law that should be retained for these students, at least until the new formula is fully funded? What more can be done to achieve the Governor's stated goals to increasing transparency in school funding, empowering parents and local communities to access information in a more user-friendly manner and enhance their ability to engage in local school matters.

<u>As mentioned previously, the LAO recommends that the Legislature work with the Administration to explore ways to ensure that districts are using supplemental funds to benefit disadvantaged students.</u>

Governor's Plan Permanently Increases Proportion of "Unrestricted" Funding for Districts and Converts Most Existing Categorical Funding to a Continuous Appropriation. The LAO estimates that the Governor's plan would make about 91 percent of state funding available to schools as discretionary funding. Currently, the LAO estimates that about 85 percent of state funding is available to schools as discretionary (unrestricted) funding, available for general purposes. (This estimate reflects the current categorical flex program in place from 2008-09 through 2014-15. Prior to categorical flexibility, the LAO estimates that about 75 percent of state funding was available as discretionary funding.)

Per the Governor's proposal, more than 40 separate budget items for existing state categorical programs have been removed from the annual budget bill. While trailer bill language has not yet been released, the Governor proposes to appropriate all funding rolled into the new funding formula through continuous appropriation in statute.

Grade Spans Added by Governor's Latest Proposal Better Reflect Cost Variances for Elementary, Middle, and High Schools. The Warren Institute brief did not specifically recommend a base formula for each grade-span. However, the brief did raise grade-span base funding levels as a question for policymakers to consider in moving forward with a weighted pupil formula. What was the rationale for these funding levels? What is known about the true education cost differences for different elementary, middle, and high school pupils? The Governor also proposes a different funding level for lower elementary (grades K-3) and upper elementary (grades 4-6). In addition, the Governor proposes special grade span adjustments for class size reduction in grades K-3 and career technical education in grades 9-12. What is the rationale for these adjustments?

Categorical "Add Ons" Proposed by Governor Undermine Equity Goals. As a part of his new K-12 funding formula, the Governor proposes to exclude two large categorical programs from the new funding formula, and to provide separate funding for these programs beginning in 2013-14. Funding for the TIIG and HTS programs – would be permanently "added on" to amounts districts receive under the Governor's new formula. Funding would be limited to districts that currently receive funding. These districts would be locked into their existing allocations; however, districts could use all of the "add-on" funding for any education purpose.

The TIIG and HTS programs are two large and very inequitable state categorical programs. In fact, TIIG and HTS may be two of the most inequitable state funding programs. While originally intended as needs-based programs, current funding allocations are highly inequitable reflecting historical funding levels and uses that are no longer clearly tied to need. Funding is limited to districts that currently receive funding. The Governor's plan would lock in these in amounts for districts and lock out funding for other districts based upon any reasonable measure of need.

The LAO has concerns about the "particularly antiquated" funding formulas for the TIIG and HTS programs, and therefore does not support the Governor's proposal to exclude these two programs from the new formula.

Governor Excludes Special Education from New Formula, But Recommends Other Reforms to Consolidate Funding and Improve Transparency. The special education formulas were updated in the late 1990s, and as such, might not fit into the targeted pupil formula. However, given the size and complexity of this categorical program – the largest state categorical program – is there room for some reform to make allocations more equitable, streamlined, and transparent?

Governor's Plan Provides More Equitable Funding for Charter Schools. The Governor's new formula provides funding for school districts, county offices, and charter schools. This appears to make charter school funding the same as funding for districts and county offices. The Governor also proposes to increase access to all charter school funding for non-classroom based charter schools.

K-14 Adult Education

BACKGROUND:

Adult Education's Primary Purpose. The primary purpose of adult education to provide persons 18 years and older with the precollegiate-level knowledge and skills they need to participate in society and the workforce.

The typical types of students served by adult education programs include: (1) immigrants who want to learn English, obtain citizenship, and receive job training; (2) native English speakers who are illiterate or only can read and write simple sentences; (3) high school dropouts who want to earn a diploma for General Educational Development (GED) high school equivalency certificate to increase their employability or attend college; (4) high school graduates who seek to earn a college degree but have not yet fully mastered reading, writing, or math at precollegiate levels; and (5) unemployed persons or unskilled workers earning low wages who seek short-term vocational training to improve their economic conditions. Adult education also serves older adults who want stay active physically and mentally, as well as parents seeking to learn effective techniques for raising their children.

Providers and Students. According to the LAO, more than 400 state-funded entities provide adult education, including 112 community colleges and about 300 K-12 adult schools. Data is incomplete, but it is estimated that 1.5 million students (headcount) were served in 2009-10 (latest estimate available). This estimate translates to about 550,000 full-time equivalent (FTE) students. (Data is incomplete because state funding for K-12 adult education programs was made flexible in 2008-09 and school districts are no longer required to report data on students served.)

System Governance and Coordination. As noted, both K-12 school districts and community college districts currently provide adult education. Adult education is not a "core" mission for either system.

For K-12 school districts, the core statutory and constitutional responsibility is for elementary and secondary education.

For community college districts, the primary mission is to offer academic and vocational education at the lower division level for both recent high school graduates and those returning to school. Another primary mission is to advance the state's economic growth and global competitiveness through education, training, and services that contribute to continuous workforce improvement. In addition, current law provides that essential and important functions include: basic skills instruction, providing English as a second language, adult noncredit instruction, and support services that help students to succeed at the postsecondary level. Finally, community colleges are also authorized to provide community service courses and programs, so long as their provision is compatible with an institution's ability to meet its obligations in its primary missions.

Throughout the adult education program's history, several legislative clarifications have been attempted and lawsuits have been filed, yet today adult education remains a bifurcated responsibility of both K-12 school and community college districts. Therefore, there is a lack of clarity about governance and coordination of adult education. As a result, instructional areas overlap in the two segments.

There are ten state-supported and state-authorized instructional areas, which K-12 and community college districts can both provide: (1) adults with disabilities; (2) apprenticeship; (3) vocational/career technical education; (4) immigrant education in citizenship and workforce preparation; (5) elementary and secondary education; (6) English as a second language; (7) health and safety, including exercise and fitness classes; (8) home economics; (9) older adults; and (10) parenting. Of these ten areas, community colleges provide instruction on both a credit and non-credit basis for the following: (1) adults with disabilities; (2) apprenticeship; (3) vocational education; (4) elementary and secondary education; (5) English as a second language; and (6) health and safety.

Figure 2

Adult Education Includes a Wide Array of Instructional Areas

Instructional Area	Adult Schools	CCC Noncredit	CCC Credit
Adults with disabilities	X	X	X
Apprenticeship	X	X	X
Vocational education[a]	X	X	X
Immigrant education (citizenship and workforce preparation)	X	X	
Elementary and secondary education	X	X	X
English as a second language	X	X	X
Health and safety[b]	X	X	X
Home economics	X	X	
Older adults	X	X	
Parenting	X	X	

[a] Also referred to in statute as career technical education.
[b] Includes exercise and fitness classes.

Funding Amount and Source. The LAO estimates that more than $2 billion in total funding was spent in 2011-12 for adult education programs, of which about $1.7 billion supported community colleges and about $400 million supported K-12 adult schools. The largest funding sources are state General Fund and local property tax revenues, which together comprise Proposition 98 funding. In addition, this total also includes student fees and federal funds.

The primary source of federal funds is Workforce Investment Act (WIA) Title II funds, of which the state received $91 million in 2011-12. Per the LAO, these funds are utilized to support instruction in adult elementary education, adult secondary education, and English as a second language. A total of 169 K-12 adult schools ($59 million), 17 community colleges with non-credit programs ($13 million), and 38 other providers such as libraries and community-based organizations ($7 million) received WIA funding. The remaining $12 million in funding is retained by the California Department of Education (CDE) to administer the program, as well as to support statewide activities such as professional development. Per the Budget Act of 2012, and beginning with the 2013-14 grant cycle, CDE is required to reopen the WIA Title II grants to new applicants as well as introduce performance measures that track student transitions from adult education to postsecondary studies and the workforce.

In addition to WIA funds, federal Perkins funding also supports vocational programs offered by K-12 adult schools and community colleges. In 2011-12, K-12 adult schools and community colleges received $8 million and $55 million in Perkins funds, respectively.

Funding Methodology. Historically, K-12 adult schools were funded based on reimbursements of average daily attendance for adult education students in districts participating as of a specific date. Beginning in 2008-09, state funding levels were reduced and a 15 percent across-the-board cut was implemented. This cut deepened to 20 percent in 2009-10 and has remained at that reduced level since then. Also in 2008-09, the state allowed K-12 school districts to "flex" their adult education funding and use it for any purpose. As a result, districts were no longer required to report data on the whether funds were expended for adult education, and, if so, how many adults were served. While actual data is not available, the LAO surveyed K-12 districts and estimated that only between 40 to 50 percent of the $635 million provided in Proposition 98 adult education funding in 2011-12 was spent for that purpose. Per the LAO, this equated to about $400 million in 2011-12.

Within the community colleges, enrollment funding can be used for both credit and non-credit instruction. The funding is allocated on a per-student (FTES) basis. In 2012-13, course rates are as follows: (1) credit rate, regardless if coursework is degree applicable or non-degree applicable, of $4,565; (2) regular non-credit rate, such as for home economics and programs designed for older adults, of $2,745; and (3) enhanced non-credit rate, for coursework in career development and college preparation, of $3,232.

Similar to K-12 school districts, community college funding has decreased in recent years. This has resulted in smaller adult education programs as many districts have targeted non-credit instruction for a disproportionate share of cuts. Statewide, the number of non-credit FTES served in 2011-12 was about 30 percent lower compared to 2008-09 levels.

Recent LAO Report Identifies Key Strengths but Many Weaknesses. In its December 5, 2012, report entitled, *"Restructuring California's Adult Education System,"* the LAO found that the state's adult education system possesses some key strengths, including having two large systems with extensive experience working with adult learners throughout the state, a data system that can measure learning gains for at least some students, and an innovative policy that allocates federal funds to providers based on performance. However, the LAO review also identified a number of major problems, including: (1) an overly broad mission; (2) lack of clear delineations between precollegiate (adult education) and collegiate coursework at the CCC; (3) inconsistent state-level policies; (4) widespread lack of coordination among providers; and (5) limited student data, which impairs the public's ability to hold the system accountable for performance.

The LAO also found that, over the past few years, the role of adult education in California has become even more clouded, as the Legislature has allowed K-12 school districts to use, for any education purpose, GF monies that previously have been dedicated to adult education.

In conclusion, the LAO found that adult education in California is a complex, confusing, and incoherent system in need of a comprehensive restructuring. The LAO's proposal to restructure the adult education system is discussed further in the "*Issues to Consider*" section below.

GOVERNOR'S PROPOSAL:

- ✓ Provides an increase of $315.7 million Proposition 98 GF to realign adult education from K-12 education and within the community college system, in order to eliminate the current bifurcated system and create a more accountable and centralized adult education learning system within the community colleges.

- ✓ Of the total funding, $300 million is new Proposition 98 GF funding to community colleges to reconstitute the adult education program within that system, and $15.7 million is a fund shift of the Apprenticeship Program from the K-12 system to the community college system.

- ✓ The $300 million in adult education funding will be allocated from a new categorical block grant based on the number of students served and only for the following six core instructional areas: (1) vocational education; (2) English as a second language; (3) elementary and secondary education; (4) citizenship; (5) apprenticeship; and (6) adults with disabilities. With this restriction, funding will be refocused away from non-mission areas and savings reinvested for additional courses in mission areas such as basic skills and workforce training. If community colleges offer non-mission courses, students will be required to pay the full cost of instruction.

- ✓ The budget bill contains placeholder language directing the California Community Colleges Chancellor's Office to develop an adult education expenditure plan for submittal to the Department of Finance by July 1, 2013. Budget trailer bill language to implement the reconstitution of the adult education program within the community colleges will also be proposed.

- ✓ The Administration indicates that the adult education funding level will be reassessed in the future based on program participation and effectiveness. Community colleges will also be encouraged to leverage the capacity and expertise currently available at the K-12 adult schools.

- ✓ The $15.7 million in apprenticeship program funding shifted to the community colleges is restricted for that programmatic purpose. Its expenditure is controlled by budget bill provisional language in the community college budget that mirrors 2012-13 budget bill provisional language contained in the CDE's budget item, including retention of an annual reporting requirement.

ISSUES TO CONSIDER:

LAO Proposal to Restructure the Adult Education System. In its December 5, 2012, report entitled, *"Restructuring California's Adult Education System,"* the LAO recommended a comprehensive restructuring that retained the comparative advantages that K-12 adult schools and community colleges currently have in delivering adult education. Though comparative data on student outcomes are limited, the LAO reported that research suggests that K-12 adult schools and community colleges perform equally well at educating adult learners. Therefore, in proposing a restructuring, the LAO built upon each segment's strengths while also addressing current problems, as summarized on the next page.

Current System	New System Under LAO Proposal
Authorizes ten state-supported instructional programs that serve various purposes.	Focuses on the six instructional programs most closely aligned with adult education's core mission.
Lacks a clear and consistent distinction between adult education and collegiate instruction.	Clearly distinguishes between adult education and collegiate education.
Applies inconsistent and conflicting policies regarding faculty qualifications, fees, and student assessments at adult schools and community colleges.	Applies a consistent set of policies for faculty and students at adult schools and community colleges.
Misses opportunities to create strong collaborations between adult schools and community colleges.	Creates a funding mechanism for adult education that promotes a coordinated system centered on student access and success.
Fails to collect key data needed to fully evaluate the effectiveness of the adult education system.	Collects some data on student enrollment and outcomes for both adult schools and community colleges. Links the respective data systems.

Adult Education a Priority in 2013-14 Budget. As emphasized by the recent LAO report, the state's existing adult education system has a number of problems, not the least of which is its bifurcated governance structure between K-12 school districts and community college districts, which results in an inefficient system that is not always structured in the best interests of adult learners. The Governor's budget would coordinate the efforts of the two segments with the stated intent to, *"eliminate the current bifurcated system and place community colleges in a position to improve coordination at the regional and statewide levels."*

The Governor should be commended for identifying adult education reform as a high state priority. At this juncture, many aspects of the Administration's proposal remain undefined or under-defined, in large part due to the fact that budget trailer bill language has not yet been transmitted to the Legislature. However, the overall approach presents a number of questions for the Legislature to consider as outline below.

Two Different Proposals to Restructure Adult Education. Given the LAO proposal described above, the Legislature effectively has before it two different proposals to restructure the state's adult education program. While the proposals share some similarities, such as the definition of "core" instructional areas (discussed further below), the plans differ significantly. The Governor's proposal would reconstitute the adult program within the community college system while the LAO's proposal would maintain the program at both K-12 and community college districts, building on each segment's strengths yet with significant policy reforms. The Governor's proposal would allocate funding to community colleges based on existing service levels, while the LAO's proposal includes a dedicated revenue stream that would provide the same funding rate for the same instruction, reward providers for student success, and align future allocations with program need. Both proposals warrant further consideration by the Legislature.

Both LAO and Governor Refocus Adult Education on Programs within Core Instructional Areas. Both the LAO and Governor's proposals continue funding authority for adult education programs within "core instructional areas" defined to include: vocational education, English as a second language, elementary and secondary education, citizenship, apprenticeship, and adults with disabilities. As a result, the proposals would continue funding for six programs currently authorized for both K-12 schools and community colleges. Four adult education programs that do not clearly fit within these core areas are not continued for funding under either proposal. Programs excluded by the plans include: health and safety (including exercise and fitness classes), home economics, older adults, and parenting classes. The plans' focus on elementary and secondary education and English as a second language reflects programs also authorized under federal adult education programs (Title II Workforce Investment Act.)

Governor's Proposed Funding Allocations within the Community Colleges in Need of Improvement. Community colleges vary significantly in terms of the extent to which they consider adult education to be part of their educational mission. This results in wide variation across the state in terms of the availability of adult education instruction at community colleges. As such, some districts might not be prepared to assume responsibility for adult education programs. Yet the Governor's plan would allocate funds to community colleges based solely on existing service levels. Going forward, this could build a significant inequity into the adult education system. It is also worth noting that, absent specific requirements about the expenditure of the $300 million, the funding could simply support existing service levels at the community colleges as opposed to expanding adult education offerings in the six core instructional areas. These policy considerations will likely become more well-defined once the Administration releases budget trailer bill language.

Different Treatment of Apprenticeship Funds under Governor's Plan. Similar to K-12 education, the 2009 budget also provided categorical flexibility for the community colleges. Included in the "flexed" programs is a community college-based apprenticeship program and $7.2 million in funding. Since 2009, roughly $69,000 per year has been transferred out of the apprenticeship program and into other categorical programs. Overall, less than $2 million per year each year has been transferred, out of total funding of roughly $440 million. This outcome could be construed several ways, including: (1) the community college apprenticeship program is critical, so districts have not used the enhanced flexibility; or (2) because the flexibility is temporary, districts have chosen not to exercise the option due to concerns that when the flexibility expires the programs will be reinstituted. It would be difficult to draw the conclusion that flexibility within the community colleges signaled lower priority programs, as so little funding has been transferred with programs. While the Governor's plan continues to flex the $7.2 million for community college apprenticeship programs, the Governor takes a different approach for K-12 apprenticeship funds. Specifically, the Governor proposes to shift $15.7 million in funding from the K-12 Apprenticeship program to community colleges; however, the Governor does not "flex" the program funding. Therefore, when community college flexibility expires in 2014-15, these issues will warrant further consideration by the Legislature.

Administration of Adult Education Programs Continues at Department of Education Under Governor's Plan. The Governor's proposal does not address adult education state operations program administration costs. Even though the budget reconstitutes the adult education program within the community colleges, CDE would retain the roughly 38 positions that currently provide oversight of state K-12 adult education programs, as well as administration of the federal WIA Title II and Perkins adult education. The budget also does not contain any state operations augmentation for the Chancellor's Office to administer the program. These choices warrant further consideration by the Legislature as it considers the budget proposal.

K-12 Adult Education Funding Already Reduced and Redirected to Other Programs Reflecting Lower Priority for Many School Districts. Statutes enacted in 2008-09, granted K-12 school districts the authority to use adult education – and nearly 40 other state categorical funds – for "any education purposes." In other words, districts are not required to use these funds for adult education. Under current law, this funding flexibility will continue through 2014-15. According to surveys conducted by the LAO, most school districts appear to be utilizing this flexibility for adult education funds. More specifically, 80 percent of school districts last surveyed by the LAO are redirecting funds away from adult education. The LAO estimates that of the $635 million appropriated for adult education in 2012-13, about $400 million (roughly 40 to 50 percent) is being spent for that purpose. The Administration estimates that school districts are currently expending less than half of the $635 million – about $300 million – for adult education programs in 2012-13.

Despite Consolidation of Administration at Community Colleges, Governor's Proposal Continues Current K-12 Funding Levels for K-12 Adult Education Making Continued Access to K-12 Adult Education Programs Possible. The Governor's proposal does not shift funding the $635 million in existing K-12 adult education funds to community colleges. Instead, the Governor retains these funds in the K-12 system and – along with nearly 50 other state categorical programs – rolls them into a new Local Control Funding Formula (discussed in detail in a separate section of this report). It would be up to K-12 districts to continue programs reflecting local needs and priorities. Understanding current adult education funding is flexed, the Governor's proposal does not represent a big change to current law, which continues through 2014-15. While the Governor plans to eliminate the statutory requirements for adult education, K-12 schools could decide to continue these programs under their own local authority.

Governor Adds New Funding to Reinvest in Adult Education System That Could Support Continuation of Adult Education Now Provided by K-12 Schools. The Governor adds $300 million in new Proposition 98 funding to the community colleges budget for adult education, to reinvest in adult education statewide. The $300 million reflects the Administration's best estimate of current adult education expenditure levels in the K-12 system. The LAO estimates expenditures of $400 million for K-12 adult education. While the Governor's plan consolidates state administration and funding of adult education programs within the community colleges, the plan clearly contemplates community college contracts with some existing K-12 adult education programs statewide.

Governor's Proposal Could Improve Access to Adult Learning Opportunities – Both Career and Higher Education. Adult education programs, as they currently exist, do not fit clearly within the mission of either K-12 schools or community colleges. That said, programs for adult learners appear a much closer fit for the community colleges, since – as stated by the Administration – serving adult learners is the system's core function. In addition, community colleges can offer opportunities for connecting adult learners to a full continuum of adult vocational and higher education opportunities.

Loss of physical access (proximity) to K-12 adult education programs in neighborhoods has been raised as a concern with the Governor's proposal. While there are about 300 K-12 adult school sites and 112 community colleges statewide, community college also operate 70 official centers and other satellite locations. In addition, both K-12 adult education and community colleges offer classes in a variety of settings – such as school sites, community centers, libraries, churches, storefronts, and job sites – in order to locate programs to best reach adult learners. Additionally, as mentioned earlier, the Governor's proposal contemplates that community colleges could contract with existing K-12 adult education programs.

Governor's Proposal Provides an Opportunity to Adopt Improvements in Adult Education Funding and Accountability -- As Recommended by the LAO. The basic intent of the Governor's proposal is "*to create a more accountable and centralized adult education learning structure.*" The Governor will provide more details for his proposal soon, however the need for consistent data and stronger accountability systems for adult education are much needed. In addition, the existing adult education funding allocations for both the K-12 education and community colleges are seriously flawed – resulting in funding distributions that are neither needs based or equitable. In the K-12 system, existing funding allocations are also outdated reflecting historical funding levels limited to districts that participated at a particular point in time.

According to the LAO, the performance-based funding and accountability system utilized by the federal WIA programs in California is commendable. Among several recommendations related to improving adult education funding allocations and accountability, the LAO recommends that adult education funds be based ultimately upon adult need and performance. Under the LAO's long term plan, adult education needs would be determined regionally, utilizing census data such as adults with less than a high school diploma and adults who do not speak English at home, as well as, regional unemployment rates, and poverty rates. At this time, the Governor's proposes to allocate funding based upon existing delivery patterns at the community colleges.

Governor's Proposal Also Provides an Opportunity to Adopt Consistent Policies on State Faculty Qualifications, Fees, and Assessment – As Also Recommended by the LAO. The Governor proposal states intent to create a more centralized and coordinated adult education system. While full details of the Governor's proposal are not yet available, the Governor's plan to consolidate administration and funding could also include changes to make differing and confusing state adult education policies more consistent. For example, the LAO recommends eliminating the credential requirement for K-12 adult education instructors but not required for community college instructors. The LAO also recommends changing state law to allow for a modest fee (such as $25 per course) for all adult education courses, to reconcile differing fee structures in place across the state. In addition, the LAO recommends that adult schools and community colleges align their different assessment and placement standards and practices to better serve students.

K-14 Education: Proposition 39

BACKGROUND:

The budget includes a proposal for expenditure of funds derived from the recently passed Proposition 39 ballot initiative. This initiative adjusts the way corporate taxes are calculated and provides for expenditures for energy efficiency and school funding for a period of five years.

State Corporate Income Taxes. The amount of money a business owes the state in corporate income taxes each year is based on the business' taxable income. For a business that operates both in California and in other states or countries (a multistate business), the state taxes only the part of its income that was associated with California. While only a small portion of corporations are multistate in nature, multistate corporations pay the vast majority of the state's corporate income taxes. This tax is the state's third largest General Fund revenue source, raising $9.6 billion in 2010-11.

Multistate Businesses Choose How Their Taxable Income Is Determined. Prior to the passage of Proposition 39, state law allowed most multistate businesses to pick one of two methods to determine the amount of their income associated with California and taxable by the state, with multistate businesses generally allowed to choose the method that is most advantageous to them for tax purposes:

> "Three-Factor Method" of Determining Taxable Income. One method uses the location of the company's sales, property, and employees. When using this method, the more sales, property, or employees the multistate business has in California, the more of the business' income is subject to state tax.
>
> "Single Sales Factor Method" of Determining Taxable Income. The other method uses only the location of the company's sales. When using this method, the more sales the multistate business has in California, the more of the business' income is taxed. For example, if one-fourth of a company's product was sold in California and the remainder in other states, one-fourth of the company's total profits would be subject to California taxation.

Energy Efficiency Programs. There are currently numerous state programs established to reduce energy consumption. These efforts are intended to reduce the need to build new energy infrastructure, such as power plants and transmission lines, and help meet environmental quality standards. For example, the California Public Utilities Commission (CPUC) oversees various types of energy efficiency upgrade and appliance rebate programs that are funded by monies collected from utility ratepayers. In addition, the California Energy Commission (CEC) develops building and appliance standards that are intended to reduce energy consumption in the state.

School Funding Formula. Proposition 98, passed by voters in 1988 and modified in 1990, requires a minimum level of state and local funding each year for public K-12 schools and community colleges. This funding level is commonly known as the Proposition 98 minimum guarantee. Though the Legislature can suspend the guarantee and fund at a lower level, it typically decides to provide funding equal to or greater than the guarantee.

The Proposition 98 guarantee can grow with increases in state General Fund revenues (including those collected from state corporate income taxes). Accordingly, a measure such as Proposition 39 that results in higher revenues results in a higher school funding guarantee.

Proposition 98 expenditures are the largest category of spending in the state's budget, totaling roughly 40 percent of state General Fund expenditures.

Proposition 39 Ballot Initiative Eliminates Ability of Multistate Businesses to Choose How Taxable Income Is Determined. Under this measure, starting in 2013, multistate businesses are no longer allowed to choose the method for determining their state taxable income that is most advantageous for them. Instead, most multistate businesses would have to determine their California taxable income using the single sales factor method. Businesses that operate only in California would be unaffected by this measure.

Proposition 39 also includes rules regarding how all multistate businesses calculate the portion of some sales that are allocated to California for state tax purposes. These include a set of specific rules for certain large cable companies.

Proposition 39 Provides Funding for Energy Efficiency and Alternative Energy Projects. This measure establishes a new state fund, the Clean Energy Job Creation Fund, to support projects intended to improve energy efficiency and expand the use of alternative energy. The measure states that the fund could be used to support:

1. Energy efficiency retrofits and alternative energy projects in public schools, colleges, universities, and other public facilities;
2. Financial and technical assistance for energy retrofits; and
3. Job training and workforce development programs related to energy efficiency and alternative energy.

The Legislature would determine spending from the Clean Energy Job Creation Fund and be required to use the monies for cost-effective projects run by agencies with expertise in managing energy projects. The measure also: (1) specifies that all funded projects must be coordinated with CEC and CPUC and (2) creates a new nine-member oversight board to annually review and evaluate spending from the fund.

The Clean Energy Job Creation Fund would be supported by some of the new revenue raised by moving to a mandatory single sales factor. Specifically, half of the revenues so raised—up to a maximum of $550 million, would be transferred annually to the Clean Energy Job Creation Fund. These transfers would occur for only five fiscal years, from 2013-14 through 2017-18.

GOVERNOR'S PROPOSAL:

2012-13 Proposition 39 Funding Proposal. The budget includes a $426 million increase in the Proposition 98 minimum guarantee for K-12 schools and community colleges as a result of new revenues generated by Proposition 39 in 2012-13. The budget does not direct these funds for any specific purpose.

The budget does not propose any funding for an energy efficiency program in 2012-13 since Proposition 39 does not require establishment of such a program until 2013-14.

The budget assumes $440 million in total Proposition 39 revenues in 2012-13, of which $426 million is appropriated for Proposition 98 pursuant to Test 1 calculations utilized by the Administration. The remaining $14 million in Proposition 39 revenues provides General Fund savings in 2012-13.

2013-14 Proposition 39 Funding Proposal. The budget provides a $520 million increase in the Proposition 98 minimum guarantee for K-12 schools and community colleges as a result of new revenue generated by Proposition 39 in 2013-014.

The budget proposes to allocate all energy efficiency funding required by Proposition 39 <u>within</u> the $520 million in Proposition 98 funding provided under his plan. Specifically, the budget proposes to expend $450 million of the $520 million in Proposition 98 funds to establish a new Energy Efficiency Program for K-12 schools and community colleges in 2013-14.

Of the $450 million proposed for the Energy Efficiency Program in 2013-14, $400.5 million (89 percent) is appropriated to K-12 schools and $49.5 million (11 percent) is appropriated to community colleges. The Department of Education and the Community College Chancellor's Office would be responsible for allocating funding on a per student basis within their respective systems.

The budget estimates $900 million in total Proposition 39 revenues in 2013-14. Under the Governor's calculations, which assume Test 3 factors applied to total estimated Proposition 39 revenues, the Proposition 98 minimum guarantee increases by $520 million in 2013-14. The budget proposes $380 million in remaining revenues as General Fund savings in 2013-14.

2014-15 through 2017-18 Propositio n 39 Funding Proposals. The Governor proposes to continue energy efficiency funding for K-12 schools and community colleges at $500 million for four additional years, from 2014-15 through 2017-18. This assumes $1.0 billion in total Proposition 39 revenues, with half provided for energy efficiency per the proposition during this timeframe. (The Governor's proposal is limited to these four years, since Proposition 39 does not require energy efficiency funding beyond 2017-18.)

Proposition 39 Energy Efficiency Investment Program Parameters. The budget approach for each year the Proposition 39 revenues are available is intended to make a substantial energy efficiency imprint throughout the state with the reduction in utility costs and in turn assisting schools and community colleges in recovering from budgetary reductions implemented over the past five years.

The Department of Education and the Chancellor's Office will be responsible for distributing funding, and may consult with both the CEC and the CPUC to develop guidelines for prioritizing the use of the funds. The *Budget Summary* indicates the guidelines will reflect the state's energy "loading order," which guides the state's energy policies and decisions according to the following order of priority: (1) decreasing electricity demand by increasing energy efficiency; (2) responding to energy demand by reducing energy usage during peak hours; (3) meeting new energy generation needs with renewable resources; and (4) meeting new energy generation needs with clean fossil-fueled generation. Schools and community colleges will be able to use Proposition 39 funding consistent with the state's loading order policies and guidance to undertake energy efficiency measures including, but not limited to, the construction or modernization of buildings in a manner that uses less energy, purchasing energy efficient equipment, as well as undertaking renewable energy projects like installation of solar panels and geothermal heat pumps.

Local schools and community colleges may use Proposition 39 funds for technical assistance to help identify, evaluate, and implement appropriate projects. Schools and community colleges will also be encouraged to partner on their energy efficiency projects with the California Conservation Corps' Energy Corps program and participating community conservation corps programs, which provide career technical education and on-the-job work experience in the energy efficiency and renewable energy industry sectors. Upon project completion, schools and community colleges will report their project expenditure information to the Department of Education and the Chancellor's Office, respectively. The Administration will work with the Department of Education, the Chancellor's Office, and the Citizens Oversight Board to ensure these funds are used by schools and community colleges in a manner that is consistent with Proposition 39.

This proposal includes budget trailer bill language.

ISSUES TO CONSIDER – PROPOSITION 98 FUNDING:

Differing Views on Calculation of Minimum Guarantee for Proposition 39 Revenues. The Governor applies Proposition 98 calculations to the total amount of Proposition 39 revenues for purposes of calculating the minimum guarantee. According to the LAO, state revenues are excluded from the Proposition 98 minimum guarantee calculations if the Legislature cannot use them for general purposes, typically due to restrictions created by a voter-approved initiative or constitutional amendment. Per the LAO, the Proposition 39 voter guide reflected this interpretation by indicating that funds required to be used for energy-related projects would be excluded from the Proposition 98 calculation. As a result, the LAO recommends that the Legislature exclude from the Proposition 98 calculation all Proposition 39 revenues required to be used on energy-related projects. The LAO recommendation would reduce the minimum guarantee to roughly $260 million, half of the $520 million proposed by the Governor.

Differing Views on Providing Energy Efficiency within Proposition 98. The Governor counts all revenue raised by Proposition 39 toward the Proposition 98 calculation and then funds energy efficiency projects within this amount. The Governor does not provide non-Proposition 98 funding for energy efficiency. According to the LAO, the Governor's approach is a serious departure from how revenues are to be treated for the purposes of Proposition 98. The LAO also believes this approach is contrary to how the official voter guide described the treatment of revenues to statewide voters. In response, the LAO recommends the Legislature count the $450 million in allocations for energy efficiency projects as non-Proposition 98 expenditures. The Legislature could choose to spend a portion on schools and community colleges per the LAO, although this is not the LAO's specific recommendation.

Total Funding for Schools and Community Colleges Using LAO Approach. A plan to provide $450 million in energy efficiency funding to schools and community colleges coupled with the two LAO recommendations above would result in roughly $190 million in additional operational Proposition 98 support for schools and community colleges in 2013-14. As indicated below, total state savings would decline by the same amount.

Bottom-line General Fund Savings. The Governor's Proposition 39 proposal results in General Fund savings of about $380 million in 2013-14. The LAO recommendations above would provide total savings of roughly $190 million, half the $380 million proposed by the Governor.

ISSUES TO CONSIDER – ENERGY EFFICIENCY:

Per Pupil Allocation of Energy Funding to Schools and Community Colleges Not Needs Based. The Governor proposes to provide school districts $400.5 million and community college districts $49.5 million for energy efficiency projects. The Administration proposes to allocate this funding to districts on a per-student basis, with school districts and community college districts receiving $67 and $45 per student, respectively. Per the LAO, the Governor's approach providing every school district and community college district with the same per-pupil funding does not tie the funding with potential benefits. Instead, according to the LAO, the Governor's plan presumes the potential for energy savings is equal among all districts and does not focus on those school and community college energy projects likely to provide the greatest energy and job benefits. Most notably, the LAO asserts that the Governor's approach does not take into account that the need for energy efficiency projects varies by district, with the need depending on the size, age, and climate zone of the facilities in each district.

Lack of Program Structure and Guidelines Could Challenge Districts to Achieve Energy Efficiencies. The *Budget Summary* describes a process whereby the Department of Education and the Chancellor's Office, who are responsible for distributing funds, may consult with the CEC and CPUC to develop guidelines for prioritizing the use of the funds. Why this is permissive, as opposed to required, is unclear. Proposition 39 specifies that all funded projects must be coordinated with CEC and CPUC. Even if this were not the case, it is illogical to distribute these funds without clear structure and guidelines. Absent this specificity, each district individually would be left to decipher what is prioritized under Proposition 39 and it is questionable if a substantial energy imprint could actually be achieved.

Why Only K-12 Schools and Community Colleges? The *Budget Summary* identifies K-12 school facilities as the single largest capital outlay investment made by the state since the mid-1990s. From 1998 to present, the state has invested more than $30 billion in school bond funding to modernize and construct school facilities. Therefore, the Administration asserts that schools and community colleges are well positioned to undertake projects that reduce their current utility requirements and expand the use of renewable energy sources.

The state has made a similar investment in higher education facilities. In the last ten years, the LAO reports that the state spent an estimated $10.1 billion on higher education infrastructure; 80 percent of that support came from general obligation bonds and an additional 19 percent from lease-revenue bonds. UC and CSU have similarly seen their budgets significantly reduced in recent years. UC and CSU are also just as well positioned as school and community college districts "*to undertake projects that would reduce their current utility requirements and expand the use of renewable energy sources*," yet UC and CSU are excluded from receiving any Proposition 39 funds under the Governor's plan. This choice warrants further consideration by the Legislature as it begins its review of the budget proposal for expenditure of Proposition 39 revenues.

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

The state currently has programs that both benefit energy efficiency and jobs through the California Conservation Corps (Corps), a department designed to provide job training to at-risk young adults. As an example, one Corps program provides energy efficiency audits of businesses, enabling the businesses to reduce energy usage while teaching Corps program participants about energy efficiency in the workplace—a dual benefit. The Governor's proposal states that schools may permissively consult or contract with the Corps; however, this scenario is highly unlikely given that the Corps program does not fall directly under the K-14 education umbrella.

Can Funding Be Appropriated Directly to Education? Proposition 39 requires that monies from the Clean Energy Job Creation Fund be appropriated only to agencies with established expertise in managing energy projects and programs. Proposition 39 also requires that funding be coordinated with the CEC and CPUC to avoid duplication and maximize leverage of existing energy efficiency and clean energy efforts. As the LAO states, the Governor's proposal does not appear to adhere to these provisions. Specifically, because the funding is to be appropriated to CDE and the Chancellor's Office, the Governor's proposal might not meet the Proposition 39 provision requiring funds be provided only to agencies with established energy-project expertise. Additionally, the Governor indicates that CDE and the Chancellor's Office have the option to consult with CEC and CPUC, despite Proposition 39 requiring more formal CEC and CPUC involvement.

Higher Education – Multi-Year Plan

BACKGROUND:

California's public higher education system involves three "segments": the University of California, the California State University, and the California Community Colleges. It also includes the Hastings College of the Law. The state's Master Plan for Higher Education, originally adopted in 1960, ascribes distinct missions to each of the segments and expresses a set of general policies for higher education in the state, including the state's intent that higher education remain accessible, affordable, high-quality, and accountable.

University of California (UC). Drawing from the top 12.5 percent of the state's high school graduates, the UC educates approximately 239,500 undergraduate and graduate students at its ten campuses and is the primary institution authorized to independently award doctoral degrees and professional degrees in law, medicine, business, dentistry, veterinary medicine, and other programs. UC manages one U.S. Department of Energy national laboratory, partners with private industry to manage two others, and operates five medical centers that support the clinical teaching programs of the UC's medical and health sciences schools and handle more than 3.9 million patient visits each year.

The UC was written into the State Constitution of 1879 as a public trust, to be administered by an independent governing board, the Regents of the University of California, which includes 28 members: seven ex officio; 20 appointed by the Governor subject to Senate confirmation; and one student appointed by the Board. The UC is headed by a President who is responsible for overall policy development, planning, and resource allocations. Chancellors are responsible for the management of individual campuses. The Regents have delegated authority to the Academic Senate to determine conditions for admission, degree requirements, and approval of courses and curricula.

California State University (CSU). Drawing students from the top one-third of the state's high school graduates, as well as transfer students who have successfully completed specified college work, the CSU provides undergraduate and graduate instruction through master's degrees and independently awards doctoral degrees in education, nursing practice, and physical therapy, or jointly with UC or private institutions in other fields of study. With 23 campuses and approximately 410,300 students, the CSU is the largest and most diverse university system in the country.

The CSU is administered by an independent governing Board of Trustees that includes 25 members: five ex-officio; 16 appointed by the Governor to four-year terms (subject to Senate confirmation); and four members appointed to two-year terms (two student representatives, one voting and one non-voting, and one representative each from faculty and alumni). The Trustees appoint the Chancellor, who is the chief executive officer of the system, and the Presidents, who are the chief executive officers of the respective campuses. The Trustees, the Chancellor, and the Presidents develop systemwide policy, with actual implementation at the campus level taking place through a broadly based consultative process. The Academic Senate, made up of elected faculty representatives from each campus, recommends academic policy to the Board of Trustees through the Chancellor.

California Community Colleges (CCC). The CCC are publicly supported local educational agencies that provide educational, vocational, and transfer programs to approximately 2.4 million students. The CCC system is the largest system of higher education in the world, with 72 districts, 112 campuses, and 70 educational centers. In addition to providing education, training, and services, the CCC contributes to continuous workforce improvement. The CCC also provides remedial instruction for adults across the state through basic skills courses and adult non-credit instruction.

The Board of Governors of the CCC was established in 1967 to provide statewide leadership and technical assistance and allocate funding to the 72 districts and 112 colleges that constitute the system. The Board has 17 members appointed by the Governor subject to Senate confirmation. Twelve members are appointed to six-year terms, and two student members, two faculty members, and one classified member are appointed to two-year terms. Locally elected Boards of Trustees work on the district level with Presidents who collectively are responsible for the operation of individual college districts and campuses.

Hastings College of the Law (Hastings). Hastings was founded in 1878 and on March 26, 1878, the Legislature provided for affiliation with the UC. Hastings is the oldest law school and one of the largest public law schools in the West. Its mission is to provide an academic program of the highest quality, based upon scholarship, teaching, and research, to a diverse student body of approximately 1,100 students.

The Hastings Board of Directors establishes policy that is carried out by the Chancellor, Dean, and other officers. The Board has 11 directors serving 12-year terms: one is an heir or representative of S.C. Hastings and the other ten are appointed by the Governor subject to Senate confirmation.

Higher Education Funding from 2008-09 thru 2011-12. From 2008-09 through 2011-12, the state reduced funding for UC, CSU, CCC, and Hastings by $2.65 billion General Fund. The most notable consequences of these reductions were significant student tuition increases (as illustrated in the chart on the next page), effectively increasing the share of total education costs being shifted to students, and declining course offerings, which made it difficult for students to complete their certifications and degrees in a timely manner. In 2012-13, and with the passage of Proposition 30, higher education budgets were held flat and mandatory systemwide tuition fees remained at the 2011-12 level.

Higher Education Annual Tuition/Fees: 2008-09 through 2012-13

Full-Time Resident Students							Change from 2007-08	
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Amount	Percent
University of California								
Undergraduate	$ 6,636	$ 7,126	$ 8,373	$ 10,302	$ 12,192	$ 12,192	$ 5,556	84%
Graduate	7,440	7,986	8,847	10,302	12,192	12,192	$ 4,752	64%
California State University								
Undergraduate	2,772	3,048	4,026	4,440	5,472	5,472	$ 2,700	97%
Teacher credential	3,216	3,540	4,674	5,154	6,348	6,348	$ 3,132	97%
Graduate	3,414	3,756	4,962	5,472	6,738	6,738	$ 3,324	97%
Doctoral	7,380	7,926	8,676	9,546	10,500	10,500	$ 3,120	42%
California Community Colleges	600	600	780	780	1,080	1,380	$ 780	130%
Hastings College of the Law	21,303	26,003	29,383	36,000	37,747	43,486	$ 22,183	104%

Source: LAO

GOVERNOR'S PROPOSAL:

Higher Education Funding. The budget provides $11.9 billion in General Fund support for higher education in 2013–14 (*including funding for financial aid programs administered by the California Student Aid Commission described in a separate chapter of this report*). This is $1.4 billion (13 percent) more than the revised 2012-13 level. The bulk of the new funding is for base increases at the universities, a general purpose increase for the community colleges, adult education restructuring, and increased participation in the Cal Grant program. A portion of the total ongoing General Fund increase is due to Budget Act of 2012 appropriations of $125 million each to UC and CSU if student tuition fee levels were held flat in 2012–13.

Higher Education General Fund Support
(Dollars in millions)

	2011–12 Actual	2012–13 Revised	2013–14 Proposed	Change From 2012–13	
				Amount	Percent
UC	$2,504	$2,567	$2,846	$279	11%
CSU	2,228	2,492	2,809	317	13
CCC	3,612	3,802	4,503	701	18
Hastings	8	9	10	—	3
CSAC	1,533	1,624	1,722	98	6
Totals	**$9,885**	**$10,494**	**$11,890**	**$1,396**	**13%**

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

Source: LAO

Multi-Year Funding Plan and Increased S tate Support for Base Budgets. The budget proposes a multi-year funding plan across all segments of higher education, including increased state support. UC, CSU, and Hastings budgets will increase by roughly five percent per year in 2013-14 and 2014-15, and by four percent in each of the subsequent two years. CCC funding will also increase by roughly five percent in 2013-14, and then grow significantly over the subsequent years of the multi-year plan. These increases translate to an additional $125.1 million each for UC and CSU, $392,000 for Hastings, and $197 million for the community colleges (an additional $179 million for the community colleges is directed to the buydown of inter-year deferrals and is discussed further in the "*Issues to Consider*" section below).

Assumes No Tuition Fee Increases Over Extended Period. The budget expects the segments to maintain current tuition fee levels for the life of the plan. No increases are necessary because any need is negated by the year-over-year General Fund increases coupled with savings from expected reforms from the improved deployment of teaching resources and from current segmental efforts to increase efficiencies. The reforms related to improved deployment of teaching resources include: (1) making available the courses students need and help them progress through college efficiently; (2) using technology to deliver quality education to greater numbers of students in high demand courses (with $37 million in designated funding for UC, CSU, and CCC as described further below); (3) improving course management and planning; (4) using faculty more effectively; and (5) increasing the use of summer sessions.

Expects Performance on Certain Priorities. The budget directs each segment to use the increased funding to achieve the following priorities: (1) provide high quality instruction at lower cost; (2) decrease the time it takes to earn a degree; (3) increase graduation rates; (4) increase the CCC transfer rate; and (5) improve credit and basic skills course completion.

Variety of Segment-Specific Proposals. The budget proposes various segment-specific "tools" to assist the segments in achieving the priorities of the multi-year plan. In addition, and in order to require the segments to factor these costs into their fiscal forecasting and decision-making, the budget proposes to shift certain costs onto the segments' budgets, such as for debt service and retiree benefits, that have been historically borne by the state's budget.

- *UC, CSU, and CCC – Funding for On-Line Education*. To expand the number of courses available to matriculated undergraduate students through the use of technology, the budget provides $10 million each to UC and CSU as part of their $125.1 million General Fund increases and a separate augmentation of $16.9 million Proposition 98 General Fund to the CCC. For all segments, the focus is on courses that have the highest demand, fill quickly, and are prerequisites for many different degrees. For UC and CSU, the budget bill earmarks the funding and requires that the courses be available to all undergraduates systemwide, regardless of the campus where they are enrolled, and that student tuition is the same as for regular academic year state-subsidized courses. For the CCC, the budget bill earmarks the funding and requires the Chancellor's Office to submit an expenditure plan to the Administration by July 1, 2013. The *Budget Summary* indicates the CCC initiative will include three key elements: (1) creation of a "virtual campus" to increase state student access to 250 new courses delivered through technology; (2) creation of a single, common, and centralized delivery and support infrastructure for all courses delivered through technology and for all colleges; and (3) expansion of options for students to access instruction in other environments and earn college credit for demonstrated knowledge and skills through credit by exam. Budget trailer bill language will also be submitted to implement this proposal.

- *UC, CSU, and CCC – Unit Caps*. To shorten students' time-to-degree, reduce costs for students and the state, and increase access to more courses for other students, the budget proposes trailer bill language to cap the number of General Fund subsidized-units students can take during the life of the plan. For UC and CSU in the first two years, the limit would be 150 percent of degree requirements (for example, 180 units for a standard bachelor's degree and 90 units for an associate's degree). The limit would be reduced in year three to the equivalent of about one extra year of full-time attendance (for example, 150 units for a bachelor's and 90 for an associate's). For CCC, starting in 2013-14, students will be allowed to take no more than 90 semester credit units (150 percent of the standard required to earn an associate's degree or credits for transfer).

- *UC, CSU, and Hastings – Bond Debt Service Costs and Capital Outlay*. The budget shifts roughly $400 million in debt service costs for general obligation bond financed capital improvements at UC, CSU, and Hastings into each segment's budget. The budget also makes one last adjustment to UC and CSU budgets for lease-revenue bond debt service costs. No further augmentations will be provided for either form of debt service payment. The budget further proposes that any new capital expenditures will be subject to approval by the Administration and there will be limits on the amount of the budget that can be spent on capital expenditures. Budget trailer bill language will be submitted to implement this proposal as well as to authorize UC and CSU to restructure their respective lease-revenue debt obligations to create budgetary savings.

- *CSU Employer Contribution to CalPERS*. The budget provides a $51.4 million General Fund increase to fund the annual increase in costs for CSU's required employer pension contribution to CalPERS. In future years, CSU will continue to receive annual General Fund adjustments based on current payroll; however, if CSU chooses to increase expenditures beyond the 2012-13 payroll level, CSU would be responsible for the associated pension costs.

- *CSU Employer-Employee Share of Cost for Health Premiums*. The budget proposes budget trailer bill language to provide CSU with the same statutory authority to negotiate or set employee health care benefit rates that is provided to the California Department of Human Resources for other state employees. Currently, CSU pays 100 percent of the health care premiums for its employees and 90 percent for employees' family members. However, for most other state employees, the state pays either 80 or 85 percent of employees' health care premiums and 80 percent for family members.

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

- *CCC Funding Incentive Initiative*. The budget proposes trailer bill language to change community college census accounting practices by adding a second census date at the end of each academic term. Over a five-year-period, the earlier census date (which is currently in the third or fourth week of the each semester) would gradually be phased-out.

Any enrollment monies that districts "lose" due to this policy change would be transferred to district categorical programs that fund student support services (such as counseling). This proposal is intended to apportion funding by focusing on completion at the end of the term, thereby incentivizing districts to focus on outcomes.

T*he Governor's proposals related to K-14 Adult Education and expenditure of Proposition 39 Energy Efficiency funds are discussed in other sections of this report.*

ISSUES TO CONSIDER:

Overall Theme to the Higher Education Budget. The Governor has identified several important areas of focus for the state's higher education system, including the need for increased productivity, a lower cost per degree for students and the state, and improved student success and outcomes. The Governor has also highlighted that continued increases in costs are not necessarily adding value or productivity. Rather, to achieve long-term financial sustainability and to fund future initiatives, higher education segments will have to lower their cost structures. The Governor also acknowledges the significant budget reductions that have been made in recent years and proposes to begin reinvesting in the higher education system.

While there will be questions raised about some of the specific reforms and tools the Governor proposes as part of his multi-year plan, the areas of focus identified therein are generally shared by the Legislature. At this juncture, many aspects of the Administration's multi-year plan remain undefined or under-defined. This will remain the case until budget trailer bill language is transmitted and subcommittee hearings begin in early March. However, the overall approach contained in the multi-year plan presents a broad threshold question about the role of the Legislature, as well as a number of other questions on specific components of the plan, as delineated below.

What is the Legislature's Role in the Multi-Year Plan? Last year, the Governor proposed a similar long-term funding plan for UC, Hastings, CSU, and the CCC that promised stable and increasing state funding and fiscal incentives to allow the segments to better manage their resources. The plan was dependent upon the passage of Proposition 30 and on the segments achieving certain performance metrics as specified by the Administration. While the Legislature expected to be provided with further details of the plan, no specific or complete plan ever materialized.

In the interim, Proposition 30 passed. In the 2013-14 budget, the Governor again proposes a multi-year funding plan for higher education but with increased funding. Similar to last year, the multi-year plan proposes a new approach to capital outlay (discussed below) and the elimination of earmarks and enrollment targets (also discussed below), all of which effectively decrease legislative oversight and remove key budget tools that the Legislature uses to guide higher education agencies. Finally, the multi-year plan identifies several performance expectations.

In short, the multi-year plan significantly increases the segments level of autonomy but does not link to any specific outcome targets or means to hold the segments accountable for meeting those expectations. This approach raises important questions for the Legislature to consider: What role should the Legislature play in making key high level decisions about the $4.5 billion spent each year on higher education, including regarding capital outlay and determining the outcomes and the metrics used to measure performance of the segments? Is the Legislature's role simply to appropriate state funding absent any earmarks and/or enrollment targets and leave it to the Administration and the segments to determine priorities and progress? If this is the funding level that the state is going to provide for higher education, what does the Legislature expect the segments to achieve? Does the Legislature want to provide even greater autonomy to the segments?

Legislature's Consistent Message on Higher Education Accountability. On a bipartisan basis, the Legislature has been developing, supporting, and refining proposals to create greater accountability for higher education since 2002. These provisions are consistent with recent LAO recommendations on the need for a public agenda and improved oversight of the higher education segments, and reflect the findings of the most recent review of the state's Master Plan for Higher Education – that there is a need for clearly articulated goals in order to enable increased accountability across the entire higher education system. This is especially true in the current fiscal climate; the state needs to be clear about priorities for the use of the public funding provided to the segments. Being clearer about the goals and the measures will highlight and drive the budget and policy decisions necessary to support the state's higher education system in meeting the state's goals.

The most recent iteration of this effort was Senate Bill 721 (Lowenthal). Passed by wide margins in both houses, this bill established goals for higher education and laid out a process for establishing metrics and targets and for assessing progress in meeting California's educational and workforce needs. The Governor vetoed SB 721, stating, "*This bill sets three goals for our colleges and postsecondary institutions and orders the Legislative Analyst to create a committee to establish metrics that measure progress towards these goals. The bill also requires annual reports. Questions about who should measure, what to measure, and how to measure what is learned in college are way too important to be delegated to the Legislative Analyst*."

The Governor's stated reason for the veto is process-orientated. Therefore, it would appear that the broad objectives of the Administration and the Legislature about goal setting and establishing metrics to measure progress are consistent. Further, SB 721 and preceding bills were approved by the Legislature in the leanest of fiscal times. This raises a key question for the Legislature to consider: now that the state is reinvesting in higher education, to be consistent with prior legislative intent and action shouldn't that reinvestment and overall higher education budget be linked directly to an accountability framework?

The State Lacks a Higher Education Oversight Structure. In 2011, the Governor vetoed funding for the California Postsecondary Education Commission (CPEC), citing the agency's ineffectiveness in higher education oversight. In light of this action, the future of higher education oversight remains unclear. While the public segments have stepped in to assume some roles previously performed by CPEC, there are concerns about how institutional and public interests will be balanced. In its January 6, 2012, report entitled, "*Improving Higher Education Oversight*," the LAO focused on the need for oversight that enables policymakers and others to monitor how efficiently and effectively the postsecondary system is serving the state's needs, and make changes to improve its performance. The specific recommendations of that report include that the Legislature: (1) define the state's postsecondary education needs, such as setting specific goals; (2) use performance results to inform policy decisions; and (3) establish an independent oversight body with limited and clear responsibilities.

Noting the difficulty of creating a new public organization in the current fiscal environment, the LAO offered a number of short-term measures to strengthen oversight in the interim: (1) amending statute to ensure pertinent data remain available to policymakers and researchers; (2) increasing direct legislative oversight and limiting new long-term funding commitments until an effective oversight structure is in place to support the legislature's decision-making; and (3) monitoring segments' allocation decisions, including investment in new programs and other major program changes, until mechanisms are in place for outcome review. The LAO's short-term measures warrant further consideration by the Legislature as it begins its review of the Governor's multi-year plan.

Online Education at the Higher Education Segments. A key component of the multi-year plan's focus on improved deployment of teaching resources is the proposal to use technology to deliver quality education to greater numbers of students in high demand courses; e.g., bottleneck courses that slow time to degree while students await a "seat" in the required course. If the reform bears fruit, the net result will be increased productivity and lower cost per degree for students and the state, as well as increased access for other students. While budget trailer bill language has not been transmitted, the *Budget Summary* and budget bill language provide insight into the Governor's vision: the focus is matriculated undergraduate students and for high demand courses. For UC and CSU, the courses will be available systemwide regardless of a student's "home" campus and tuition will be the same as for regular courses. For the CCC, a "virtual campus" will be created and credit by exam options will be expanded.

While the state's colleges and universities have been providing distance education for decades through university extension programs, online instruction for credit towards undergraduate and graduate degrees has become a much more prominent part of postsecondary education in recent years. At the same time, debates have been sparked about quality assurances. Recent media reports have been focused on the rapid rise of MOOCs (massive open online courses), which are online courses aimed at large-scale participation and open access via the web. Though the design of and participation in a MOOC may be similar to college or university courses, MOOCs typically do not offer credits awarded to paying students at schools. However, that aspect is changing as universities here, and nationally, are now examining opportunities to use the MOOC platform for credit instruction, including the recently announced pilot at San Jose State using a MOOC platform for introductory and remedial classes.

In its October 2010 report entitled, "*The Master Plan at 50: Using Distance Education to Increase College Access and Efficiency*," the LAO found that while distance education is not, and is not intended to be, suitable for everyone (students as well as faculty), it offers an important alternative means of providing instruction that can complement existing formats and expand options for the state's students and segments. In order to take fuller advantage of this potential, the LAO recommended that the Legislature guide a clearer statewide vision that specifies data which the segments should collect and report on distance-education students and clarifies expectations concerning intercampus collaborations and other partnerships. Specific LAO recommendations included: (1) streamlining educational pathways for online students; (2) promoting the sharing of curriculum across campuses; and (3) encouraging collaborative academic programs.

There are several other key questions for the Legislature to consider: (1) What is online credit instruction? Should it be more than simply taking the traditional classroom model and moving it online without any change in approach? (2) How much are the segments currently spending for online credit instruction and can supplanting be prevented? (3) What will move the needle? Should the focus be systemwide, for projects that can ease taking courses across campuses and/or support the development of courses to be used across campuses? (4) What is the appropriate balance between investing funds in proven methods versus new and emerging methods? (5) How can the quality of instruction be ensured?

Unit Caps on State-Subsidized Courses at UC, CSU, and CCC. The budget proposes caps on the number of units the state will subsidize at UC, CSU, and CCC. While budget trailer bill language has not been transmitted, the Administration has indicated that the cap would apply to both new and continuing students beginning in the 2013-14 academic year and be in place over the life of the multi-year plan. The budget would allow the universities and colleges to grant waivers and allow students to take additional units above the cap; however, the state would provide no subsidy so either the student pays full freight or the institution bears the entire cost of providing the instruction. This approach raises important considerations for the Legislature.

The initial limit for UC and CSU (150 percent of standard requirements) likely would not have a significant impact, but the eventual limit to be imposed at the universities after two years (125 percent of standard requirements) would impact more students primarily at CSU. For the community colleges, however, the impact is much more immediate and significant. For instance, in 2009-10, nearly 120,000 students had earned 90 units or more.

The cap is intended to create an incentive for students to shorten their time-to-degree, reduce costs for the state, and increase access to more courses for other students. This is a legitimate goal, but ignores some of the realities of the current situation. Students should be able to take appropriate courses and earn degrees in a timely fashion, but there needs to be shared responsibility for doing so. However, this proposal penalizes only students and ignores the reasons why students may accrue excess units, including the unavailability of courses, inconsistent transfer requirements, and requirements of particular majors, and to what degree those reasons are within the control of students.

A one-size-fits-all approach is potentially punitive to those who have a double major and those who may be returning to college to train for a new job. For the community colleges specifically, the cap would also apply to so-called freeway fliers, who are students that, largely out of necessity, enroll and take classes at multiple colleges and/or districts. It is not clear that the community colleges have the data capabilities to track those students and the number of accumulated units. This raises a legitimate question about enforcement of the cap within the community college system.

A Ne w Ap proach to UC and CSU Capital Outlay. The *Budget Summary* indicates the Administration is considering some changes to the state's infrastructure spending practices, including identifying alternatives to limit future bond authorizations backed by the General Fund, currently the state's main source of infrastructure funding. Some alternatives mentioned include identifying new funding sources and creating new mechanisms to prioritize and limit capital spending.

For higher education, and consistent with the above direction, the budget proposes a new approach to UC and CSU capital outlay, including how debt service costs are budgeted and structured as well as how future projects are approved and funded. While many details remain outstanding, including what, if any, role the Administration envisions for the Legislature in approval of new higher education capital outlay expenditures and the impacts of the proposal to authorize UC and CSU to restructure their respective lease-revenue bond debt to create budgetary savings, the approach raises important considerations for the Legislature.

The approach is a departure from how UC and CSU capital outlay has been historically addressed. Under prior practice, and in the last ten years, the LAO reports that the state spent an estimated $10.1 billion on higher education infrastructure; 80 percent of that support came from general obligation (GO) bonds and an additional 19 percent from lease-revenue bonds. Associated higher education debt-service costs more than doubled during this same time period, from about $516 million in 2000-01 to an estimated $1.1 billion in 2010-11. Most of the GO bond spending was from bonds approved by the voters in 1998, 2002, 2004, and 2006. In general, the state provides less funding for higher education projects when the balance of GO bonds is exhausted. In the case of UC and CSU, the state has typically offset some of this reduction by funding some projects with lease-revenue bonds. All of these projects were presented as part of the annual budget process, thereby ensuring the segments requested approval from the Administration and Legislature for any projects funded with either GO bonds or state-issued lease-revenue bonds.

At this point, the remaining higher education GO bond authority has all but been exhausted. This Administration has not advanced any new lease-revenue bond financed projects. To wit, the Budget Act of 2012 included very limited new funding for capital outlay. For UC, $4.75 million (2006 GO bond funds) was appropriated for preliminary plans and working drawings for a new building at UC Merced. For CSU, $10.995 million (GO bonds) and $11.155 million (federal funds) to fund all phases of five seismic upgrade projects at the Los Angeles, San Luis Obispo, Bakersfield, and Humboldt campuses.

Looking ahead to 2013-14, both the UC and CSU governing boards adopted extensive state-funded capital outlay programs, with 39 projects totaling $788.5 million and 38 projects totaling $520 million, respectively. The request submitted to the Administration was much smaller: UC advanced three projects totaling $73 million and CSU advanced 21 projects totaling $390.3 million. The budget includes no capital outlay projects for UC; for CSU, the budget includes $3.637 million (GO bonds), for equipment phases of already constructed projects at the San Jose, Maritime Academy, Bakersfield, and Fresno campuses.

By shifting the debt service payments into the segments' base budgets, the Administration asserts that this would limit the segments' capital spending by highlighting the trade-offs between spending on infrastructure versus operations. As it stands now, these debt service costs are borne by the state's budget providing no incentive for the segments to limit the number and scope of capital projects they submit to the Administration and Legislature. Yet, this change in approach raises several questions for the Legislature to consider, including: (1) Is the 2013-14 funding provided adequate to annually service the segments' existing bond debt in the coming years? (2) Is the proposed total base funding (which could grow by up to five percent annually over the life of the multi-year plan) reasonable to cover the UC's and CSU's various operational and bond-related costs? (3) To what extent, and in what ways, will the Legislature have a role in approval of higher education capital outlay projects?

Elimination of UC and CSU Budge tary Earmarks. Typically, the annual budget act includes a number of conditions on UC's and CSU's General Fund appropriations. These earmarks for UC and CSU funding have varied over the years in keeping with the Legislature's and Governor's particular concerns at the time and have covered such programs as nursing and medicine, student financial aid, and science and math teaching initiatives. Due to Governor's vetoes, the Budget Act of 2012, for the first time, included minimal earmarks in UC's and CSU's budgets. The budget contains no earmarks except for a new one to address the Governor's priority, namely the $10 million provided to each segment to increase the number of courses available through the use of technology.

The UC and CSU are governed by independent boards that make various decisions about how the universities will spend their resources, including the number of faculty, executives, and other employees on the payroll and those employees' salary and benefits; student tuition levels; and the amount of tuition revenue redirected to financial aid, among other fiscal decisions. Further, UC has constitutional autonomy afforded by the California Constitution, under which the Regents have "*full powers of organization and governance*" subject only to very specific areas of legislative control, such as budget act appropriations.

Given this dynamic, where significant budget authority has already been delegated to UC and CSU, the Legislature has relied on earmarks to ensure key concerns are addressed within the funding appropriated to the universities. The inclusion of earmarks in the budget bill provides a clear public record of budgetary allocations and expectations. The Governor's approach effectively eliminates this budgetary tool for Legislative priorities, but creates a new earmark for his priority.

The LAO has recommended that rather than simply abandoning all earmarks in the universities' budgets, the Legislature should reevaluate budgetary earmarks on a case-by-case basis. In some cases, the Legislature may decide that a particular earmark is no longer a priority. In others, the Legislature may wish to keep or change or add an earmark. To help in evaluating potential earmarks, the Legislature may wish to develop guidelines such as approving only those earmarks that serve a broader state purpose.

Elimination of UC and CSU Enrollm ent Targets. The *Budget Summary* states that "*enrollment based funding does not promote innovation and efficiency or improve graduation rates. It does not focus on critical outcomes, affordability, timely completion rates, and quality* *programs. Instead, it builds on the existing institutional infrastructure, allowing public universities and colleges to continue to deliver education in the high-cost, traditional model*." Therefore, the budget does not include enrollment targets for either UC or CSU, effectively allowing UC and CSU to make their own decisions about how many students to enroll with the funding available to them.

Historically, UC's and CSU's budget have been tied to a specified enrollment target. To the extent that the segments failed to meet those targets, the state funding associated with the missing enrollment reverted to the General Fund. Beginning with the Budget Act of 2011, enrollment targets were included but without any penalty should a segment fail to meet its target in recognition of the overall reductions to higher education budgets.

Enrollment levels are irrefutably a fundamental building block of higher education budgets. The number of students enrolled is a direct measurement of the "access" provided to higher education. Further, enrollment levels are a central cost driver for the segments and drive other costs, such as state financial aid. For these reasons, enrollment targets have been a major legislative concern in recent years. With no target, as proposed by the Governor, the segments would have wide discretion as to their enrollment levels. For example, they could significantly reduce the number of students served, thus raising the amount of funding available per student. Or UC and CSU could reduce the number of undergraduates served, and use the funding to add a smaller number of higher-cost graduate students. Certainly choices here link back to the multi-year plan and its expectations for segmental performance on certain priorities. For instance, it is unlikely the segments would decrease the acceptance of community college transfer students, as that is an identified priority of the multi-year plan. Nevertheless, enrollment decisions have implications not just for educating students, but they also have a profound effect on the level of access provided at each segment.

In the past, the LAO has recommended the rejection of any proposal to eliminate enrollment targets. Further, to the extent that the Legislature chooses to significantly increase a segment's budget, it may wish to modify the enrollment targets. Alternatively, the Legislature may wish to require the segments to achieve greater efficiencies without reducing enrollment. In addition, this proposal raises other key questions for the Legislature's consideration: With no enrollment target, what assurances does the Legislature have that UC and CSU will continue to serve all students eligible for their institutions under the Master Plan? What recourse would be available if the segments fail to do so?

CSU Employer Costs for Retirement. CSU's required employer contribution to CalPERS has been historically borne by the state's budget. Each year, the annual budget act provided an adjustment for either the increase or decrease in the required contribution level as determined by the CalPERS Board of Administration. CSU's base budget of $1.9 billion contains $460 million for this purpose. The budget proposes an annual adjustment of $51.4 million General Fund and a substantive change in approach going forward. In future years, CSU will continue to receive annual General Fund adjustments for CalPERS costs based on 2012-13 payroll; however, if CSU chooses to increase payroll expenditures above the 2012-13 level, CSU would be responsible for the associated pension costs. CSU could be concerned that under the budget proposal, it and its employees will have little flexibility and few tools beyond salary/benefit setting authority to manage unfunded liabilities and higher costs that could result in the future. For instance, the CalPERS Board sets the employer contribution rate. However, this is not unique to CSU as an employer; this also applies to the state as well as every other public employer who contracts with CalPERS. Absent the Governor's proposal, the alternative is that the state's budget will continue to bear these costs yet have no control over the salary/benefits and resulting pension costs (above the 2012-13 expenditure level) that CSU negotiates with its employees.

CSU Employee Health Care Benefit Rates. The budget proposes trailer bill language to provide CSU with the same statutory authority to negotiate or set employee health care benefit rates that is provided to the California Department of Human Resources (CalHR) for other state employees. A similar proposal was included as part of the 2012 May Revision but was not part of the final budget. Last year concerns were raised about timeliness given that CSU was actively bargaining with the majority of its represented employees. At present, all of CSU's bargaining units are under contract. While the actual trailer bill language has not been transmitted, the Governor is raising a legitimate point about providing CSU with the same tools as CalHR to better manage and negotiate the entirety of its personnel costs, including employee health care benefit rates.

Community College Base Budget Increase. The budget provides $197 million in Proposition 98 General Fund support for the community colleges. Unlike other state funds in the community college budget, the budget would allow the Chancellor's Office to make its own decisions about how the funds would be distributed and for what purpose. This is a broad departure from past practice, whereby any increase in base budget funding was provided for a specific purpose, such as for growth (unfunded FTES) or a cost-of-living-adjustment (increase in the per FTES amount). The LAO has raised concerns about whether the Governor's approach would ensure that the state's highest community college priorities would be addressed. For instance, the Legislature has enacted several pieces of legislation specifying a number of priorities to fund once new resources become available, such as a common assessment instrument to place incoming students into appropriate coursework, additional academic counselors to help students identify and make progress toward their educational goals, and a system for electronic student transcripts to improve campus record-keeping and efficiencies. In addition, the state has a number of outstanding community college-related liabilities, including over $300 million that is owed for past mandate claims.

Buydown of Community College I nter-Year Deferrals. The Governor's budget proposes an increase of approximately $1.9 billion in Proposition 98 General Fund to reduce inter-year budgetary payment deferrals for K-14 education in 2013-14. Of that total, $179 million is for community colleges reducing the deferral debt owed to the community colleges to $622 million (the Budget Act of 2012 reduced the debt to $801 million from a total of $961 million). The level of deferral "buy down" is consistent with, and proportional to, the payment of deferred funding in K-12 education; e.g., basically a 50-50 split of new funding versus deferral buydown. The Governor further plans to eliminate all inter-year payment deferrals to schools and community colleges over the next few years. From a fiscal and policy standpoint, it is prudent to reduce these inter-year deferrals, as they remain outstanding obligations on the state's books. The deferrals also were an agreed-upon solution to avoid more draconian cuts to K-14 budgets. They also come with borrowing costs for districts, in order to address cash flow concerns caused by the delayed state payments. It remains unclear if there are any advantages to delaying repayment of inter-year deferrals for K-12 schools and community colleges to future years.

Board of Governor's Fee Waiver Program Reform. The budget proposes to require all community college students seeking financial aid, including Board of Governor's (BOG) Fee Waivers, to fill out a Free Application for Federal Student Aid (FAFSA) form.

The BOG Fee Waiver program waives enrollment fees for CCC students who demonstrate financial need. The cost of the program, which is covered by Proposition 98 General Fund monies, has grown rapidly in recent years with waiver costs projected to total $855 million in 2012-13. Under current law and regulation, there are three means of eligibility: (1) Part A, if students or their parents receive cash assistance from other need-based programs (such as CalWORKs); (2) Part B, if a student's or his/her family adjusted gross income is at or below 150 percent of the federal poverty level; and (3) Part C, if students have any financial need (cost of attendance exceeds their federally determined family contribution by $1,104 or more; $1,104 is the amount of annual fees charged to a full-time student taking 24 units). Students can apply for a fee waiver by completing: (1) the FAFSA or (2) for Part A and B waivers, the BOG Fee Waiver application. Verification policies differ by which type of fee waiver is sought. For instance, under Part A, appropriate documentation includes copies of a student's benefits check. Under Part B, Chancellor's Office guidelines give districts flexibility to determine what "documentation" means; acceptable methods include verifying tax records or "self-certification," whereby students are taken at their word about their or their family's income level. All students signing the BOG Fee Waiver application form do so under penalty of perjury. The Chancellor's Office indicates that 80 percent of students currently receiving aid filled out a FAFSA.

The LAO has previously recommended that the Legislature enact the statutory changes necessary to add satisfactory academic progress requirements to the BOG Fee Waiver program (Chapter 624, Statutes of 2012). The LAO also recommended that the Legislature enact the statutory changes necessary to require students to apply for a waiver using the FAFSA to ensure that they are considered for the full spectrum of federal and state aid. In considering this proposal, an important consideration is to avoid creating a new reimbursable state mandate.

Community College Funding Incentives Initiative. The budget proposes to change the basis on which districts are funded for credit instruction by phasing in a second census date at the end of each academic term to focus on completion at the end of the term. While the Governor raises a fair point about the benefit about moving to a funding model that is more outcome-oriented, legitimate concerns can be raised about unintended consequences in the classroom, such as grade inflation or reductions in course rigor. The LAO has also noted that by redirecting any "lost" funds to a district's categorical program, the budget presupposes that students do not complete their coursework because of inadequate support services. This may be a contributing factor, but it ignores the many other factors that could be at play such as a poorly designed or taught course. The LAO has suggested the Legislature consider changes to the funding model that would place greater emphasis on more meaningful outcomes, such as rewarding colleges for student learning gains and program completions (such as obtaining a degree or skills certificate) rather than course completion. Given that the Student Success Task Force (SSTF), which is discussed below, considered and rejected a similar proposal, the Legislature should consider the interaction of this proposal with the work of the SSTF, such as establishing enrollment priorities, which is already underway and could accomplish the same goal.

Interaction with the Priorities of the Student Success Task Force. Pursuant to Chapter 409, Statutes of 2010, the Board of Governors (BOG) created the Student Success Task Force (SSTF) to research, study and debate the best methods to improve student outcomes. The SSTF final report was unanimously adopted by the BOG in January 2012. The SSTF efforts resulted in 22 specific recommendations, to be accomplished through regulatory changes, system-wide administrative policies, local best practices, and legislation. Major recommendations address linkages with K-12 schools, student intake and support, instructional programs, and accountability. Seven of the 22 recommendations are in the implementation phase, as follows: (1) Common Core State Standards; (2) Common Assessment; (3) Statewide Enrollment Priorities; (4) BOG Fee Waiver Requirements, contained in Chapter 624, Statutes of 2012; (5) Student Success Score Card; (6) Longitudinal Student Record System; and (7) Student Support Initiative, also contained in Chapter 624. With all of this work related to the SSTF recommendations underway, the conversation has effectively moved from "what" recommendations to "how" the recommendations are implemented. The Legislature has been a full partner in this process as evidenced by Chapter 624.

There is, however, an interesting juxtaposition between the SSTF recommendations and the budget reforms. The SSTF is an example of local control that the Governor supports, yet some of the budget reforms would supersede the SSTF work done to date and planned for the future. For instance, there is overlap between the SSTF recommendations and the budget reforms (such as differing policy changes regarding BOG waiver requirements and unit caps), other SSTF recommendations address issues not identified in the budget reforms (such as establishing registration priorities, including allowing students who participate in orientation and academic assessment programs and have 100 units or less to enroll in classes first), and some of the budget reforms go well beyond the SSTF recommendations (such as the proposed funding incentives initiative). Given these intersections, and prior legislative support for the SSTF process and recommendations, careful legislative consideration is warranted of all related budget proposals.

Student Financial Aid – Cal Grant Program

BACKGROUND:

The Cal Grant program is the primary financial aid program run directly by the state. Modified in 2000 to become an entitlement award, Cal Grants are guaranteed to students who graduated from high school in 2000-01, or beyond, and meet financial, academic, and general program eligibility requirements. Administered by the California Student Aid Commission (CSAC), Cal Grant programs include:

- *Cal Grant A** high school entitlement award provides tuition fee funding for the equivalent of four full-time years at qualifying postsecondary institutions to eligible lower and middle income high school graduates who have at least a 3.0 grade point average (GPA) on a four-point scale and apply within one year of graduation.

- *Cal Grant B** high school entitlement award provides funds to eligible low-income high school graduates who have at least a 2.0 GPA on a four-point scale and apply within one year of graduation. The award provides up to $1,473 for book and living expenses for the first year and each year following for up to four years (or equivalent of four full-time years). After the first year, the award also provides tuition fee funding at qualifying postsecondary institutions.

- *Community College Transfer Award* provides a Cal Grant A or B to eligible high school graduates who have a community college GPA of at least 2.4 on a four-point scale and transfer to a qualifying baccalaureate degree granting college or university.

- *Cal Grant Competitive Award Program* provides 22,500 Cal Grant A and B awards available to applicants who meet financial, academic, and general program eligibility requirements. Half of these awards are reserved for students enrolled at a community college and who met the September 2 application deadline.

- *Cal Grant C Program* provides funding for financially eligible lower income students preparing for occupational or technical training. The authorized number of new awards is 7,761. For new and renewal recipients, the current tuition and fee award is up to $2,462 and the allowance for training-related costs is $547.

*In 2013-14, the maximum award for Cal Grants A and B are equal to the mandatory systemwide tuition fees at the UC ($12,192) and CSU ($5,472), $9,084 at independent non-profit institutions and WASC-accredited private for-profit institutions, and $4,000 at all other private for-profit institutions.

Cal Grant Program Awards/Funding (dollars in thousands)

	2011-12	2012-13	2013-14
Entitlement Awards			
Number	204,182	222,433	241,538
Amount	$1,366,180	$1,461,798	$1,569,028
Competitive Awards			
Number	37,868	38,510	39,183
Amount	$128,236	$124,255	$117,405
Cal Grant C			
Number	7,910	7,936	7,899
Amount	$8,964	$8,212	$7,947
Total			
Amount $1,503,380		**$1,594,265**	**$1,694,380**

GOVERNOR'S PROPOSAL:

- ✓ Proposes no programmatic changes to the Cal Grant program.
- ✓ Accounts for an additional $61 million in 2012-13 and $161.1 million in 2013-14 to fully fund Cal Grant programmatic costs. Of the 2013-14 amount, $19.5 million is attributable to implementation of Chapter 604, Statutes of 2011 (The California Dream Act).
- ✓ Proposes to offset $942.9 million GF in Cal Grant program costs by utilizing federal Temporary Assistance for Needy Families (TANF) program funds. The Administration indicates that this shift is an allowable use of TANF funds because support for low-income, unmarried students age 25 or younger could prevent and reduce out-of-wedlock pregnancies, which is one purpose of TANF. This level of offset is an increase of $139.2 million over the level included in the Budget Act of 2012, which was the first time this offset was adopted.
- ✓ Proposes to offset $60 million GF in Cal Grant program costs due to the availability of surplus funds from the Student Loan Operating Fund (SLOF), which receives proceeds from the federal guaranteed student loan program. The Budget Act of 2012 included an offset of $84.7 million GF from this same fund source.

ISSUES TO CONSIDER:

Recent Changes to the Cal Grant Program to Reduce Program Costs. In the 2011 and 2012 Budget Acts, significant changes were made to the Cal Grant program, particularly with regard to eligibility criteria for participating institutions with a substantial proportion of their students borrowing federal student loans, to address concerns about participating institution quality and in order to reduce overall program costs. However, none of these changes, which are summarized below, impacted the entitlement aspect of the Cal Grant program.

Program Change	2013-14 Law	*Prior Law*
Tighter Eligibility Criteria for Participating Institutions	Participating institutions must maintain a maximum cohort default rate (CDR, proportion of former students defaulting on federal student loans) of 15.5 percent and a minimum graduation rate of 30 percent.	*No policy prior to 2011-12, when a CDR of 24.6 percent was instituted.*
Reduction in Award Levels for Non-Public Institutions	Cal Grant A and B new maximum awards will be $9,084 at independent non-profit institutions and WASC-accredited private for-profit institutions, and $4,000 at all other private for-profit institutions.	*Prior to 2012-13, the maximum award levels had been $9,708 for all non-public institutions since 2000 (except for 2004-2006, in which it was reduced to $8,322). In 2012-13, Governor's veto reduced award levels by five percent, to $9,223.*
Renewal Awards at Ineligible Institutions	Cal Grant eligible students attending an ineligible institution will not be able to renew their Cal Grant for the 2013-14 academic year if they choose to remain at that ineligible institution.	*No policy prior to 2011-12, when renewal awards were reduced by 20 percent if a student chose to remain at an ineligible institution.*
Tighter Eligibility Criteria for Renewal Recipients	Cal Grant recipients applying for renewal awards must meet certain financial eligibility criteria.	*Prior to 2011-12, Cal Grant recipients had to demonstrate financial need but not meet these "certain" criteria upon renewal.*
Awards Levels Reduced Through Governor's Veto Action	Through a veto action, the Governor reduced certain Cal Grant awards by five percent ongoing: (1) Cal Grant B access award – $1,473; (2) Cal Grant C tuition and fee award – $2,462; and (3) Cal Grant C book and supply award – $547.	*Prior to 2012-13, Cal Grant B access award had been $1,551; the Cal Grant C tuition award had been $2,592; and the Cal Grant C book and supply award had been $576.*
Community College Transfer	Codified CSAC practice limiting community college transfer entitlement awards to students who attended a CCC in the academic year before transferring to a four-year institution.	*N/A*

Budget Act Reforms Reduce Student Choices but in Long-Term Improve Outcomes. Under the new institutional eligibility standards, 154 schools, comprising 35 percent of all institutions and more than 80 percent of private for-profit schools participating in the Cal Grant program in recent years, have been deemed Cal Grant-ineligible. This shift in eligibility is evident in where the Cal Grant funds flow. Of the $1.6 billion in Cal Grant program costs in 2012-13, five percent of those costs are within the private for-profit sector, 15 percent are within the private non-profit sector, and 80 percent are within the public sector. Of the $1.3 billion within the public sector, 45 percent of those costs are at UC, 29 percent at CSU, and six percent at CCC. As a result, the new rules have reduced Cal Grant recipients' college choices and, at least in the short term, their access to postsecondary education. However, it is important to note that the ineligible schools are those where less than 30 percent of students are graduating and where more than 15.5 percent of students are defaulting on their federal student loans. Both of these "tests" are indicators of outcomes and student success. Therefore, in the longer term, the eligibility changes could improve outcomes for Cal Grant recipients as students shift to eligible schools and institutions make investments to improve their outcomes (and regain eligibility for the Cal Grant program).

Even With Recent Reforms Cal Grant Program Costs Continue to Increase. The Governor's Budget proposes a funding level of $1.7 billion ($720 million state GF, $942.9 million TANF, and $60 million SLOF), an increase of roughly six percent over 2012-13. Cal Grant program costs are affected by award amounts, program eligibility policies, and the number of students participating in the program. Cal Grant participation has grown between four percent and eight percent in recent years, despite constraints on campus enrollments, as more students have applied and qualified for need-based aid. Another contributing factor is Chapter 604, Statutes of 2011, which allows certain previously ineligible students to receive state financial aid beginning in 2013.

Interaction with Tuition Fees at UC and CSU. Under current state policy, Cal Grant award amounts keep pace with tuition fees at UC and CSU. This link has been a primary driver of dramatically increased program costs through the 2011-12 year (UC and CSU fees have since been held at the 2011-12 level). The Governor's Budget assumes no tuition fee increases at UC and CSU in 2013-14 (*See the Higher Education chapter in this report*). However, the 2013-14 budget bill retains controlling language that states UC and CSU maximum Cal Grant awards shall be $12,292 and $5,472, respectively, or <u>whatever lesser or greater amount</u> is approved for mandatory systemwide tuition by the respective governing boards. The Legislature may wish to consider amending this language to delete the linkage to Cal Grant award amounts should either or both of the governing boards act to increase tuition fees in 2013-14. The LAO has also suggested that in future years, if annual tuition fee increases are implemented, the Legislature might want to explore ways to constrain the anticipated growth in associated Cal Grant program costs. For example, the LAO has suggested that the Legislature could limit award amounts for CSU and UC students to either a fixed amount or a share of tuition that varies according to student need.

LAO's Analysis of the New Eligibility Rules. The recent budget act changes included a requirement that the LAO monitor initial implementation of the changes and analyze the state's other options for measuring institutional quality. In its report issued January 7, 2013, the LAO found that the changes, which primarily affect students at for-profit schools, are generally working as intended but have three notable drawbacks: (1) schools can manipulate the CDR; (2) the rules exempt some institutions without strong justification for doing so; and (3) the standards penalize institutions serving more disadvantaged students. The LAO recommended exploring alternative student debt measures when the information needed to calculate these measures becomes more readily available and applying the graduation rate requirement to all schools but modifying the measure to track the graduation rate only of Cal Grant recipients. In addition, the LAO recommended taking into consideration a school's student characteristics to avoid creating a disincentive to serve disadvantaged students.

The LAO also raised concerns about the actual implementation of the new standards and made recommendations to address those concerns. More specifically, although CSAC is required by statute to certify institutional eligibility by October 1 each year, the U.S. Department of Education plans to release new graduation rate data later in October. For this reason, the LAO recommended changing the certification deadline to November 1 if the Legislature maintains the current graduation rate measure. The LAO also noted that the recent policy changes, implemented in the middle of Cal Grant award cycles, have left many students with insufficient time to make alternative plans for the coming academic year. Moving forward, the LAO recommended the Legislature avoid making changes to eligibility rules during award cycles already underway, instead making them effective for the next award cycle. Some eligibility changes, such as those requiring consultation on specific metrics to be used, may require even longer implementation lags.

SUBCOMMITTEE NO. 2

NATURAL RESOURCES, ENVIRONMENTAL PROTECTION, ENERGY, and TRANSPORTATION

Natural Resources

Transportation

An Update on the State of State Parks

BACKGROUND:

2012 Budget Proposal—Park Closures and Budget Reductions. The 2012-13 budget year was a pivotal time for the Department of Parks and Recreation (Parks). The January budget implemented reductions of $22 million adopted the previous year as well as began a planned closure of 70 parks. As the budget season progressed, the Senate developed a long-term sustainable plan that would implement a series of actions to provide funding flexibility to the department. These included promoting revenue generating and entrepreneurial activities at the district level, increasing the flexibility of existing funding sources and allowing the department to access alternative funding sources for water and wastewater capital projects.

Hidden Funds and Personnel Violations Found Over Summer. In July 2012, after the budget had passed, the department was found to have been hiding funding from the Legislature and the Department of Finance. At the time, it was unclear whether the hidden funds encompassed the State Parks and Recreation Fund as well as the Off-Highway Vehicle Program Trust Fund. In addition, senior administrators at the department were found to have violated multiple personnel rules by approving vacation buyouts and out-of-class payments to various levels of personnel.

Legislative and Administration Response. The Legislature took immediate action to investigate the department's finances and the administration's response to the department's actions. The department's senior administrators were removed from their positions and the Natural Resources Agency took over the day-to-day administration of the department. At the same time, a series of audits and investigations were started that are summarized below. These include audits by the Department of Finance's Office of State Audits and Evaluations, the California Department of Justice, the State Controller's Office and the Bureau of State Audits. At this time, results are available from all but the Bureau of State Audits which is due in February of this year.

The result of the immediate findings of the Legislature was the discovery of $21 million of one-time funds that were hidden by the department from the Legislature and the Department of Finance. The Legislature, as a result of its summer investigations, adopted AB 1478 (Leno) to address some of the key problems at the department and to provide the public with an immediate action plan for the department as the investigations continued.

Statutory Changes in AB 1478

Goal Summary	
Moratorium on Park Closures for Two Years	• Prohibits the department from closing or proposing the closure of a state park in the 2012-13 and 2013-14 fiscal years.
Matching Funds for Park Donors and Local Agreements	• Provides a one-time appropriation of $10 million from revenues generated by the department to be allocated to match contributions from donors and local partner agreements for 2012-13 and 2013-14.
Funding to Prevent Park Closures	• Provides a one-time appropriation of $10 million to parks that remain at-risk of closure in order to maintain a two-year moratorium on park closures.
Funding for Audits and Investigations	• Provides a one-time appropriation of $500,000 to ensure that all ongoing internal and external investigations into the department are fully funded.
Funding for Capital Projects	• Provides a $10 million one-time appropriation of bond funds for capital improvements projects to prevent full or partial park closures.
State Park and Recreation Commission	• Establishes criteria for membership positions on the commission including requirements for cultural and park management experience. • Requires the appointment of two ex officio legislative members by the Assembly and Senate Rules committees, respectively. • Allows the commission a more direct oversight role of the department, particularly over the department's deferred maintenance backlog.
Funding for the Park Enterprise Fund	• Clarifies funds appropriated to the California State Park Enterprise Fund, established to enable the department to set revenue targets and goals, are transferred appropriately from the State Parks and Recreation Fund. Provides for annual accounting and reporting.

SUMMARIZING AUDIT AND INVESTIGATION RESULTS:

The ongoing audits were mostly concluded in December of 2012. The results of these audits are summarized briefly below and discussed in more detail following the table.

Summary of Investigations and Findings

Investigator	Results
Department of Justice (Attorney General)	• Confirms deliberate hiding of $21 million State Parks and Recreation Fund from Legislature and Administration • Confirms no Off-Highway-Vehicle funds hidden • Recommends oversight measures
State Controller's Office	• Management processes circumvented for out-of-class payroll • Personal leave program violations • Retired annuitants and non-permanent employees exceeded hours allowed
Office of State Audits and Evaluation (OSAE)	• Key budgeting functions need improvement • Risks over State Park Contingent Funds • Key internal controls over procurement violated
Bureau of State Audits	• Forthcoming
Local District Attorney	• Declined to take up criminal charges

California Department of Justice/Attorney General (AG) Investigation. The AG was called upon to provide an independent review of the preliminary investigation into the department by the Natural Resources Agency that stated a discrepancy of up to $54 million dollars from two funds, the State Parks and Recreation Fund (SPRF) and Off Highway Vehicle (OHV) fund. The AG interviewed 44 former employees of the department, excluding former Director Ruth Coleman whose lawyer advised against an interview. The investigation concluded the following:

- There was no evidence of intentional or systematic failure to disclose OHV fund monies. Instead, the evidence indicates this discrepancy was due to historically erratic and disparate fund balances reported to DOF and the Controller's Office rather than any attempt to hide funds.
- The investigation did discover that the failure to accurately report all SPRF monies to DOF was conscious and deliberate. Initially these funds began and unintentionally grew due to a year-end reporting anomaly. However, by no later than 2003, and perhaps as early as 1999, the funds were deliberately kept hidden from DOF by fiscal managers at the department. Because the funds were never spent, however, the monies seem to have represented an essentially useless reserve by the department. The report concludes that with new coordination and oversight measures established by the administration, a repeat of any such non-disclosure is less likely.

State Controller's Office Payroll Investigation. The State Controller's Office independently undertook a review of the department's payroll to confirm the payroll discrepancies reported to the administration and Legislature. The investigation focused on payroll processes and internal controls, and out-of-class assignment pay. Their findings include:

- Management processes were circumvented for out-of-class pay leading to various problems including improper payment calculations for individuals.

- Personal leave program hours were inappropriately given to individuals on non-industrial disability insurance.
- Retired annuitants and various other non-permanent employees exceeded the number of hours allowed per year.

Department of Finance Office o f St ate Audits and E valuations (OSAE). The OSAE conducted an audit of the Parks Administrative Services Division to (1) determine the ending fund balances of both SPRF and OHV fund, (2) assess if key internal controls over the other funds are in place, and (3) assess if key internal controls are in place over procurement activities. In general, the audit found that the department must improve its accountability, transparency and communication to restore trust with the public, their partners and internally within the department. The audit recommends a corrective action plan to address its key findings. The audit determined:

- The governance structure over budgeting functions needs to be strengthened
- Risks over State Park Contingent Fund exists.
- Key internal controls over procurement activities need improvement.

Bureau of State Audits. The Legislature requested a more comprehensive audit by the Bureau of State Audit (BSA) that is due in February 2013. This audit is intended to address both the vacation buyout program, staffing decisions at the department, revenue and reserve balances, and reasons for misreporting to the Legislature. The report is intended to provide the Legislature with an independent and objective review of the department's overall management shortcomings, and provide recommendations for action that can be implemented.

ISSUES TO CONSIDER:

Funding shifts and funding increases mask a challenged budget environment. Over the past five years, the department has shifted its main source of funding from the General Fund to the State Parks and Recreation Fund (SPRF). On paper, this means that the department's spending power has effectively remained the same between these two funding sources since 2008-09. In fact, with other sources of funding, the department's overall budget has grown from $367 million to $432 million. Even excluding one-time bond expenditures, the budget has grown about 18 percent in the past several years. Much of this growth can be attributed to other funding sources including increased reimbursements, increases in the Off-Highway Vehicle Trust Fund, and other dedicated funding sources for specific purposes.

State Parks and Recreation Funding 2008-09 to 2012-13
(dollars in thousands)

	2009-10	2010-11	2011-12	2012-13	2013-14
General Fund	$120,720	$117,458	$121,219	$110,591	$114,552
State Parks and Recreation Fund	118,080	114,339	136,014	148,146	130,263
Other Funds	127,286	130,313	148,023	245,505*	229,383
Subtotal	**$366,086**	**$362,110**	**$405,256**	**$504,242**	**$474,198**
Bond Funds (One-Time)	40,542	116,243	255,309	275,452	17,131
Total (including bond funds)	**$406,628**	**$478,353**	**$660,565**	**$779,694**	**$491,329**

*Reflects the merger of the Department of Boating and Waterways into the Department of Parks and Recreation.

Parks Infrastructure Costs Are Increasing With An Aging System. During the time of the budget increases, costs to run state parks have also increased. Many state parks are over 50 years old and have an aging infrastructure, much like our state levees and wastewater infrastructures. Decades old septic systems designed for lower visitor usage are being put to the test and, in many cases, failing and requiring more and more costly repairs to maintain. Additionally, as we increase fees for park visitors, those visitors expect amenities that are reflective of an increased cost to use the park. Even such basics as flushing toilets and garbage service have increased in cost.

Revenue Generation Only as Good as Parks Makes It. The legislative discussion both before and after the summer revelations at the department focused on making the department more self-sustaining, and modernizing its revenue management. For example, small changes such as accepting credit cards at state parks, allowing for hourly parking at state beaches, and simply collecting revenue at popular state parks had been elusive for some time. The Legislature created a series of incentives for local districts to creatively approach revenue generation in ways that would not be prohibitive to visitors, while at the same time providing needed funding to enhance the visitor experience. Because this is a big shift in the way Parks conducts itself, the Legislature should continue to oversee how these funds are collected and used, and determined whether or not the department's districts embrace a new entrepreneurial spirit needed to keep Parks open.

Individual Parks Still Costing the State. As an example of increased costs, the Empire Mine State Park has cost the state $36 million over the past six years due to toxic runoff from the mining operation conducted there over 50 years ago. The park was a gold mine for 100 years until it closed in 1956. The state acquired the property in Grass Valley, with more than 850 acres of forested land, mine buildings, and historic properties in 1975. The state park was the subject of a series of lawsuits and cleanup and abatement orders related to the park's 367 miles of abandoned and flooded mine shafts and toxic legacy from gold mining. The rulings required the state to clean up toxic runoff from the gold mining legacy. The state has been in negotiations with the former owner over the cleanup since the orders were issued; however according to the latest budget proposal, mediation has stalled while cleanup is still required. This year's budget includes again a $5.2 million General Fund allocation to this park.

A New Park Funding Obligation Has Arisen at Border Fields State Park. The department requests a $1.1 million ongoing augmentation from the State Parks and Recreation Fund to fund trash cleanup in the Goat Canyon area of the park, originating mainly from Mexico through the Tijuana River. Visitation to this park reached 45,000 in 2010, however less than 5,000 visitors paid for entrance to the park. In addition, the majority of the visitors did not visit Goat Canyon but rather the beach areas that have direct access to the California-Mexico border. A nearby nature preserve also is served by visitors to the State Park system. Periodic funding has been allocated from other sources over time for cleanup but this is the first time the administration has proposed an ongoing program for the park. The question remains, if the state was on the verge of having to close state parks due to ongoing funding problems, what is the impact of expending $1.1 million annually from the Parks budget for this purpose?

Is it Time to Review The Size Of The State Parks System in a Meaningful Way? The vast majority of state parks have strong visitation or a clear cultural value to the state. However, one outcome of the administration's proposal to close state parks is the idea that some state parks would be better served by other public entities, either through their local park systems, federal park and land management, or through some type of public or nonprofit management. Even those parks with high visitation might be eligible for a type of realignment of parks. The administration's proposal from 2011 lacked the in-depth review and transparency necessary to open such a dialogue. At times, the Legislature was blindsided by announcements of park closures just hours after public hearings where such closures plans were directly requested by elected officials. Given the department's new management focus, a deliberate dialogue on the size and type of the State Park system would be in order.

Groundwater and Drinking Water Cleanup

BACKGROUND:

Funding for Groundwater and Drinking Water Cleanup. Over the past several years, the Legislature has focused oversight efforts on the provision of safe drinking water throughout the state, and in particular to small, disadvantaged communities mainly in rural areas. The 1969 Porter-Cologne Water Quality Act established the state's role in the protection of water quality and was followed by various groundwater and drinking water protection laws throughout the following decades. The Legislature, starting in 2008, has held numerous oversight hearings discussing groundwater and drinking water legislation, with a focus on providing clean drinking water, and looking at the root causes of water quality degradation. The conclusion of these hearings, as well as various reports, is that the majority of water supply in California is safe and clean. However, where there are gaps in some areas, the provision of water is a challenge, particularly in small, disadvantaged and rural communities.

Chapter 1, Statutes of 2008 (SBx2 1, Perata), required the State Water Resources Control Board (State Board), in consultation with other agencies, to prepare a report to the Legislature to outlining the causes of groundwater contamination and identifying potential remediation solutions and funding sources to recover state costs of providing clean drinking water to all communities. This report, prepared by UC Davis researchers, provides the basis for much of the groundwater and drinking water discussion this year. In addition, Chapter 685, Statutes of 2012 (AB 685, Eng) declares that it is the established policy of the state that every human have the right to water for domestic uses. The bill requires state agencies to consider this as they move forward with water policies in the future. The Legislative Analyst's Office, Senate Office of Research and UC Davis all provide a good background for this budget discussion, which are summarized in this analysis.

The Groundwater-Drinking Water Connection. Throughout the state, groundwater supplies all or part of the water supply for public water systems. In any given year, groundwater may contribute between 20 and 40 percent of the state's water supply. However in many communities where surface water (rivers and streams) are not accessible or economically feasible, groundwater provides 100 percent of a community's water supply. Nearly half of all Californian's obtain at least some of their water from groundwater.

What is A Small, Disadvantaged Community? For the purposes of state water programs, a small disadvantaged community (SDAC) is a community with a population of less than 20,000 persons and a median household income of less than 80 percent of the statewide median. The challenges SDACs face in implementing wastewater projects generally result from a lack of adequate local monetary resources, combined with insufficient access to technical expertise. Due to their small rate base, SDACs lack the economies of scale to build and maintain adequate water systems. They are also commonly located in rural, sparsely-populated areas, that require greater pipeline and pumping infrastructure. Many SDACs are on failing septic systems or have old and undersized wastewater treatment plants that cannot meet current water quality standards.

Some residents are even forced to discharge wash water directly onto their lawns and/or experience sewage overflowing into their houses and yards. Such systems can cause significant health and safety problems, endanger surface water uses, and pose a threat to groundwater supplies.

State Agencies Involved with Groundwater/Drinking Water

Department	Key Water Quality Responsibilities
Department of Public Health	• Enforces the federal and state safe drinking-water acts. • Ensures the quality of the state's drinking water from the point where water is pumped from a drinking water well or surface water intake point.
California State Water Resources Control Board and Regional Water Quality Control Boards	• Protects the quality of surface water and groundwater to the point where the water enters a drinking water well or surface water intake point.
California Department of Pesticide Regulation	• Develops mitigation measures to prevent pesticide contamination of groundwater and surface water.
California Department of Toxic Substances Control	• Ensures that groundwater at toxic sites is monitored and remediated.
Office of Environmental Health Hazard Assessment	• Performs health risk assessments related to setting drinking water standards.
California Public Utilities Commission	• Ensures that customers of regulated water utilities receive reliable service.
Delta Stewardship Council	• Improves Sacramento–San Joaquin Delta water quality for drinking, agriculture, the environment, and Delta species.

Source: Senate Office of Research, 2011

What Happens When Groundw ater is Contaminated? Groundwater can be an inexpensive water source. However, discovery of contamination in a drinking water well often leads to closure of the well. In areas where other sources of water or alternate groundwater resources are not available, bottled water may be the only available water supply. In 2007, approximately 1.5 million California residents –4 percent of the population that gets water from public water systems—received water from a system that had a monitoring or reporting violation under the Safe Drinking Water Act. In the Tulare Lake Basin and Salinas Valley, both subject of an intensive analysis of water pollution, about 254,000 people are at risk for nitrate contamination of their drinking water. The Department of Public Health reported that nitrate was detected in 921 public drinking water wells, mostly in agricultural areas, prior to a 2008 hearing.

According to a 2008 LAO report, cleaning up groundwater can be very expensive. For example, the Underground Storage Tank (UST) Cleanup Fund was established in 1989 to provide financial assistance to owners and operators of USTs containing petroleum to remediate conditions caused by leaking USTs—which include contamination of groundwater supplies. Annual expenditures have varied between $180 million to $289 million in the ten years prior to 2008, and individual site cleanups have reached as much as $1.5 million. In some cases, where contamination is too severe, the groundwater supply is completely lost and the only solution is to either seal the groundwater basin or to "pump and treat"—meaning removing the water from the basin, treating it and discharging into another water system. Groundwater systems with this type of contamination generally remain out of service for drinking water purposes in perpetuity.

Why Focus on Nitrates? Groundwater use is prevalent throughout California but no more so than in the Central Valley and rural agricultural areas where more than 85 percent of community public water systems rely on groundwater for at least part of their drinking water supply. According to the UC Davis report, nitrate is one of California's most widespread groundwater contaminants. This is in part because many rural areas get water from shallow wells. These wells in turn are contaminated by both household wastewater and agricultural runoff. While nitrogen is part of the natural environmental cycle, it is also key to food production and is a major component in commercial fertilizers. Because of this, nitrate concentrations have increased and continue to do so, particularly in rural areas. Too much nitrogen in drinking water can cause many human health problems, particularly in infants and children.

Historical Funding of Groundw ater and Drinking Water Programs. Regulation of water quality, both drinking water and source water (such as groundwater) has historically been paid for by the general public, mainly through fees to public and private water and wastewater providers. A portion of these fees are used by the state to regulate, monitor and clean up water quality. The Federal government also provides between $5 and $10 million per year for water quality programs, mainly through federally authorized revolving loan funds that provide low or no-interest loans for infrastructure investments at the Department of Public Health (DPH) and the State Board. Funding for individual cleanups are generally ordered by a court and can reach millions of dollars paid either by responsible parties or by the government, where no responsible party can be found.

Options for Funding Groundw ater Cleanup in Small, Disadvantaged Communities . The UC Davis study on nitrates in drinking water recommended several options for funding water quality improvements. Recognizing that nitrates are a primary source of ongoing and legacy contamination, of water quality in these systems, the report provides a series of options to fund both groundwater cleanup and safe drinking water systems in areas with nitrate water contamination. These include fixed fees on drinking water, groundwater pumping fees, fertilizer taxes, property taxes and fees on bottled water. Each option has advantages and disadvantages, and each varies in the direct incentive to reduce nitrates.

GOVERNOR'S PROPOSAL:

No Comprehensive Proposal. The Governor's budget does not include a formal proposal for comprehensive funding for small, disadvantaged community water systems. The Administration intends to recommend efficiencies and alignments to ensure access to safer water. While no timetable has been set, the budget states that the State Board will recommend potential funding mechanisms to provide disadvantaged communities with safe, affordable, and reliable drinking water. Stakeholders will be consulted in the development of a proposal to improve the administration of water programs and implement sustainable funding mechanisms.

Small Community Grant Program. The budget also includes a proposal to augment $7 million in local assistance authority for the State Water Pollution Control Revolving Fund Small Community Grant Fund (Grant Fund). This fund is designed to assist small disadvantaged communities with their wastewater infrastructure needs. The grant fund was established in 2008 through an annual charge on financial agreements in lieu of interest. These charges are anticipated to collect about $7.1 million in the budget year and supplement bond funds that were appropriated by the Legislature in previous years. New bond funds designated for SDAC wastewater projects have not been approved since 2002.

In recognition of the repayment challenges facing SDACs, Legislature and water boards allowed for principal forgiveness funds, which are similar to grant funds, within the Clean Water State Revolving Fund program in 2009. This was in conjunction with an influx of funds from the American Recovery and Reinvestment Act (ARRA) program. Principal forgiveness and grant funding for SDAC Wastewater project demand is mainly for upfront planning costs to get projects moving forward with construction. The state board encourages the use of the funds in order to prevent enforcement actions for non-compliance in these water systems, and to help SDACs develop long-term wastewater system development.

ISSUES TO CONSIDER:

Action on Small Disadvantaged Communities. Given the number of reports on SDACs and the comprehensive analysis provided by the UC Davis nitrate report, the Legislature should have enough information to begin a discussion of policy and funding options. The complexity of the issue will necessitate both a budget and policy response. Several issues to consider include:

- Should smaller community water and wastewater systems be required to combine in order to achieve greater efficiency of service?
- Should the Legislature restrict nitrate contamination in rural areas further than it has already done, and if so, what would be the impact to these communities?
- If it is possible to treat nitrate contaminated water, what funding mechanism provides the most options for comprehensive water quality solutions with the least financial impact?

Shifting Drinking Wat er to the Water Boa rd. Though the budget does not specifically address this issue, there are hints that the Administration is considering a shift that would the

DPH drinking water programs under the State Board's jurisdiction. This would allow for the combination of the two federally funded infrastructure loan programs (drinking water and wastewater), and could bring efficiencies in the administration of water programs, particularly in rural areas. SB 117 (Rubio), introduced this year, would transfer the various duties and responsibilities imposed on the DPH by the California Safe Drinking Water Act to the State Board and make conforming changes.

Energy Efficiency Programs

BACKGROUND:

During the 2012 session, the Legislature considered multiple policy and budget proposals to increase energy efficiency and its funding. These included an administration proposal to reinstate the Public Goods Charge through a California Public Utilities Commission (CPUC) rulemaking process (discussed below under the Electricity Procurement Investment Charge header), various greenhouse gas emission reduction programs that target energy programs, and renewable energy bills.

Given what seemed to be an abundance of existing energy-efficiency programs, the 2012 budget required the LAO to review energy efficiency programs throughout state government and to provide both (1) a list of all programs and funding related to energy efficiency and alternative energy, and (2) provide a preliminary assessment of these programs in terms of priority, overlap, and redundancy. The LAO report is partially summarized in this analysis on current energy efficiency budget issues.

Summary of State Energy Efficiency and Alternative Energy Programs

Program Category	2012-13	Cumulative Funding to Date
Energy Efficiency (Investor Owned Utility, federal funding and state financing programs)	$1 billion	$9.5 billion
Renewable Energy (Public Interest Renewable Energy Program, Go Solar California Program, Self-Generation Incentive Program, And Clean Energy Upgrade Financing Program	$317 million	$4.2 billion
Advanced Transportation and Low-Carbon Fuels	$250 million	$683 million
Energy Research	$44 million	$556 million
Totals	**$1.6 billion**	**$15 billion**

a) Source: Legislative Analyst's Office, 2012

In no less than 10 separate programs and spanning five state departments, over $1.6 billion was spent directly on energy efficiency and alternative energy programs. Cumulatively to date nearly $15 million has been spent by the state. The vast majority of funding for these programs comes from utility ratepayers. Most of these programs are located in three state departments: the CPUC, the California Energy Resource Conservation and Development Commission (CEC), and the California Alternative Energy and Advanced Transportation Authority.

NEW PROGRAMS AND THE BIGGER PICTURE:

Cap and Trade Funding. In the near future, new funding will be available to support programs as a result of the state's cap-and-trade auctions, a tool to reduce greenhouse gas emissions (GHG). As part of the Global Warming Solutions Act of 2006, commonly referred to as AB 32, the goal of reducing greenhouse gas emissions to 1990 levels by 2020 was established in statute. AB 32 revenues generated from the auctions constitute a mitigation fee, a nexus must exist between an activity for which the fee is paid and the adverse effects related to the activity on which that fee is levied. Therefore, in order for their use to be valid as mitigation fees, revenues from cap-and-trade auctions must be used only to mitigate GHG emissions or the harms caused by these emissions. A number of the existing energy efficiency and alternative energy programs currently also have a focus on GHG emission reductions. It is conceivable that the new auction revenues could either supplant or be used in addition to funding for these existing programs. The Governor has not released his expenditure plan for auction credits and therefore it is unknown what the budget proposals may entail.

Proposition 39, passed in November 2012, eliminates the ability of multi-state businesses to choose the way in which their taxable income is determined. As a result, some corporations will pay higher taxes, resulting in projected revenues of $1 billion per year. Under the measure, half the annual revenues—up to $550 million—will be deposited into a new Clean Energy Job Creation Fund to support projects intended to improve energy efficiency and expand the use of alternative energy for a five year period (2013-14 through 2017-18). The Legislature will determine spending from the fund and is required to use the monies for cost-effective projects run by agencies with expertise in managing energy projects. These projects must also be coordinated with the CEC, CPUC, and with a newly established nine-member oversight board to annually review spending from the program. Proposition 39 requires funds to be used to support:

- Energy efficiency retrofits and alternative energy projects in public schools, colleges, universities, and other public facilities;
- Finance and technical assistance for energy retrofits; and,
- Job training and workforce development related to energy efficiency and alternative energy.

Why State Program Funding is Not the Whole Picture. One cannot review energy efficiency in the state solely on the basis of state-funded programs. In addition to programs where funding is managed through state agencies, other actions and agencies impact our state's overall energy efficiency and may have had even more profound effects. For example, the both the state and federal government have building standards that reduce energy usage in all new construction. Appliances have minimum energy standards and a federal "energy star" program that allows consumers to compare and choose energy efficient products. Commercial buildings, outdoor lighting and many other areas of energy are regulated by both state and local agencies. In many cases, locals may go further than the state. Local water and energy utilities (those local entities that provide water and energy directly to customers), also have programs designed to reduce energy usage—including many programs independently not managed by the state.

GOVERNOR'S PROPOSAL:

Proposition 39. The Governor's budget includes all of the revenue derived from proposition 39 in the calculation of the education Proposition 98 minimum guarantee. The budget proposes to use that funding for energy efficiency projects at schools and community colleges. We discuss this proposition in greater detail under in the K-14 Education section.

Electricity Procurement Investme nt Charge (EPIC) Background. In December 2011, funding for the state's Public Goods Charge (PGC) on electricity ratepayers expired. The PGC funded energy efficiency research and development and renewable energy programs. Efforts to continue the surcharge, which requires a 2/3 vote of the Legislature failed. The charge, considered a tax for voting purposes, supported about a quarter of the total energy efficiency programs funded by the state and energy utilities.

In September 2011, the Governor sent a letter to the CPUC requesting that they take action under to ensure that programs, like those funded under the PGC, would be continued, but with the modifications legislators discussed during the PGC renewal deliberations. In December 2011, the CPUC initiated a rulemaking (essentially started a pathway to a new policy) continue the programs similar to PGC with a sole focus on the investor-owned utilities (IOUs). The Commission planned a two-phased deliberation. The first phase addressed the appropriate funding levels for renewables and research and development. The second phase, currently under way, creates a detailed program.

2012 Budget Action. In the 2012 Budget, the Legislature approved $1 million from the EPIC and 4.5 positions specifically to complete an investment plan for the future appropriations from this charge established by the CPUC (and also described above) in the 2012 budget. Considerable thought was given to this appropriation given it was established administratively. Specifically the Budget Trailer bill requires the CPUC to administer the fund, and funds are required to be collected by the CPUC and forwarded to the CEC for administration. The budget trailer bill specifically did not authorize the levy of this charge at the CPUC or increase the amount collected for an existing charge.

Governors 2013-14 EPIC Proposal . The Governor requests baseline authority for 55.5 position, $575,000 in technical assistance funds and $159.3 million in project funds for the implementation and execution of the EPIC program. The proposal includes an additional $25 million in EPIC Funds the CPUC may approve for the New Solar Homes Partnership program. Proposed expenditures would roughly be broken out with $76 million for applied research, $62 million for demonstration and deployment, and $20 million for market facilitation. All funding for the programs would be derived from utility ratepayers. The program would increase to $185 million in 2014-15.

The proposal continues to assume that the EPIC Program will be developed fully by the CPUC who would then direct the CEC programs related to EPIC. The Legislature would essentially be approving programs already developed by the CPUC. In addition, the CPUC could also develop programs and activities by the investor-owned utilities that would not be subject to legislative budgetary review.

ISSUES TO CONSIDER:

LAO Analysis and Rec ommendations. The LAO reviewed the various energy efficiency and alternative energy programs for overlap and coordination issues. They recommend a comprehensive strategy be developed that: (1) avoids program duplication, particularly where departments have overlapping jurisdiction; (2) align programs with legislative priorities, including those the CPUC administers for investor-owned utilities; (3) measures program effectiveness across the state agencies.

The LAO has made a strong case for development of unified energy efficiency and alternative energy policies. The lack of coordination makes it difficult to determine where scarce resources should be directed, and how much a given ratepayer should pay. This also sets up an unbalanced ratepayer system wherein those in investor-owned utilities ratepayer areas pay into a statewide program while those in other areas, such as those in publicly owned utilities ratepayer areas do not. The Legislature should consider policy before budget, and should determine which activities should be funded by clarifying statute before budget actions take place.

Proposition 39 Proposal Energy Efficiency Gains Unclear. As we discuss in the Proposition 39 section under K-14 Education, Proposition 39 energy efficiency funding is proposed to be allocated on a per-pupil basis, with no regard for energy efficiency needs or current energy efficiency investments. The Legislature should consider whether this reflects the ballot analysis submitted to the voters, and whether or not this meets the Legislature's intent for energy efficiency programs in schools statewide.

EPIC Program—Legislative Involvement Needed? The state currently spends over $1 billion per year on energy efficiency programs, most of this derived directly from utility ratepayers. In developing the EPIC Program at the CPUC, the administration purposefully bypassed the Legislature after the failed reauthorization of the Energy Public Goods Charge. The Legislature should consider whether or not the CPUC is the appropriate place to allow new policies to be developed, including those that increase costs to energy customers in the state. Is it appropriate for one state agency to develop programs for another state agency without statutory approval by the Legislature? If so, what would stop the CPUC from developing any number of off-budget activities without statutory approval?

The EPIC program continues funding for activities that were authorized by two-thirds vote of the state Legislature. As such, funding could be used as a tax for basic activities such as research and development. This new program did not have such an authorization. The CPUC and CEC should describe the nexus between the program activities and fee payers based on fee versus tax related case law. The administration also has not submitted a plan for proposed expenditures under the EPIC program as required by the 2012 budget. Therefore there is little review for the budget change proposal.

Transportation

BACKGROUND:

After several years during which the state made significant changes to its transportation financing mechanisms in order to respond to the economic downturn and resulting budget shortfalls, the current year is a period of relative status quo. The overall level of revenue available to fund transportation remained relatively stable. However, going forward, structural changes at both the federal and state levels—specifically, enactment of the Moving Ahead for Progress in the 21st Century Act (MAP-21) by Congress in July 2012 and the 2012 Governor's Reorganization Plan (GRP)—may impact the way in which the state prioritizes, funds and delivers transportation projects. At the same time, the depletion of certain one-time funding, most significantly that from the federal American Recovery and Reinvestment Act (ARRA) and the Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006 (Prop 1B), mean that on the current trajectory, the state is headed toward a period of constrained resources for transportation needs.

In 2011, the California Transportation Commission (CTC) completed a Statewide Transportation System Needs Assessment which forecast that, over the next ten years the state is expected to receive or generate approximately $240 billion ($24 billion/year) from all federal, state and local sources. While significant, this amount represents less than half of the projected $536 billion needed to adequately maintain and invest in the transportation system, excluding High-Speed Rail (HSR) capital needs. The funding described in this section relates to state highways, local roads, mass transit, and vehicle safety and regulation. HSR funding is excluded from this section as it is discussed separately in a subsequent section of the *Overview*.

Overview of Transportation Funding for California

Transportation in California is funded from multiple sources at the federal, state, and local level. State departments funded with this revenue include the Department of Transportation (Caltrans), the California Highway Patrol (CHP), and the Department of Motor Vehicles (DMV), as well as the CTC.

Major Sources of Transportation Funding
Fiscal Year 2013-14
(Dollars in Billions)

Funding Source	Annual Amount	Comments
Local Revenues	$13.0	Includes locally-imposed revenues such as add-on sales tax, property tax, developer fees, and transit fares. Some used to reimburse Caltrans for locally supported work on the State Highway System).
Federal Revenues	$4.5	Primarily consists of federal gas tax revenue (18.4 cents/gallon but augmented by General Fund in MAP-21. Includes funds for both highways (Caltrans funds) and transit (local agency funds).
State gasoline and diesel excise tax	$5.7	Allocated to the state and local governments from the 36 cent state gasoline excise tax and 10 cent diesel excise tax.
Fees on cars and drivers	$2.9	Primarily from vehicle registration and driver licenses. Supports the operations of the DMV, CHP and Air Resources Board.
Truck weight fees	$0.9	Revenue primarily supports debt service and interest on transportation-related general obligation bonds.
Diesel sales tax	$0.6	Primarily supports local transit operators.
GO bonds	$2.9	State general obligation bonds, primarily from Prop 1B.
Total $30.5		

Transportation Agency
The 2012 GRP establishes a new agency focused on transportation. The new agency, which formally becomes operational July 1, 2013, includes the three transportation members of the old Business, Transportation and Housing Agency (Caltrans, CHP and DMV), along with CTC, High Speed Rail Authority, the Board of Pilot Commissioners, and the Office of Traffic Safety. The formation of this new agency may signal the Administration's intent to concentrate attention on addressing transportation needs. The Governor's Budget indicates the agency will convene a state/local stakeholder workgroup to further define and prioritize the state's infrastructure needs and to develop long-term funding solutions. An additional impact of the reorganization may be increased coordination among members of the new agency that could lead to increased efficiencies and cost savings.

Federal Funding—MAP-21
The new federal Surface Transportation Act, MAP-21, signed into law July 6, 2012, represents the most significant overhaul of federal surface transportation policy since the Intermodal Surface Transportation Efficiency Act (ISTEA) in 1991. Since that time there have been two multi-year transportation acts, the Transportation Efficiency Act for the 21st Century (TEA-21) in 1999 and the Safe, Accountable, Flexible, Efficient Transportation Equity Act-A Legacy for

Users (SAFETEA-LU) in 2005. However, both of those measures largely built on the ISTEA framework and neither implemented major structural change.

In contrast, by any measure MAP-21 represents a major structural shift. The measure consolidates the total number of program funding streams from more than 100 to six core programs, and simultaneously increases flexibility in the use of the funding. The Act does NOT, however, significantly change the total amount of federal funding available to the state. MAP-21 also requires the Federal Highway Administration (FHWA) to establish various performance measures that will be used to evaluate states' progress toward various goals, such as pavement condition and collision/fatality reduction. However, many of these performance measures are not expected to be available until sometime in 2014.

Under MAP-21, California is slated to receive an estimated $3.5 billion in total federal apportionments for federal fiscal year (FFY) 2013, which began October 1, 2012. This is approximately equal to the FFY 2012 level and represents nearly 9.5 percent of the national total. In addition, local transit agencies in California will, cumulatively, receive approximately $1.0 billion in federal apportionments. The state is expected to receive a similar level of apportionments in FFY 2014. However, unlike prior surface transportation bills, which typically cover five or six FFYs, MAP-21 is a two-year bill, meaning that anticipated federal funding levels beyond FFY 2014 are uncertain. In recent years, revenues into the federal Highway Trust Fund (FHTF)—the primary source of federal transportation funding—have declined to the point that they are insufficient to support existing funding levels. In order to sustain 2012 funding levels in MAP-21, Congress authorized an $18.8 billion General Fund augmentation to the FHTF. Should Congress fail to enact a solution to address this structural funding gap, California (along with other states) could face a substantial drop in federal funding as soon as FFY 2015.

Historically, federal Surface Transportation Act funding in California has been split between the state and locals with the state receiving approximately 63 percent state of overall funding and the locals 37 percent. With the consolidation of funding into six core programs, the Administration, in fall 2012, proposed maintaining this overall split for FFY 2013, in order not to impact ongoing funding for previously programmed projects. The Administration also determined that despite the consolidation, no immediate changes to state law would be required to implement this status quo scenario.

Under MAP-21, the six core programs (with FFY 2013 apportionments) include the following:

- **National Highway Performance Program ($1 .9 billion).** This new program contains elements of several prior programs, including the old Interstate Maintenance, National Highway System and highway bridge programs. Historically, these funds have remained primarily under state control. They represent the primary funding source for State Highway System (SHS) maintenance and rehabilitation.
- **Surface Transportation Program ($873 million).** This flexible program can be used by the state or local agencies to fund virtually any federally eligible transportation improvement. Historically, these funds have been split between state and local control. Under SAFETEA-LU, that split was 62.5 percent local and 37.5 percent state. MAP-21

specifically requires that 15 percent of these funds be spent on 'off system' (non-national highway system) bridges.

- **Congestion Mitigation/Air Quality (CMQA) Program ($445 million).** This program, which is largely unchanged from prior transportation acts, funds projects to meet the requirements of the Clean Air Act. Only certain regions qualify for CMAQ funds based on air quality non-attainment factors. State law subvents all CMAQ funds to local agencies based on formulas prescribed in prior federal law.
- **Highway Safety Improvement Program ($209 million).** This program funds improvements to reduce highway fatalities and serious injuries. Project eligibility must be based on data driven criteria. Historically, California has split these funds approximately evenly between state and local projects consistent with intent language in state law.
- **Transportation Alternatives ($72 million).** This program resulted from the consolidation of several smaller programs from prior federal bills, including "Transportation Enhancements," Recreational Trails, Safe Routes to School and other alternative transportation programs. However, the program is roughly 30 percent smaller than the combined size of those programs.
- **Metropolitan Planning ($48 million).** This program is administered by Caltrans' Division of Planning and funds are apportioned to Metropolitan Planning Organizations (MPOs) by formula.

State Transportation Funding

The Governor's Budget notes that over the past decade voters approved nearly $30 billion of GO bonds for transportation purposes, including a maximum of $19.9 billion for various specified purposes as part of the Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006 (Prop 1B), which includes $9.9 billion in funds from the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century. Debt service on these bonds is expected to exceed $1 billion in FY 2013-14 and will continue to increase in future years as more of the bonds are sold.

In part to address these expanding debt service obligations in a time of severe budget stress, in 2010 the state enacted a statutory mechanism, commonly termed the gas tax swap, to increase flexibility in the expenditure of state transportation funding. This mechanism, outlined more fully in the *Overview of the 2012-13 Budget Bill*, was devised as a revenue-neutral solution that enables the use of transportation funds to service transportation-related GO bonds. Prior to the swap, that funding was tied to specific types of new projects. Passage of Proposition 22 in November 2010 forced the Legislature to re-enact the swap in early 2011 in a somewhat different form in order to conform to new constitutional requirements. The result, however, is largely consistent with the prior action, in that the state directs approximately $900 million in transportation funds (truck weight fee revenue) to GO bond debt service.

A second budget solution beyond dedication of weight fees to debt service, also enacted in 2010-11, redirects miscellaneous transportation revenue, such as rental income and revenue from the sale of surplus property, to partially offset transportation-related debt service. Previously, these miscellaneous funds had flowed from the State Highway Account (SHA) to the Public Transportation Account (PTA) and eventually become available for transit related capital improvement purposes through the State Transportation Improvement Program (STIP). However, with the state facing severe General Fund budget cuts, these funds were redirected to debt service. Under current law, this redirection, which totals approximately $67 million annually, is slated to sunset at the end of FY 2012-13, after which the funds would flow back to the PTA.

The state will continue to service this debt for the foreseeable future; however, the vast majority of Prop 1B funding, including virtually all funds for state highway projects, is already committed to projects and will be expended within the next few years as these projects are completed. In addition, the 2009 ARRA funding, a one-time source, will also have been largely expended. Thus, without identification of additional revenues, the state can anticipate a significant reduction in volume of funded projects within the next few years. A breakdown of current Prop 1B funding is presented in the following table.

Proposition 1B Bond Funding
(Dollars in Thousands)

Category	Amount	Allocated	Unallocated	Budget
Corridor Mobility Improvement Account (CMIA)	$4,500,000	$4,489,707	$10,293	Caltrans
Route 99 Corridor Account (Rte 99)	$1,000,000	$995,542	$4,458	Caltrans
Trade Corridors Improvement Fund (TCIF)	$2,000,000	$2,000,000	$0	Caltrans
State Transportation Improvement Program (STIP) Augmentation	$2,000,000	$2,000,000	$0	Caltrans
State Highway Operations and Protection Program (SHOPP)	$500,000	$500,000	$0	Caltrans
Traffic Light Synchronization	$250,000	$250,000	$0	Caltrans
State-Local Partnership Program Account	$1,000,000	$358,300	$641,700	Caltrans
Local Bridge Seismic Retrofit Account	$125,000	$125,000	$0	Caltrans
Highway-Railroad Crossing Safety Account	$250,000	$250,000	$0	Caltrans
Intercity Rail Improvement	$400,000	$400,000	$0	Caltrans
Public Transportation Modernization, Improvement, and Service Enhancement Account	$3,600,000	$1,897,097	$1,702,903	State Transit Assistance
Local Street and Road, Congestion Relief, and Traffic Safety Account of 2006	$2,000,000	$998,791	$1,001,209	Shared Revenues
Goods Movement Emission Reduction Program	$1,000,000	$461,000	$539,000	Air Resources Board
School Bus Retrofit and Replacement Account	$200,000	$200,000	$0	Air Resources Board
Port, Harbor, and Ferry Terminal Security Account	$100,000	$100,000	$0	Office of Emergency Services
Transit System Safety, Security & Disaster Response Account	$1,000,000	$400,000	$600,000	Office of Emergency Services
Total	**$19,925,000**	**$15,425,437**	**$4,499,563**	

GOVERNOR'S PROPOSAL:

For the second year in a row, the Governor's Budget does not include any significant changes in the way transportation is financed. Funding for the core transportation agencies and programs remains relatively stable. The decline (excluding debt service), from $17.2 billion in current year expenditures to a projected $16.6 billion in the budget year, appears to reflect in part, a significant decline in Proposition 1B funding, specifically from the Corridor Mobility Improvement Account. This is certainly a precursor to expected future declines as this one-time revenue source is expended.

MAP-21
While MAP-21 purports to streamline the flow of federal funds to states and increase flexibility in states' use of that funding, the Governor's Budget proposes to maintain the status quo, at least in terms of the overall federal funding split between the state and local transportation agencies. Because MAP-21 doesn't represent any actual increase in funding, the budget intends to ensure that existing projects already scheduled for construction either by state or local entities, are not adversely impacted. Other than creation of the Active Transportation Program (ATP), discussed below, which would affect the distribution of some federal funds, the budget does not propose any policy changes in this area.

Active Transportation Program
The Governor's Budget proposes creation of the Active Transportation Program (ATP). ATP would represent the consolidation of five existing programs into a single $134.2 million program. The five programs to be consolidated include the federal Transportation Alternatives program (from MAP-21), which includes the Recreational Trails program, the state and federal Safe Routes to School Programs, the state Environmental Enhancement and Mitigation (EEM) Program, and the state Bicycle Transportation Account (BTA). By consolidating these small funding pots into a new larger program, this proposal seeks to enhance the profile of active transportation projects, defined as any method of travel that is human-powered. It also seeks to increase program efficiency by eliminating the need to administer these programs individually and to focus funding on high-priority projects to reduce greenhouse gas emissions, consistent with the objectives of Chapter 728, Statutes of 2008 (SB 375). Consistent with this approach, the budget eliminates five staff positions within Caltrans currently associated with administration of these programs.

The proposal seeks to achieve efficiency through creation of a single set of program guidelines and a single application and project selection process through which the 'best projects' among all eligible categories would be identified and funded. However, it is important to note that while the existing component programs certainly have common elements, each has particular goals and objectives. For example, Safe Routes to School has the twin goals of <u>both</u> increasing the number of K-12 students walking or biking to school <u>and</u> improving safety for those students who do so. In contrast, BTA focuses primarily on improving safety and accessibility for existing bicycle commuters. While improved facilities may incentivize new bicyclists, this is neither the purpose of the BTA nor one of its measured outcomes.

Miscellaneous Revenues Used for Debt Service
The Governor's Budget also proposes to make permanent the annual transfer of miscellaneous transportation revenue, such as rental income and the sale of surplus property, from the SHA to partially offset the cost of servicing transportation-related general obligation bond debt. As noted above, this provision is scheduled to sunset after FY 2012-13, after which these funds would flow through the PTA and eventually be available to fund transit-related capital projects through the STIP.

Zero-Base Budgeting—Restructuring of Caltrans Programs
Pursuant to Executive Order, the Department of Finance (DOF) is currently engaged in a multi-year efficiency review of Caltrans programs which, during 2012, included review of the Divisions of Planning and Local Assistance. This review identified a reduction of 20 positions and savings of $1.5 million associated with various efficiency measures within Local Assistance. Within the Division of Planning, DOF identified the need for an $8.4 million increase along with 10 positions to address increased workload and to implement efficiency measures, at least in the short term. Part of this effort involves streamlining and standardizing the department's planning documents. It also involves an audit to ensure that workload tasks and charging practices are fully captured. Following this evaluation, the program will be reevaluated.

ISSUES TO CONSIDER:

MAP-21
Through consolidation of more than 100 federal funding streams into six core programs with significantly increased flexibility, MAP-21 may afford California an opportunity to examine its funding priorities and ensure that the state is using its transportation funds on the most critical priorities. While heeding the caution that MAP-21 does not provide any additional revenue, and thus any spending increase in one area necessarily would require a reduction to existing programs or projects, the Legislature may wish to explore whether some restructuring or reprioritizing may be desirable. In some cases it may be prudent to wait until FHWA releases the performance measures that will drive the prioritization and use of federal funds going forward. However, the Legislature may wish to consider whether or not any immediate changes are necessary or appropriate. Moreover, while the governor's proposed 'status-quo' budget may be the prudent course in the short term to ensure that already programmed projects aren't adversely impacted, any potential changes could be phased in over multiple years.

On the other hand, because MAP-21 consolidates a number of programs such as Safe Routes to School and the Bridge Program, making them eligible uses under the core programs rather than set-asides, the Legislature may wish to consider whether or not any of these should be maintained as separate programs at the state level, and if so, whether or not legislation is required to accomplish this.

Active Transportation Program
The Governor's proposed ATP would consolidate a number of small funding programs into a single larger program focused on 'active transportation' and specifically seek to address

greenhouse gas reduction. Certainly, the size of this new program would elevate the profile of active transportation as a state priority and potentially streamline program administration to some degree.

Beyond the question of whether or not this is an appropriate priority, however, the proposal also raises other significant questions that the Legislature may wish to consider. In particular, because the existing component programs proposed to be consolidated under the ATP umbrella have different goals and objectives, it is unclear how a single program administration process would effectively weigh the relative merits of these different goals in developing a single program of projects. Because the existing programs have different goals and objectives, the metrics governing what constitutes a successful project likely vary. It is unclear at this point how the proposed ATP would seek to compare projects across different categories in seeking to develop a single program of projects. Also unclear is what types of projects among all those in the existing program categories, would fare best under this system. It seems at least conceivable that a single set of selection criteria might favor one type of project to the detriment, or even exclusion, of high-quality projects of a different category.

The Legislature may wish to consider whether or not the goals and objectives of each of the component programs continue to be a priority and are worthy of continued funding. If so, the Legislature may wish to consider modifying the proposal in some fashion to ensure at least a minimum level of funding for each type of project. In addition, Administration officials have recently indicated a desire to increase the focus on active transportation, yet at proposed, the ATP does not appear to focus any new funding on these types of projects. The Legislature may wish to consider whether or not the ATP could be structured such that a portion of the funds might be used to incentivize the use of other funds by local agencies on active transportation projects.

Debt Service and Miscellaneous Revenue

In making permanent the transfer of miscellaneous special fund revenue to the General Fund for transportation-related debt service—a strategy that was originally proposed for three years as a budget balancing scheme—the Governor's Budget implicitly acknowledges that GO bond debt service represents a long-term, and growing, funding challenge for the state. Because the special fund revenues are being used to service transportation related debt, the management of which is a challenge for the state, it can reasonably be argued that this is an appropriate step to take. However, because this proposal was originally presented as temporary solution, before making it permanent the Legislature may wish to consider whether permanent redirection of these funds could have any unintended adverse impacts to transportation in California. As noted above, under existing law, if the sunset was not removed the funds would flow through the PTA beginning in FY 2013-14.

High-Speed Rail

BACKGROUND:

The California High-Speed Rail Authority (HSRA) was created by Chapter 796, Statutes of 1996, to direct development and implementation of inter-city high-speed rail service that would be fully coordinated with other public transportation services. Until California voters approved the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century, also known as Prop 1A, the HSRA was a small entity with limited funding that focused its efforts primarily on program level studies and other analyses. Since approval of Prop 1A, and the receipt of $3.5 billion in additional federal funding through the American Recovery and Reinvestment Act (ARRA) in 2009 and 2010, the HSRA's size and scope of work has grown substantially. Federal funding requires a substantial state match and would not be available to the HSRA absent Prop 1A.

HSRA is led by a Chief Executive Officer, and governed by a nine-member Board, five of whom are appointed by the governor, two by the Senate Committee on Rules, and two by the Speaker of the Assembly. It currently has 71.5 authorized staff positions and, while in the past it has struggled to fill many of these jobs, it has made substantial progress in filling key management jobs over the past year. Last fall, it hired the last of three regional directors and the Chief Program manager.

Financing High Speed Rail

Under Prop 1A, approximately $9.9 billion in general obligation funding is authorized for the project. The funds are subject to appropriation by the Legislature. Of this total amount, $950 million is set aside for capital improvements to existing intercity urban and commuter rail systems to provide direct connectivity to high-speed rail, are incorporated as part of high speed rail, or provide safety or capacity enhancements.

The remaining $9.0 billion in Prop 1A is specifically set aside for the high-speed rail project. Up to $450 million is available for general administration and up to $675 million is available for initial construction activities, such as environmental studies and preliminary engineering; no match is required for this $1.1 billion. The remaining $8 billion is available for construction; however, a non-bond match of at least 50 percent is required for each corridor or segment. The bond act specifies certain characteristics for the design of the system, including electrified trains capable of sustaining speeds of no less than 200 miles per hour and capacity to achieve travel times between San Francisco and Los Angeles Union Station of 2 hours, 40 minutes.

Proposition 1A requires the HSRA to follow a number of steps in order to access funding for construction. These steps are not described here but are outlined in some detail in the *Overview of the 2012-13 Budget Bill.*

Business Plan

In April 2012, the HSRA released its revised 2012 Business Plan. In November of 2011 it had released a draft Business Plan, along with a Funding Plan, which had outlined a five step strategy to complete Phase 1 of the project, from San Francisco to Anaheim, and tagged the cost of this phase at $98 billion. These steps, while not outlined here, are also described in the *Overview of the 2012-13 Budget Bill*. The April 2012 revised Business Plan was billed by the HSRA as a significant refinement of the original plan which would enhance local rail service immediately and, over the long-term, cut costs by $30 billion, to a total of $68 billion for Phase 1. According to the revised plan, construction of the entire 520-mile system would be completed in 2028. Key features of the revised plan include the following:

- Construction of a 300-mile initial Operating Section of electrified rail from Merced to the San Fernando Valley, beginning in 2013 and completed within 10 years.
- Improvements to existing rail service in the Bay Area and Los Angeles regions (the bookends) to prepare those regions for high-speed service. These include conversion of local diesel-powered rail systems to electric power and safety improvements such as positive train control, including upgrades on the Amtrak/Metrolink corridors between Los Angeles and Anaheim.
- Cost reduction of $30 billion relative to the 2011 draft plan, achieved through use of a blended approach, cost savings, and inflation assumptions.
- The potential to access cap and trade revenue as a backstop for federal funding.

Legislative Appropriations

Following release of the revised 2012 Business Plan, the governor released his revised budget which proposed the following appropriations:

- $5.9 billion ($3.2 billion federal funds, $2.6 billion Prop 1A bond funds) to construct an initial 130 mile segment of the high-speed rail project between Madera and Bakersfield.
- $253 million ($48 million federal funds, $204 million Prop 1A bond funds) for completion of environmental and preliminary design work for various segments of the system. This includes $152.4 million to complete environmental review for each of the 10 segments comprising the system, as well as $100.2 million to fund full preliminary design of the Merced-Fresno and Fresno-Bakersfield segments and partial design of other segments.
- $819 million (Prop 1A connectivity bond funds) for intercity (Caltrans funded) and local rail operators to improve existing rail operations to improve connectivity to the future high-speed rail system. This appropriation consists of $106 million for intercity projects to increase travel speeds and frequencies and $713 million for enhancements to local systems that will directly benefit the HSR project.

These appropriations were included in SB 1029 (Chapter 152, Statutes of 2012) along with an additional package of $1.1 billion in bond funds for investment in the bookends in northern and southern California regions. These projects include $600 million primarily for electrification of the Caltrain corridor between San Francisco and San Jose and $500 million for projects to improve the Metrolink corridor between Palmdale and the San Fernando Valley. These improvements are needed to improve travel times for Metrolink trains providing service as part of the blended system. The legislation includes extensive language that restricts expenditures or requires reporting to various control entities and to the Legislature. Review or approval is required at specified points in the process from the Secretary of Business, Transportation and Housing Agency (or its successor), the Public Works Board, the DOF, and the Joint Legislative Budget Committee, as well as other legislative committees.

GOVERNOR'S PROPOSAL:

Following the multi-billion dollar appropriation in the 2012-13 budget to complete preliminary design and commence construction of the initial project phase, the Governor's Budget makes only minor modifications. The budget adds 15.5 staff positions, most of which are in the area of software and information systems.

The Governor's Budget notes that in September, the Federal Railroad Administration approved the required environmental impact assessments for the Merced-Fresno alignment and that the public comment period on the draft environmental document for the Fresno-Bakersfield alignment concluded in October. The summary also notes that final selection of specific projects for the 'bookend' investments (the $1.1 billion noted above) is expected by the end of the current fiscal year and construction work on the initial operating segment is expected this summer. The summary does acknowledge that, consistent with the 2012 revised business plan, additional funds will be needed to complete the Merced-San Fernando Valley segment.

ISSUES TO CONSIDER:

In approving last year's multi-billion dollar appropriation, the Legislature effectively gave the HSRA the green light to move forward with initial construction of the high-speed rail project. Thus, the current scope of issues open for legislative consideration with regard to this project is limited. The one issue that the Legislature will need to consider at some point is the matter of additional funding. As noted, the Governor has acknowledged that additional funding will be needed and has proposed use of cap and trade funds as a fiscal backstop. Specifics regarding cap and trade funding will continue to be discussed, but the Legislature may wish to consider whether this would be an appropriate use of those funds. If so, the Legislature would also need to consider whether those funds would provide an adequate fiscal backstop and, if not, would need to explore other options.

SUBCOMMITTEE NO. 3

HEALTH and HUMAN SERVICES

Health

Human Services

Medi-Cal

BACKGROUND:

Proposed Medi-Cal Funding and Enrollment. The Department of Health Care Services administers the Medi-Cal program (California's Medicaid health care program). This program pays for a variety of medical services for children and adults with limited income and resources.

The Governor proposes total expenditures of $59.8 billion ($15.3 billion General Fund) which reflects a General Fund increase of $354 million or 2.4 percent above the Budget Act of 2012. Generally, each dollar spent on health care for a Medi-Cal enrollee is matched with one dollar from the federal government.

Caseload is anticipated to increase by about 485,500 for a total of about 8.7 million[1] average monthly eligibles primarily due to the transition of children from the Healthy Families Program to Medi-Cal. Of this total, approximately 4.6 million are children.

According to the Administration, Medi-Cal provides health insurance coverage to about 21.7 percent of Californians. Of the total Medi-Cal eligibles about 33 percent, or 2.9 million people, are categorically-linked to Medi-Cal through enrollment in public cash grant assistance programs (i.e., SSI/SSP or CalWORKs). Almost all Medi-Cal eligibles fall into four broad categories of people: (1) aged, blind or disabled; (2) families with children; (3) children only; and (4) pregnant women.

Currently, Medi-Cal eligibility is generally based upon family relationship, family income level, asset limits, age, citizenship, and California residency status. Other eligibility factors can include medical condition (such as pregnancy or medical emergency), share-of-cost payments (i.e., spending down to eligibility), and factors that are related to a particular eligibility category.

GOVERNOR'S PROPOSAL:

In comparison to the last few years, the budget does not include major reductions to the Medi-Cal program. Key proposals are discussed below.

Health Care Reform. The budget includes $350 million General Fund for 2013-14 (for six months) and projects $700 million General Fund annually thereafter as placeholder for the costs of providing coverage to individuals who are already eligible for Medi-Cal but not presently

[1] This caseload estimate does not include new enrollees expected with the implementation of Medi-Cal expansion under health care reform.

enrolled. The Administration also proposes to expand Medi-Cal to adults with incomes up to 138 percent of FPL. The budget presents two options to do this (a state-based option and a county-based option) and does not include any fiscal estimates for these costs. These proposals are discussed in further detail later in this chapter.

Hospital Quality Assurance Fee Extension. The Governor proposes an extension of the hospital quality assurance fee, which will sunset on December 31, 2013. This fee provides funds for supplemental payments to hospitals and offsets the costs of health care coverage for children. The revenues generated from this fee are proposed to offset $310 million in General Fund expenditures for the Medi-Cal program. These General Fund savings are included as part of the Administration's $1 billion budget reserve. As with past extensions of this fee, it is proposed that the budget score the savings resulting from this fee and that the extension of this fee be a policy bill.

Gross Premium Tax Reauthorization. The Administration proposes the reauthorization of the Gross Premium Tax on Medi-Cal managed care plans on a permanent basis. Reauthorizing this tax would generate General Fund savings of $131 million in 2012-13 (applied to the Healthy Families Program) and $232 million in 2013-14. The Administration proposes to continue to use 50 percent of the gross premium tax revenue to draw down federal funds and, in turn, make plans whole and 50 percent of the revenue to offset General Fund spending. These General Fund savings are also included as part of the Administration's $1 billion budget reserve. This proposal is discussed in more detail later in this chapter.

Coordinated Care Initiative/Duals Demonstration Project. The budget includes $170.7 million General Fund savings in 2013-14 and estimates future annual savings of $523.3 million General Fund as a result of this initiative. This is a reduction in savings of $356.7 million General Fund in the budget year compared to what was estimated at the time of the 2012 Budget Act (due to the factors discussed below).

The 2012 budget authorized the Coordinated Care Initiative (CCI), by which persons eligible for both Medicare and Medi-Cal (dual eligibles) would receive medical, behavioral, long-term supports and services, and home- and community-based services coordinated through a single health plan in eight demonstration counties (Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, and Santa Clara). Budget year savings have been revised compared to previous estimates as the population estimated to be included in CCI has decreased, the scheduled phasing for the enrollment in CCI has been delayed until September 2013, and the state has not yet developed a Memorandum of Understanding with the federal CMS to implement CCI. DHCS indicates that delay in timeline means that the first notices that any enrollees would receive about this transition would come no earlier than June 2013.

Limit Annual Open Enrollment for Medi-Cal Enrollees. A reduction of $1 million General Fund is assumed by limiting Medi-Cal enrollees who are families and children (i.e., persons who are not seniors or persons with disabilities) to an annual open enrollment, in lieu of being able to change plans more frequently throughout the year. This proposal requires trailer bill legislation.

Medi-Cal Managed Care Efficiencies. The Administration includes a decrease of $135 million General Fund in the Medi-Cal program as a result of implementing additional efficiencies in managed Care. DHCS proposes to look for new ways to improve quality and the efficiency of the health care delivery system and develop payment systems that promote quality of care and improve health outcomes.

Provider Rate Reductions. AB 97 (Chapter 3, Statutes of 2011) enacted provider rate reductions beginning June 1, 2011. However, DHCS was prevented from implementing many of the reductions due to court injunctions. The budget assumes positive resolution of the court injunctions in March 2013, resulting in General Fund savings of $488 million in 2013-14. On January 28, 2013, provider groups filed a request for a rehearing of this case.

The budget proposes to begin collection of the retroactive rate reductions (back to June 1, 2011) from the enjoined fee-for-service providers starting on September 2013.

Legally the Administration cannot retroactively recoup this rate reduction on managed care plans; however, there is a separate Managed Care Efficiencies proposal (discussed above) that is intended to achieve a similar amount of savings applied to managed care plans.

Healthy Families Program Transition. The budget reflects $129,000 General Fund savings in 2012-13 and $42.6 million General Fund savings in 2013-14 as a result of the transition of children from the Healthy Families Program to Medi-Cal. This is a reduction in General Fund savings of almost $13 million in 2012-13 as a result of a slower transition of these children to Medi-Cal and an increase in Medi-Cal managed care capitation payments for these children. This estimate also assumes that the gross premium tax on Medi-Cal managed care plans is reauthorized in the current year and that a portion of the revenues ($131 million) derived from this tax is directed to the Managed Risk Medical Insurance Board.

Withdrawal of Pharmacy Copayment from Last Year. The 2012 Budget Act included the implementation of a copayment for prescription drugs. It was estimated that this proposal would achieve $13 million General Fund savings. The Administration has withdrawn this implementation of this copayment and the corresponding General Fund savings are not included. DHCS indicates that this copayment was not workable.

ISSUES TO CONSIDER:

Continued Oversight of Prior Year Proposals. While there are major new health proposals in the budget, it is important for the Legislature to continue to monitor the implementation of prior year budget proposals. These include:

- *Healthy Families Transition.* The federal CMS approved the state's proposal to transition children from the Healthy Families Program (HFP) to Medi-Cal on December 31, 2012. The first phase (Phase 1a) of transition occurred on January 1, 2013 and included about 200,000 children. To date, it appears that the transition has generally gone smoothly, as it was only for children in HFP plans that matched Medi-Cal plans and whose provider network was determined adequate for transition.

On February 15, 2013, the first monitoring report of this transition is due to the Legislature. This report will include information on health plan grievances related to access to care, continuity of care requests and outcomes, and changes to provider networks (including provider enrollment and disenrollment). Additionally, it should be noted that CMS has required federal approval for each of the phases prior to implementation of the phase and demonstration of successful implementation of the previous phase is required prior subsequent phased implementation.

Each subsequent phase will present opportunities for oversight as the level of plan and provider overlap decreases and the risk of children losing access to care and services increases.

- *Duals Demonstration/Coordinated Care Initiative.* Enacted last year, the Coordinated Care Initiative integrated medical, behavioral, long-term supports and services, and home- and community-based services coordinated through a single Medi-Cal health plan in eight demonstration counties. The 2012 budget had assumed a June 1, 2013 implementation date and 50:50 shared savings with the federal Medicare program. The state has not yet heard back from the federal CMS on an agreement regarding the shared savings or a six-month lock-in enrollment period for participants. Statute requires that in the event DHCS has not received, by February 1, 2013, federal approval, or notification indicating pending approval, then effective March 1, 2013, the provisions of the dual demonstration project, enrollment of dual beneficiaries into Medi-Cal managed care, and long-term supports and services integration become inoperative. At the time of this report, the Legislature had not received notice of federal approval.

  This initiative is a substantive undertaking and affects the lives of over 500,000 dual eligibles. As discussions and planning continue, it is important to ensure that standards are in place to ensure that managed care plans are ready for the integration of medical, behavioral, long-term supports and services, and home- and community-based services and that enrollees, providers, and community organizations are well-educated on this transition.

Medi-Cal Managed Care Efficiencies Proposal Lacks Details. According to the Administration, legislation to implement the changes necessary to achieve $135 million General Fund savings from Medi-Cal managed care is not necessary because these changes would be implemented as part of the managed care rate setting process. DHCS has no specific proposals on how to achieve these efficiencies and does not propose to engage stakeholders or the Legislature prior to implementation of this substantial reduction to managed care rates.

Medi-Cal – Health Care Reform

BACKGROUND:

Health Care Reform. The federal Patient Protection and Affordable Care Act (ACA) (health care reform) increases access to private and public health care coverage. Under the ACA, most U.S. citizens and legal residents will be required to have health insurance beginning in 2014. It is estimated that 4.7 million Californians who were uninsured during some part of 2009 will be eligible for health coverage under the ACA. The ACA increases access through various mechanisms including:

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

- *Medi-Cal Streamlining Eligibility and Retention.* The streamlining of eligibility, enrollment, and retention rules for persons already eligible for Medicaid (Medi-Cal in California). The cost associated with this new caseload will be generally split equally between the state and federal government. These changes are effective January 1, 2014.

- *Expanding Coverage to Low-Income Adults through Medi-Cal.* The expansion of Medi-Cal coverage to adults with incomes up to 138 percent of FPL. (Generally, these are childless adults who are nonelderly and nondisabled.) Under the ACA, the federal government will pay for 100 percent of the costs for this population for the first three years (2014-2016) with funding gradually decreasing to 90 percent in 2020. See table below for specific federal matching rate by calendar year. This change is effective January 1, 2014.

Federal Matching Rate for Medi-Cal Expansion to Adults with Incomes Up to 138 Percent of FPL

Calendar Year	Federal Match*
2014	100%
2015	100%
2016	100%
2017	95%
2018	94%
2019	93%
2020 and thereafter	90%

*Applies to only health care services, not administrative costs.

On June 28, 2012, the U.S. Supreme Court upheld the constitutionality of the ACA; however, it found that the ACA's provision allowing the federal government to remove all federal Medicaid (Medi-Cal in California) funding for states that do not expand Medicaid coverage to 138 percent of FPL was unconstitutional. The Court treated the ACA's expansion of the Medicaid program as if it were a new program and determined that the federal government could not condition funds for the existing Medicaid program on participation in the "new program" created by the ACA. This ruling effectively made the Medicaid expansion to low income adults optional for the states.

Impact of Medi-Cal Expansion in California. A recent report[2] quantifying how the ACA may impact the Medi-Cal program was released in January 2013 by the UCLA Center for Health Policy Research and the UC Berkeley Labor Center. This report finds that expanding Medi-Cal will have "far-reaching benefits for the health outcomes of Californians, providers, and the California economy."

This report estimates that about 2.5 million Californians are currently income eligible for Medi-Cal but not yet enrolled.[3] Of these already eligible, 200,000 to 440,000 will enroll into Medi-Cal in 2014, growing to 240,000 to 510,000 in 2019.

It also estimates that more than 1.4 million[4] Californians will be newly eligible for Medi-Cal and that between 480,000 and 780,000 of these individuals would enroll in Medi-Cal in 2014, growing to up to 910,000 by 2019. See the table that follows for more details on these estimates.

[2] Laurel Lucia, Ken Jacobs, Greg Watson, Miranda Dietz, and Dylan Roby, "Medi-Cal Expansion under the Affordable Care Act: Significant Increase in Coverage with Minimal Cost to the State," UCLA Center for Health Policy Research and UC Berkeley Labor Center, January 2013.
[3] Of the 2.5 million Californians that are currently income eligible for Medi-Cal, 35 percent are uninsured, 11 percent are covered by the individual market, and 54 percent have employer sponsored insurance.
[4] Of the 1.4 million Californians newly eligible for Medi-Cal, 60 percent are uninsured, 17 percent are covered by the individual market, and 23 percent have employer sponsored insurance.

Predicted Increase in Medi-Cal Enrollment

Year	Scenario*	Already Eligible	Newly Eligible	Total
2014	Base	200,000	480,000	680,000
	Enhanced	440,000	780,000	1,220,000
2016	Base	230,000	630,000	860,000
	Enhanced	490,000	880,000	1,370,000
2019	Base	240,000	750,000	990,000
	Enhanced	510,000	910,000	1,420,000

*Base Scenario assumes a 10 percent take-up rate for the Already Eligible and 40 percent for the Newly Eligible. Enhanced Scenario assumes a 61 percent take-up rate for the Already Eligible and a 75 percent take-up rate for the Newly Eligible.

Additionally, the report finds that the federal government will pay for at least 85 percent of the total new Medi-Cal spending between 2014 and 2019. This includes funding for those that are already eligible and the newly eligible. It is projected that the Medi-Cal expansion will bring in between $2.1 billion and $3.5 billion in new federal Medi-Cal dollars to California in 2014.

Low Income Health Program. The Low Income Health Program (LIHP) is a voluntary, county-run program to provide a Medicaid-like coverage to low-income individuals who are uninsured. There are 17 LIHPs in operation, covering 51 counties, and each LIHP can have different income eligibility requirements. The County Medical Services Program (CMSP) LIHP includes 35 counties.

The LIHP is authorized under the state's Section 1115 Medicaid Waiver. The 1115 waiver provides a bridge to implement the ACA and an opportunity for county health departments to improve coverage, increase access to care, pay for uncompensated services, identify persons eligible for care under the ACA, and build the right delivery systems for a uninsured population with a 50:50 match of existing county health spending for the newly eligible and federal funds. The terms of this waiver limit operations of LIHP to December 31, 2013.

The LIHP consists of two programs: Medicaid Coverage Expansion (MCE) and the Health Care Coverage Initiative (HCCI). MCE will provide coverage for very low-income adults with incomes under 138% of FPL, and its federal funding through the waiver is uncapped. HCCI is coverage for low-to-moderate income adults with incomes between 138 and 200% of FPL, and its expenditures are capped. See the table that follows for LIHP enrollment information.

Low Income Health Program (LIHP), October 2012 Monthly Enrollment

LIHP	Medicaid Coverage Expansion			Health Care Coverage Initiative			Total LIHP Enrolled
	Start Date	Upper Income Limit	Number Enrolled	Start Date	Upper Income Limit	Number Enrolled	
Alameda	07/01/2011	133% of FPL	37,940	07/01/2011	200% of FPL	8,591	46,531
CMSP (County Medical Services Program)	01/01/2012	100	56,564			0	56,564
Contra Costa	07/01/2011	133	9,763	07/01/2011	200	2,026	11,789
Kern	07/01/2011	100	6,023			416*	6,439
Los Angeles	07/01/2011	133	205,257			185*	205,442
Orange	07/01/2011	133	33,855	07/01/2011	200	9,775	43,630
Placer	08/01/2012	100	1,908			0	1,908
Riverside	01/01/2012	133	23,893			0	23,893
Sacramento	11/01/2012	67	0**			0	0
San Bernardino	01/01/2012	100	24,659			0	24,659
San Diego	07/01/2011	133	32,794			89*	32,883
San Francisco	07/01/2011	25	9,386			1,085*	10,471
San Joaquin	06/01/2012	80	1,502			0	1,502
San Mateo	07/01/2011	133	8,452			197*	8,649
Santa Clara	07/01/2011	75	12,242			763*	13,005
Santa Cruz	01/01/2012	100	2,196			0	2,196
Ventura	07/01/2011	133	8,418	07/01/2011	200	2,892	11,310
TOTAL			**474,852**			**26,019**	**500,871**

*These programs are not currently operating an HCCI, the enrollment numbers reflect legacy program caseload.

**Sacramento implemented on 11/1/2012 and did not have enrollment in October.

It is anticipated that Monterey will implement a LIHP in February 2013. DHCS is working with Tulare towards implementation in March 2013. Both Stanislaus and Santa Barbara LIHPs are pending and implementation dates have not been established, these LIHPs will likely not be established due to the diminishing implementation timeframe. Fresno, Merced, and San Luis Obispo have withdrawn their interest in creating a LIHP.

How Counties Provide Uncompensated Care. California's counties, per Welfare and Institutions Code Section 17000, are the health care providers of last resort for county indigent with no other source of health coverage. Counties implement this responsibility in several different ways: (1) they provide the care in their own hospitals and clinics, (2) they pay for care delivered in private hospitals, clinics and doctor's offices, (3) they provide outpatient care in their own clinics and pay for private hospital care, or (4) they collectively pay private providers for care to the county indigent in 35 small counties (CMSP counties).

County indigent health is generally funded with 1991 Realignment funds, county general fund, as well as with support from the state (e.g., Proposition 99 funds and federal Maternal Child and Adolescent Health Funds). Additionally, counties with hospitals that serve high numbers of uninsured and Medi-Cal enrollees have access to federal Disproportionate Share Hospital Funds.

GOVERNOR'S PROPOSAL:

Special Session. The Governor convened an extraordinary session that began on January 28, 2013 to consider and act upon legislation necessary to implement the ACA. Senate Bill 1X 1 (Hernandez and Steinberg) has been introduced to implement the ACA's Medi-Cal streamlining provisions and the expansion of Medi-Cal to low-income adults.

Already Eligible. The budget includes $350 million General Fund for 2013-14 (for six months) and projects $700 million General Fund annually thereafter as placeholder for the costs of providing coverage to individuals who are currently eligible for Medi-Cal but not presently enrolled (referred to as "already eligible"). The Administration's projected caseload estimates on the number of the already eligible individuals who would enroll are not yet available.

It is expected that these currently eligible individuals will enroll in Medi-Cal because of streamlining in eligibility (establishing a new income standard based on the Modified Gross Income—MAGI; the elimination of the asset and disability tests) and redeterminations that would make it easier for individuals to enroll and remain on Medi-Cal; the individual mandate (under the ACA) that requires most individuals to obtain health coverage; and the extensive marketing by Covered California (California's health benefit exchange) about health care coverage options. The Administration considers this group of individuals the "mandatory expansion."

Newly Eligible Adults with Incomes Up to 138 Percent of FPL. The Administration proposes to expand Medi-Cal to adults with incomes up to 138 percent of FPL (referred to as "newly eligible"). The budget presents two options to do this and does not include any fiscal estimates for these costs. (The 138 percent of FPL is $15,415 for individual or $26,344 for family of three in 2012.) The Administration refers to this expansion as the "optional expansion."

These two options are:

- *State-Based Option.* The first option is a state-based Medi-Cal expansion that would build upon the existing state-administered Medi-Cal program and managed care delivery system.

- *County-Based Option.* The second option is a county-based Medi-Cal expansion that would build upon the Low Income Health Program (LIHP). This option would require waiver of federal requirements. Under this option, counties would have operational and fiscal responsibility for implementing this expansion. These responsibilities include: (1)

establishing networks of providers to deliver health care services, (2) setting payment rates to providers, and (3) processing claims billed by providers.

Under both of these options, the benefit package proposed by the Administration would be comparable to what is available today in Medi-Cal, but would exclude long-term care coverage (both institutional care and home- and community-based programs). In order to receive long-term care coverage, the individual would have to qualify under the state's current eligibility rules (i.e., would have to meet asset and disability requirements). Under the county-based option, counties could offer additional benefits, except for long-term care.

The Administration indicates that it has presented these options as a framework to begin discussions with counties and stakeholders, including the Legislature, on how the state and local governments should share the risks and costs associated with expanding public health coverage to this population.

According to the Administration, counties are spending between $3 billion and $4 billion annually on health care costs, this spending varies significantly by county. This estimate includes $1.5 billion from the 1991 Health Realignment Account, $1 billion in county maintenance of effort (the 1991 realignment of funding for county health services retained the concept of a county's level of effort for the provision of health services), and was informed by County Medical Services Program, the Medically Indigent Care Reporting System, and data provided by counties to DHCS for claiming under the Medicaid Waiver for the uninsured. Additionally, counties that own and operate hospitals also use local funds to fund the non-federal share of Medi-Cal for inpatient Medi-Cal services provided in their facilities.

ISSUES TO CONSIDER:

Medi-Cal Expansion Brings Many Benefits to State. As ruled by the U.S. Supreme Court, the expansion of Medicaid to low-income adults is an optional provision of the ACA. The Administration has recognized the benefits of expanding Medi-Cal coverage to low-income childless adults. These benefits include: (1) providing health coverage to more of the state's uninsured population, (2) an influx of federal funding to the state to support this expansion of health coverage, and (3) general economic benefits to the state, such as job creation.

Already Eligible Caseload Estimates Unavailable from Administration. The Administration has not yet provided its estimates on the number of persons who are already eligible for Medi-Cal and are projected to enroll on or after January 1, 2014. Without these numbers it is difficult to evaluate the basis for the placeholder $350 million General Fund for 2013-14 (for six months) and $700 million General Fund for 2014-15 (and ongoing) included in the budget.

Newly Eligible – State and County Costs Uncertain. The Administration also has not provided any caseload or fiscal estimates on the newly eligible individuals expected to enroll in Medi-Cal.

Nor does the Administration have a timeline or proposal on how the state and counties should share the risks and costs associated with expanding public health coverage to this population.

In determining these costs and risks, it will be important to consider the following factors:

- How quickly will individuals obtain coverage and access to services?
- What level of savings will be realized by the counties as individuals who were formerly covered by county indigent health programs are now covered by Medi-Cal?
- What will be the remaining county obligations to provide care to those individuals who do not qualify for Medi-Cal?
- What will be the nonfederal costs of providing this coverage (as the federal matching rate declines starting in 2017)?
- What short- and long-term checkpoints should be considered to evaluate the assumptions and methodology on how the state and counties should share the risks and costs of this expansion?

These factors will need to be considered differently depending on how each county provides indigent health care services. For example, counties that own and operate public hospitals, health systems and clinics are important safety-net providers and are different from counties that contract out (e.g., a CMSP county) entirely for the provision of indigent health care services.

County-based Option Not Viable. Medi-Cal is currently a state-based program administered by DHCS. The county-based option is not viable option for many reasons including:

- *Inefficient.* Implementation of this expansion at the county level would take a significant amount of work and would be inefficient as each county would have to develop or contract out for fiscal (e.g., claiming) and operational activities and would have to develop its own provider networks. The state already has these processes established for the state Medi-Cal program and could implement this expansion using existing contracts.

- *Varied Implementation*. Although all counties would have to expand coverage on the same date and for the same population, this option could lead to varied implementation by counties. As exemplified by LIHP, counties have developed different provider networks and have taken a varied interest in providing coverage for the uninsured population. A state-based option would help ensure timely and consistent statewide implementation and access to coverage.

- *Families Could Be Split Across Programs*. Under this option, there could be a situation in which children in a family would be covered by the state-based Medi-Cal program and the parents in the family would be covered by the county-based Medi-Cal program. This could mean that one family is covered by multiple health plans and providers. Additionally, women who become pregnant would switch programs at the time of pregnancy. A state-based option would eliminate any potential for fragmentation and churning between the Medi-Cal programs.

- *Not All Counties Operate LIHPs.* The Administration argues that under the county-based option, counties could build upon their LIHPs. However, not all counties have implemented LIHPs. Consequently, those counties without LIHPs would likely need a significant amount of time to develop health coverage programs for this expansion population.

- *Unclear if County-Based Option Would Get Federal Approval.* The Administration has indicated that it is unclear if the federal government would approve implementation of this expansion at the county level instead of at the state level.

Exclusion of Home- and Community-Based Services in Medi-Cal Benefit Package. As discussed above, the Administration proposes that long-term supports and services (LTSS), both institutional care and home- and community-based services (HCBS), be excluded from the Medi-Cal benefit package for the already eligible and the newly eligible who enroll in Medi-Cal on and after January 1, 2014.

The Administration argues that this Medi-Cal benefit package should not include LTSS because these individuals have qualified without an asset or disability test and that these individuals could, for example, have assets that could be liquidated to cover the costs of LTSS. (Under the ACA's efforts to streamline eligibility and enrollment, the current Medi-Cal asset and disability tests are eliminated.) The Administration indicates that these individuals would be eligible for LTSS if they qualify under the current asset and disability rules.

By not including LTSS, home- and community-based services in particular, in the Medi-Cal benefit package for the newly eligible individuals, the state is forgoing a higher federal matching rate (100 percent for the first three years and no lower than 90 percent in the out years) for these benefits. If these newly eligible individuals qualify under the asset and disability tests, the state would be responsible for 50 percent of the costs. Consequently, it could make sense to include these benefits as the federal government would be contributing at a significantly higher matching rate. The Administration has not presented any fiscal estimates justifying the exclusion of these benefits from the Medi-Cal benefit package.

Additionally, the exclusion of HCBS, at the very least, appears counter to DHCS's Coordinated Care Initiative (discussed earlier) intended to coordinate medical, behavioral, long-term supports and services, and home- and community-based services through a single health plan and; consequently, achieve net savings in the Medi-Cal program (through a reduction in inpatient care, for example).

No Estimate on the Savings from Other State Health Programs. As individuals become eligible and enroll in comprehensive health coverage (either through Medi-Cal or Covered California), it is expected that the state would realize cost savings in various smaller health care programs (e.g., the Breast and Cervical Cancer Treatment Program and the Family Planning, Access, and Care Program). The LAO estimates about $100 million in reduced General Fund costs in 2013-14 and ongoing reductions of about $200 million, but notes that there is a significant amount of uncertainty surrounding these estimates as the fiscal effects will largely depend on future policy decisions about the modification of these programs in response the Medicaid expansion.

Short Timeline for Implementation of these Expansions. Given that the state is operating under a very tight timeline for these changes (this expansion begins January 1, 2014), it is critical that a decision be made as soon as possible on the details of implementing this expansion. If the state does not meet the January 1, 2014 timeline, hundreds of millions of dollars in federal funding could be lost.

Federal Guidance on Key Issues Still Outstanding. There are several key aspects of ACA implementation for which federal guidance has not yet been issued including the methodology for claiming enhanced federal funding for the newly eligible Medi-Cal population.

Medi-Cal – Gross Premiums Tax

BACKGROUND:

Managed Care Organization Fee. In 2005, California enacted a quality improvement fee (QIF) on Medi-Cal managed care organizations.[5] Based on federal rules, the fee was assessed on all premiums paid to legal entities providing health coverage to Medi-Cal enrollees. When the fee was established, 75 percent of the revenue generated was matched with federal funds and used for payments to managed care organizations and the remaining 25 percent was retained by the state General Fund. Under this arrangement, the managed care organizations received a rate adjustment (i.e., on the net, health plans gained).

Effective October 1, 2007, as part of the implementation of the state's new managed care rate methodology, this arrangement changed and 50 percent of the revenue generated by the QIF was matched with federal funds and used for payments to managed care organizations and the remaining 50 percent was retained by the state General Fund.[6] Under this allocation, managed care plans were made whole in that they were reimbursed the amount of QIF they paid, but no longer realized a net benefit.

Changes in federal law resulted in this fee sunsetting on October 1, 2009 as it no longer complied with federal requirements. New federal law required that provider fees be "broad based" and uniformly imposed throughout a jurisdiction, meaning that they cannot be levied on a subgroup of providers, such as only those enrolled in Medicaid programs.

Gross Premiums Tax (GPT). Assembly Bill 1422 (Chapter 157, Bass, Statutes of 2009) extended the 2.35 percent premium tax imposed on all types of insurance to include all comprehensive health plans contracting with Medi-Cal. The revenues from this tax were directed to fund health coverage for children through the Healthy Families Program, provide a cost-of-living increase to health plans participating in Healthy Families, and increase Medi-Cal capitation rates to health plans. Under this arrangement, 50 percent of the revenue was matched with federal funds to make health plans whole and 50 percent of the revenue was used to maintain the Healthy Families Program. This tax expired December 31, 2010 and was extended twice until it expired on June 30, 2012.

It should be noted that because the GPT is an existing tax on a broad group of insurers, the overwhelming majority of which are not health care insurers, it can be extended to Medi-Cal managed care plans without being considered a fee under federal law. As such, the state does

[5] Assembly Bill 1762 (Committee on Budget, Chapter 230, Statutes of 2003)
[6] "Financing Medi-Cal's Future: The Growing Role of Health Care-Related Provider Fees and Taxes," California HealthCare Foundation, November 2009.

not have to meet federal requirements for provider fees to obtain federal matching funds, using this source of revenues as the state match.

Last Year's Proposal. Last year, the Administration proposed to permanently extend the GPT. It was estimated that about $187 million from the GPT would be directed to the Healthy Families Program (and that Medi-Cal managed care plans would receive a rate adjustment to make them whole). The Senate Budget and Fiscal Review Committee approved a two-year extension of this tax; however, this proposal was not voted on by the Legislature. Consequently, this tax expired on July 1, 2012.

The 2012 Budget Act assumed reauthorization of the GPT, and, based on this assumption appropriated no General Fund to cover the Healthy Families Program. On January 7, 2013, the Administration notified the Joint Legislative Budget Committee of an unanticipated cost funding request of $15 million General Fund from the Managed Risk Medical Insurance Board. These requested funds would be used to cover the capitation and administrative vendor costs for the month of December 2012 for the Healthy Families Program.

GOVERNOR'S PROPOSAL:

Permanently Extend Gross Premiums Tax. The Administration proposes to reauthorize the gross premiums tax on Medi-Cal managed care plans permanently on a retroactive basis starting July 1, 2012. Reauthorizing this tax would generate General Fund savings of $131 million in 2012-13 and $232 million in 2013-14. The Administration proposes to continue to use 50 percent of the gross premium tax revenue to draw down federal funds and make plans whole and 50 percent of the revenue to offset General Fund spending.

It should be noted that one of the components of the Administration's proposed $1 billion reserve, is $364 million from the gross premiums tax ($131 million from 2012-13 and $232 million from 2013-14).

ISSUES TO CONSIDER:

Gross Premium Tax Brings In Additional Federal Funding to State. With the expiration of the GPT, the state is forgoing hundreds of millions of dollars in additional federal funding for the Medi-Cal program as the revenue from the gross premiums tax can be used as a match for federal funding for Medi-Cal.

State Has One of Lowest Capitation Rates in Country. Medi-Cal capitation rates are among the lowest Medicaid rates in the country.[7] With the implementation of the ACA's Medicaid

[7] "Public Partner: The California Health Benefit Exchange Aligned with Medi-Cal," California HealthCare Foundation, October 2011.

expansion, discussed earlier, it will be important to ensure that Medi-Cal rates are at a level to ensure provider participation in the program in order to ensure access to services. Consequently, as part of these discussions it will be important to consider the cumulative impact of the AB 97 rate reductions, the managed care efficiencies proposal, and Medi-Cal expansion when evaluating this reauthorization and the allocation of the revenues generated from this tax. For example, should the revenues from the GPT be used to offset General Fund expenditures in Medi-Cal or should they be used to increase rates to Medi-Cal managed care plans given their important role in the Medi-Cal expansion. As noted above, when the QIF was first assessed on managed care organizations, it was used to provide a rate increase to managed care plans.

GPT Revenue Does Not Account for Medi-Cal Expansion. The Administration's estimated GPT revenues do not include the impact of the Medi-Cal expansion (related to health care reform). Accordingly, GPT revenues will be higher (likely in the tens of millions) than projected in the Governor's budget as more people will be covered by Medi-Cal managed care.

Permanent Extension Makes Evaluation Difficult. A permanent extension of this tax would make it difficult to periodically evaluate its effectiveness and its impact on Medi-Cal managed care.

In-Home Supportive Services (IHSS)

With a proposed 2013-14 budget of $6.2 billion ($1.8 billion GF) for services and administration, the IHSS program provides personal care services to approximately 420,000 qualified low-income individuals who are blind, aged (over 65), or who have disabilities. Services include tasks like feeding, bathing, bowel and bladder care, meal preparation and clean-up, laundry, and paramedical care. These services frequently help program recipients to avoid or delay more expensive and less desirable institutional care settings. In contrast to recent years, the Governor's budget does not include new proposals for reductions to IHSS. At the same time, there are several significant prior reductions that are currently enjoined as a result of ongoing litigation that could take effect in 2013-14 or further into the future.

BACKGROUND:

IHSS Funding: The average annual cost of services per IHSS client is estimated to be around $12,000 for 2012-13. The program is funded with federal, state, and county resources. Prior to July 1, 2012, the state and counties split the non-federal share of IHSS funding at 65 and 35 percent, respectively. A 2012-13 budget trailer bill changed this structure as of July 1, 2012 to instead base county IHSS costs on a maintenance of effort (MOE) requirement. The change was related to enactment of the Coordinated Care Initiative (CCI, also called the Duals Demonstration project), which is a demonstration project authorized in eight counties. CCI is intended to improve integration of medical and long-term care services through the use of managed health care plans and to realize accompanying fiscal savings.[1]

A Few Facts About IHSS:

- There are 420,000 low-income IHSS recipients who are aged, blind, or who have disabilities
- Services include personal care (e.g., bathing) & domestic and related activities
- There are roughly 380,000 IHSS providers with hourly wages varying from $8.00 to $12.20
- In 2012-13, IHSS services are estimated to cost an average of around $12,000/year per client

Program Structure and Employment Model: County social workers determine IHSS eligibility and perform case management after conducting a standardized in-home assessment of an individual's ability to perform activities of daily living. Based on authorized hours and services, IHSS recipients are responsible for hiring, firing, and directing their IHSS provider(s). In the vast majority of cases, recipients choose a relative to provide care.

In 2012, there were around 380,000 IHSS providers with hourly wages varying by county and ranging from $8.00 to $12.20 per hour. Prior to July 1, 2012, county public authorities or nonprofit consortia were designated as "employers of record" for collective bargaining purposes on a statewide basis, while the state administered payroll and benefits. Pursuant to 2012-13

[1] For additional details on CCI, see the Medi-Cal section of this report under the heading of Health.

trailer bill language, however, collective bargaining responsibilities in the eight counties participating in CCI will shift to an IHSS Authority administered by the state.

IHSS Savings Adopted in the Past Four Budgets have included the following:

Policies that Have Taken Effect

	Estimated GF Savings (in 000s, if available)[2]	Other Notes
Enhanced federal funding from Community First Choice Option	$107,000 in 2013-14	2012-13 savings were $201 million, but are expected to decline under fed. rule changes.
Requirement for health care provider to certify need	$63,500 in 2013-14	
Across-the-board cut of 3.6% of authorized service hours in 2010-11 through 2012-13	$60,000 in 2012-13	Governor's budget sunsets reduction as scheduled on 7/1/13.
Increases to out-of-pocket costs for some consumers	$45,000	
Program integrity measures (background checks, criminal exclusions, training, etc.)		
Reductions in administrative funding		

Policies Awaiting Approval or Enjoined in Ongoing Litigation

Across-the-board cut of 20% of authorized hours, with exceptions (impacts about 300,000 recipients)	$243,000	Enjoined in ongoing litigation with next hearing March 2013. Governor's budget assumes implementation November 2013.
Enhanced federal funds from match to use of revenues from sales tax on support services (with reimbursement of tax payments to IHSS providers)	$95,500	Awaiting federal response; no savings assumed in Governor's budget.
Loss of eligibility for individuals with assessed needs below specified thresholds	$92,000	Enjoined in ongoing litigation. Statute prevents changes until final, non-appealable order.
Reduction in state participation in provider wages (from maximum of $12.10 to $10.10 per hour)	$65,500	Enjoined in ongoing litigation. Statute prevents changes until final, non-appealable order.

[2] Savings are annual in the first year of implementation, unless otherwise specified.

GOVERNOR'S 2013-14 BUDGET PROPOSALS:

Coordinated Care Initiative and County MOE for IHSS: The Governor's budget assumes continued implementation of the CCI/Duals Demonstration in 2013-14, although proposes to delay the phasing in for enrollment until September 2013. As a result of county IHSS MOE funding requirements that were enacted along with CCI and took effect July 1, 2012, the budget includes increases of $17.5 million GF in 2012-13 and $47.1 million GF in 2013-14 to reflect costs estimated to shift from counties to the state.

Across-the-Board Reduction of 20 Percent: Of recently adopted policies awaiting approval or enjoined in ongoing litigation (see chart on preceding page), the Governor's budget assumes that the across-the-board reduction of 20 percent in authorized IHSS hours, with specified exception processes, is the only one that will be implemented in 2013-14. The budget assumes $113.2 million GF savings from implementation beginning November 1, 2013 that would impact the vast majority (374,000) of recipients.

ISSUES TO CONSIDER:

There is a substantial degree of uncertainty regarding recently adopted policies intended to achieve hundreds of millions of dollars in IHSS savings that are currently tied up in federal decision-making processes and the courts. Correspondingly, the potential impacts if some or all of those policies take effect could be dramatic for hundreds of thousands of low-income aged, blind, or disabled IHSS recipients who could lose in-home care services and for IHSS providers who could lose wages and/or hours of employment.

In addition, the short and long-term impacts of CCI on the IHSS program and its recipients are not yet known and will depend not only on implementation of the overall initiative, but also on the effects of related changes to the state/county IHSS funding structure and collective bargaining over IHSS wages.

CalWORKs

California Work Opportunities and Responsibilities to Kids (CalWORKs), the state's version of the federal Temporary Assistance for Needy Families program, provides cash assistance and welfare-to-work services to eligible low-income families with children. The program benefits 563,000 families with around 1.1 million children. In the last several years, CalWORKs has sustained very significant reductions, as well as programmatic restructuring. Assuming continuation of those changes, along with a $136.8 million increase for employment services, the Governor's budget includes $5.4 billion (federal, state, and local) in funding for CalWORKs. In contrast to recent years, the budget does not include new CalWORKs reduction proposals.

BACKGROUND:

CalWORKs Grants: The average CalWORKs grant for recipient families is $467 monthly (up to a maximum of $638 for a family of three in a high-cost county with no other income). More than half of the time, the state provides cash assistance on behalf of children only and does not provide adults with cash aid or welfare-to-work services. These are known as "child-only" cases, and the highest grant a family of three with two children and no aided parents can receive is $516 monthly. In most child-only cases, a parent is in the household, but ineligible for assistance due to receipt of Supplemental Security Income, sanction for non-participation in welfare-to-work requirements, time limits, a previous conviction, or immigration status. In other cases, no parent is present, and the child resides with a relative or other adult.

> ***Quick CalWORKs Facts:***
>
> - Approximately 563,000 families receive CalWORKs benefits
> - 78% of recipients are children
> - At $638 monthly, the highest CalWORKs grants for a family of 3 provides around 40 percent of income that federal guidelines indicate it takes to meet the most basic of needs

Welfare-to-Work Program: Adults eligible for CalWORKs are subject to a lifetime limit of 48 months of assistance. Unless exempt for reasons such as disability or caregiving for an ill family member, they must participate in work and other welfare-to-work (e.g., educational) activities. Depending on family composition, these activities are required for 20, 30, or 35 hours per week. The program also offers related services, such as childcare and transportation. Beginning January 1, 2013, there are new restrictions regarding what counts as an eligible work activity that will result in some adults losing all assistance after 24 months.

Caseload and Some Context About CalWORKs Recipients' Circu mstances[1]: CalWORKs benefits 563,000 families. At 1.1 million, around three-quarters of all recipients are children. Nearly half of those children are under the age of six. The Governor's budget projects small caseload declines in the 2011-12, 2012-13, and 2013-14 fiscal years. The vast majority (92 percent) of heads of CalWORKs recipient households are women. Two-thirds are single and

[1] Context information comes from sample data collected by the Department of Social Services (DSS) and from studies in single or multiple counties, as summarized in *Understanding CalWORKs: A Primer for Service Providers and Policymakers,* by Kate Karpilow and Diane Reed. Published in April 2010; available online.

have never married. Close to half have 11th grade or less education, and 10-28 percent are estimated to have learning disabilities. Around 80 percent of these adults report experiencing domestic abuse at some point and an estimated 19-33 percent have mental or emotional health problems.

Recent Reductions in CalWORKs have included:

GRANT REDUCTIONS

	GF savings[2] (in 000s), if available	**Effective Period**
Suspension of annual cost of living adjustment (COLA) (enacted in 2008-09 budget)	$163,000	Ongoing
Suspension of COLA *and* 4% grant cut (2009-10)	$226,000	Ongoing
Elimination of statutory basis for future COLAs (2009-10)		Ongoing
Additional 8% grant cut (2011-12)	$314,000	Ongoing
Changes to earned income disregard that mean faster reductions to grants or exits from aid due to earnings (2011-12)	$83,000	7/1/11 through 10/1/13

TIME LIMIT REDUCTIONS

Reduction of adults' lifetime time limit from 60 to 48 months (2011-12)	$104,000	Ongoing
Creation of a 24-month time limit with more flexible welfare-to-work activities before it has been reached and stricter requirements afterward (up to 48 total months) (2012-13)		Ongoing, with fiscal effect starting 2014-15

REDUCTIONS TO WELFARE-TO-WORK SERVICES

Exemption from welfare-to-work services for parents of one child from 12 to 24 months old or 2 or more children under age 6 (savings from not providing services) (2009-10)	$375,000	7/1/09 through 1/1/13 (with phase-out of policy then lasting 2 years)
Suspension of CalLearn intensive case management for teen parents (2011-12)	$43,600	7/1/11 through 7/1/12, with funding phased back in during 2012-13
Once in a lifetime welfare-to-work exemption for parents with children under 24 months old (2012-13)		Ongoing, beginning 1/1/13

[2] Savings figures on this page are annual in the first full-year of implementation. On an ongoing basis, exact savings will vary with caseload and other policy changes.

2012-13 Restructuring of CalWORKs: As described in the chart above, a 2012-13 budget trailer bill, SB 1041 (Chapter 47, Statutes of 2012), changed welfare-to-work participation rules and created a differentiation between rules that apply before expiration of a 24-month time limit (which are more flexible than prior law in how they count education and treatment-related activities) and stricter rules that now apply after that time period (which can sometimes include more than 24 calendar months because of how months are counted). SB 1041 also allows for extensions of up to six months (reviewed at least every six months) of the more flexible rules for up to 20 percent of participants. SB 1041 additionally modified the required number of weekly welfare-to-work participation hours to conform to what is federally countable and created the changes to welfare-to-work exemption policies described in the chart above. To implement this restructuring of CalWORKs, the trailer bill required the Department of Social Services (DSS) to convene stakeholder workgroups. Those workgroups met throughout the fall of 2012.

SB 1041 also required DSS to convene a related workgroup to identify best practices and other strategies to improve the process for engaging new CalWORKs clients upfront and for efforts to help clients overcome barriers to success. That workgroup has been meeting since late October of 2012. The Department was required to report back to the Legislature regarding resulting administrative changes and policy recommendations by January 10, 2013, but has not yet provided that report. Finally, SB 1041 requires DSS to contract with an independent, research-based institution for an evaluation and written report regarding the changes enacted in SB 1041. The report must be provided to the Legislature by October 1, 2017.

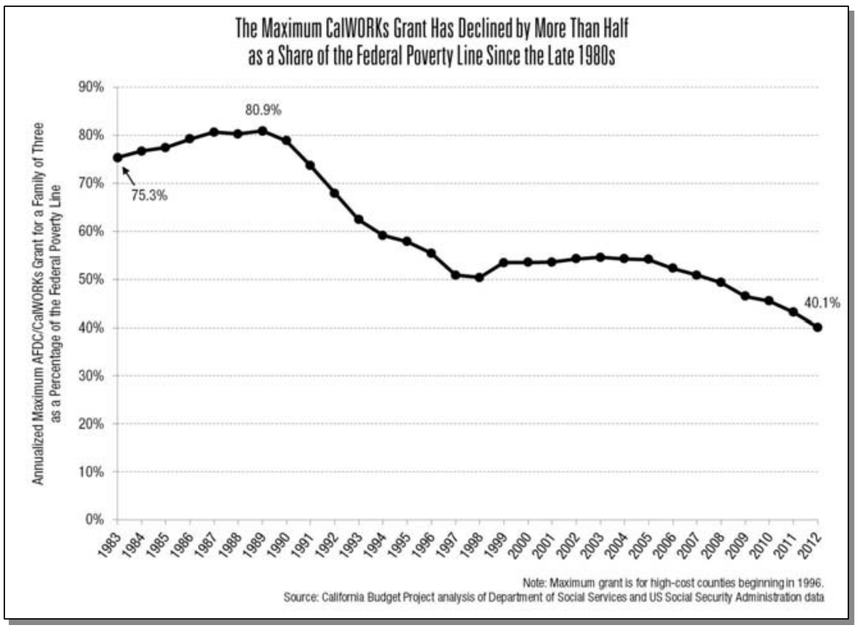
GOVERNOR'S 2013-14 BUDGET PROPOSALS:

The Governor's budget includes $5.4 billion in funding (federal, state, and local) for CalWORKs in 2013-14. In comparison to the last several years, it does not propose any major new reductions to the CalWORKs program. The budget does, however, assume continuation of all recent reductions to grants and elimination of the previously required COLA, continued implementation of the new 24 and 48-month time limits and accompanying policy changes, and the reengagement in welfare-to-work requirements of parents who had previously received temporary exemptions due to having young children (unless they are exempt for other reasons). In addition, the budget includes a new methodology for calculating the costs of employment services and $136.8 million in additional funding for those services tied to outreach, case management, and job development workload created by the new 24-month time limit structure.

ISSUES TO CONSIDER:

Given the volume of recent reductions and restructuring, the program is in a state of flux. Successive reductions and changes to CalWORKs grants, time limits, and work participation rules have resulted in additional layers of complexity within an already complicated state program. With many changes happening at once and applying differently to varying recipient families, front line social workers, county and state administrators, and client advocates may face daunting challenges to ensure that the program is implemented as intended and is as effective as possible. In addition, the Administration has not yet reported to the Legislature as required regarding administrative changes and/or policy recommendations intended to improve the upfront engagement of clients in welfare-to-work programs and the ways that CalWORKs assists clients in removing barriers to success. These policy changes were intended to coincide with implementation of new welfare-to-work rules that took effect January 1, 2013. As recent and impending changes become integrated, budgeting methodologies and programmatic outcomes will need ongoing evaluation by the Legislature.

California's unemployment and poverty levels are very high and CalWORKs grants have declined dramatically in their ability to help families meet basic needs. According to the California Employment Development Department, 2012 unemployment rates were still very high at 11.3 percent in January and 9.7 percent by December. Low-income families are also more likely to be unemployed than the workforce as a whole, and during economic downturns less educated workers sustain bigger job losses than those with more education.[3] Recent reports additionally indicate that women, who are heads of most CalWORKs recipient households, are recovering from the recession more slowly than men are, and that the economic downturn reduced employment for single mothers far more than for married parents.[4]



Poverty measures are intended to draw a line between whether or not a family has minimal resources necessary to meet the most basic needs (i.e., food, shelter, and clothing). As measured by the U.S. Census Bureau, California had more than 6 million residents who lived in poverty in 2011 (or 16.6 percent of the population). In 2010, nearly one in four (23 percent) of California's children was considered impoverished. According to federal guidelines established by the Health & Human Services Agency for 2012, a family of three needs annual income of more than $19,090 to live above the poverty line. At $638 per month, today's highest CalWORKs grants available for a family of three (the grant level for families in a high-cost county that include an aided adult and have no other income) result in income of $7,656 annually, or around 40 percent of what the guidelines indicate it would take to meet basic needs.[5] Research indicates that children who live in poverty are at significantly higher risk for health problems, lower educational attainment, and a number of other negative outcomes well into their adulthood.

[3] Wonho Chung, Phil Davies, and Terry J. Fitzgerald, *Degrees of Job Security* (Federal Reserve Bank of Minneapolis: December 2010); available online at: http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4592.

[4] *Falling Behind: The Impact of the Great Recession and the Budget Crisis on California's Women and their Families* (California Budget Project; February 2012).

[5] Chart displaying CalWORKs grants as compared to federally established poverty line over time created by and included with permission of the California Budget Project.

SUBCOMMITTEE NO. 4

STATE ADMINISTRATION and GENERAL GOVERNMENT

State Administration and General Government

Information Technology

BACKGROUND:

California has had a difficult time designing and implementing Information Technology (IT) projects in state government, and determining the level of oversight provided to the entity charged with managing the state's many IT projects. The passage of AB 2408 (Smyth), Chapter 404, Statutes of 2010, codified a cabinet-level agency to serve as the central organization to provide approval and oversight of all state IT projects. The passage of the Governor's Reorganization Plan No. 2 (GRP2) (codified in Chapter 147, Statutes of 2012) consolidated the agency with several others within the Government Operations Agency. Thus, the newly-named Technology Department will logically be housed within an agency whose primary focus is to support the services of other state entities.

Historically, the Department of General Services (DGS) has been viewed as the entity responsible for all procurement by state agencies, including IT services, and is generally considered the business management entity for the state. Purchasing authority for IT-related projects is spelled out in Public Contract Code Sec. 12100, and modifications to the IT procurement process have been recently made to offer alternative approaches. Specifically, the Legislature adopted language (Chapter 32, Section 29, Statutes of 2012) providing the Technology Department with the authority, in conjunction with existing authority provided to the Department of General Services, to undertake a negotiated procurement process, if feasible. The intent was to alleviate some of the rigidity associated with the IT procurement process in order to deliver a better product to the end user. In addition, the negotiated process was seen as a means to drive down IT costs by attracting more vendors and thus ensuring a more competitive process.

The state is currently undertaking a large number of IT-related projects totaling nearly $5.0 billion. These IT projects vary from upgrading and connecting the state's payroll and disbursement system to completely overhauling the state's financial management capabilities. Two particularly important examples of the state's current IT-related projects are discussed below.

Financial Information System for California
The Financial Information System for California (FI$Cal) is an enterprise resource planning IT platform designed to consolidate the functions of budgeting, accounting, procurement, financial management and cash management. FI$Cal is based on an off-the-shelf software package and the project is designed to require a limited number of modifications. The FI$Cal project stems from a requirement for the Department of Finance (DOF) to establish a new budget information system that would replace the current network of legacy systems that exist throughout the state's departments and agencies.

The most recent projections for the overall cost of the project are $616.8 million, representing a significant reduction from the earlier estimate of $1.6 billion. This downward revision is attributable to cost reductions in several areas, including: departmental project staff; data management, and departmental end-user staff. In addition, the primary vendor was able to develop a more detailed and reduced cost estimate as the program has continued to evolve. The final wave of FI$Cal has a go-live date of July 2016, and will begin standard maintenance and operations procedures by the 2017-18 fiscal year. The 2012 Budget Act included a revised the funding formula for FI$Cal, such that nearly all of the financial support directed to FI$Cal is provided through various special and nongovernmental cost funds. The Governor's Proposed 2013-14 Budget includes $84.8 million, ($2.1 million General Fund) in support for the FI$Cal program.

The state utilized a multi-stage procurement process for the FI$Cal project. Upon legislative approval, project staff released a request for proposal (RFP), which identified the business requirements that vendors would need to meet. After screening for eligible vendors, the second phase allowed the prospective vendors access to state IT infrastructure in order to gain a better understanding of the project requirements. Following this process, the prospective vendors are expected to submit a proposal that will be evaluated against the original RFP. As noted above, the benefit of a multi-stage procurement is that the prospective vendors have a better understanding of the departments' requirements and can develop a more technical proposal that more accurately reflects the cost of the proposed program. Some of the disadvantages of a multi-stage procurement are that it involves a lengthier period of time than a traditional, firm fixed price (FFP) procurement and there are more upfront costs required to evaluate eligible vendors.

The project is currently progressing in accordance with the timeline outlined in the most recent Special Project Report, and should be fully implemented by the 2017-18 fiscal year. Currently, FI$Cal is set to begin implementation activities for a small number of state entities in 2013 including: the Agricultural Labor Relations Board; the Office of Environmental Health Hazard Assessment; the Department of Aging; the California Arts Council; and the Department of Fair Employment and Housing.

21st Century Project

The state is also engaged in a major effort to update and consolidate the current patchwork of human resources and disbursement management systems throughout the state. The State Controller's Office (SCO) is responsible for issuing pay to the state's 294,000 employees located within 160 different departments, and therefore responsible for the implementation and management of the new disbursement system, the 21st Century Project. The SCO devised a two-stage procurement process that would first allow the agency to purchase a commercial off-the-shelf software product, and then contract with a vendor to complete the systems integration services. The state terminated the integration services contract in January 2009, and has subsequently identified and is working with a new systems integration vendor.

Currently, total project costs are estimated to be $370.63 million, while original estimates for the project were approximately $130 million. The 2012 Budget Act included $81 million ($46.9 General Fund) in support for the project, and represented the high-water mark in funding for the 21st Century Project.

21st Century Project Costs
(Dollars in Millions)

Year	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Project Costs	1.4	4.9	11.6	35.8	19.1	19.6	31.4	65.6	64.0	81.4	33.2	5.1	370.2
General Fund	0.0	0.0	0.0	18.1	9.9	11.8	16.2	30.3	34.5	46.9	6.5	0.0	174.2

The 21st Century Project has suffered a number of setbacks that have forced the project managers to readjust the timeline. In 2009, the project management team terminated its contract with the original systems integrator because it was unable to meet contractual obligations. More recently, the 21st Century Project management team had to delay the second phase of the pilot at least 6 months due to the severity of complications stemming from the limited introduction in the first pilot. The Legislature will need to continue to monitor the project as it progresses.

ISSUES TO CONSIDER:

The state will continue to require on-going improvements and upgrades to its IT infrstaructure. As such, decision-makers will need to identify which mechanisms ensure that it receives the most value from each procurement. There are a variety of mechanisms that the state can utilize to maximize the value of each contract; however, a one-size fits all approach will not benefit the state, and, may actually discourage some vendors from participating in the bid process. The Legislature may wish to consider mechanisms that ensure a more collaborative relationship between the vendor and the end-user can be fostered.

One of the state's primary objectives remains avoiding cost overruns and schedule slips while also integrating complex systems into the state's IT portfolio. To reach that objective the state will need to ensure the roles of each entity are clearly defined throughout the procurement process. The Government Operations Agency, created as part of GRP2, and which took effect July 3, 2012, was intended to better align state agencies that serve a similar purpose. Under GRP2, both the Department of General Services and the Department of Technology will be housed under the same agency which could lead to a more collaborative procurement process between the two entities.

The Department of Human Resources (CalHR) is also aligned within the same agency as the Department of Technology. Placing the two organizations within the same structure should allow for the department to recruit and retain qualified IT professionals; a difficult task when competing against the private sector. The Legislature may wish to explore what efforts can be made to further assist the Department of Technology in recruiting and retaining well qualified IT professionals in the future.

With respect to particular projects, while implementation of FI$Cal remains on track, there are still some issues that could alter either the cost or implementation timeline of the project. For example, the Bureau of State Audits (BSA) found, in its most recent annual update on the FI$Cal project, that there are a few issues that could be of concern to the Legislature, including data management and conversion, which are critical components required to fully implement FI$Cal. The magnitude of these project components is considerable. The project management team has completed an inventory and has identified 2,200 legacy systems that will need to be converted to FI$Cal. Additionally, there are 3,400 interfaces that will exchange data with FI$Cal. The project management team cancelled the procurement of a data management contractor in June 2011, and the procurement of a new data management vendor has still not yet been completed. Given the scale and complexity of data required to be converted, the Legislature should continue to monitor the progress of data management.

Numerous setbacks have hampered the progress of the 21st Century Project. The project team has moved on to the second vendor for the 21st Century Project and is currently revising the implementation timeline. The first phase of the project did not meet the level of results originally anticipated, delaying the project by at least six months. The delay will allow the vendor to address the issues that were brought forth by the project management team at the 21st Century Project. Unlike FI$Cal, there is not an independent audit conducted annually to review the progress of the 21st Century Project. Given the resources, both financial and personnel, required to implement the 21st Century Project, it may be wise for the Legislature to ask the Bureau of State Audits to conduct an annual audit of the 21st Century Project. The audit would be similar in scope to the annual audit on FI$Cal that the Bureau of State Audits has been asked to complete.

Revenues and Taxes

BACKGROUND:

The Governor and the LAO have both forecast modest growth in the economy, leading to a gradual recovery in state revenues. The state's recovery has begun to gather some momentum as a result of better real estate conditions, faster job growth, and improved consumer attitudes. Nonfarm employment is projected to grow 2.1 percent in 2013, 2.4 percent in 2014, and 2.5 percent in 2015. California personal income is projected to grow by $83 billion or 5.1 percent in 2012. For 2013 and 2014, growth in personal income is expected to 4.3 percent and 5.5 percent, respectively. The state's slow but steady recovery has significant implications for the state's revenue picture.

The state relies on three principal taxes for revenue sources to support the General Fund. Over the recent past, personal income taxes (PIT) have typically contributed about 50 percent, sales and use taxes (SUT) about 30 percent, and corporation taxes (CT) about 10 percent of total revenues. This revenue profile will change somewhat as a result of the two tax measures approved by the voters in November 2012 (described below) and the realignment of a portion of the state SUT to local governments to fund the 2011 Public Safety Realignment. For the budget year, the PIT is expected to generate $61.8 billion (63 percent), the SUT $23.3 billion (24 percent) and the CT $9.1 billion (9 percent). For the current year, the PIT and the SUT show slight improvements (less than 1 percent) over the 2012 Budget Act. In contrast, the CT shows an erosion of about 10 percent, continuing a long-term trend.

Based on continued moderate economic growth in the state and the passage of the two tax measures, the major revenue sources are expected to display year-to-year growth of 2.5 percent for the PIT, 1.1 percent for the SUT, and 2.2 percent for the CT. The budget includes increased PIT and SUT revenues due to the passage of Proposition 30. PIT revenues are expected to increase by $3.2 billion in 2011-12, $4.8 billion in 2012-13 and $4.9 billion in 2013-14. SUT revenues are forecast to grow by $611 million and $1.3 billion in 2012-13 and 2013-14, respectively. The passage of Proposition 39 will result in additional CT revenues of $440 million in 2012-13 and $900 million in 2013-14.

Proposition 30, the Governor's tax measure, raises tax rates for the PIT and the SUT on a temporary basis. The additional revenues are derived from:

- **Personal Income Tax Rates on High Income Taxpayers** —Increases PIT for high income taxpayers for seven years, beginning tax year 2012. Under prior law, the maximum marginal PIT rate was 9.3 percent. This measure temporarily raises PIT rates for higher incomes by creating three new tax brackets with rates above 9.3 percent.
    - A 10.3 percent tax rate on income between $250,000 and $300,000 for individuals and $500,000 and $600,000 for joint filers.

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

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

Proposition 39, which affects the CT, changes the apportionment of income for multistate corporations. Prior to 2011, California had long had a four-factor apportionment formula which allocated income to California for tax purposes by using the average of California's proportional share of a multistate corporation's property, payroll and sales (weighted twice) factors. Beginning in 2011, multistate corporations were able to use this four-factor formula or alternatively use just a single sales factor (SSF), representing California's proportion of all of a company's sales. The passage of Proposition 39, eliminated this so-called 'option" to use either of the two formulas effective in 2013, and stipulated that multistate corporations use the SSF.

The passage of the temporary taxes in the fall of 2012 gives the state some breathing room in terms of budgetary pressures and also provides an opportunity to evaluate the state's revenue system and its current structure.

GOVERNOR'S PROPOSAL:

The Governor's Budget includes no major tax and revenue proposals. As noted, significant recent tax changes occurred as a result of the passage of Proposition 30 and 39 last November. However, the Governor has proposed certain regulatory changes to the Enterprise Zone (EZ) program. The EZ program provides various tax credits to businesses employing certain qualified individuals within designated areas. Over the decades since its inception, significant design and administrative weaknesses in the program have been noted. These include the ability to claim tax credits well-after the qualifying employment has occurred and the existence of inadequate or flawed verification of qualifications for employees. These problems serve to substantially weaken or eliminate any hiring incentive the program is intended to provide.

The Governor proposes regulatory changes that are intended to eliminate or mitigate some of the most obvious weaknesses and inconsistencies in the program. The regulations are designed to:

- Limit retro-vouchering by requiring all voucher applications to be made within one year of the date of hire.
- Require third-party verification of employee residence within a Targeted Employment Area.
- Streamline the vouchering process for hiring veterans and recipients of public assistance.
- Create stricter zone audit procedures and audit failure procedures.

The proposed regulations will affect primarily revenues from the CT but have a minor impact on the PIT as well. The Administration estimates that the changes will result in increased revenues of $10 million in 2012-13 and $50 million in 2013-14. In addition to these proposed regulations, the Administration has indicated that it will be pursuing further EZ reform through legislation, although to date, no language on the proposed statutory reforms has been made available.

ISSUES TO CONSIDER:

Tax Expenditures

The state's major income taxes incorporate numerous policies that result in special treatment for individuals or businesses based either on situational factors or for engaging in certain activities. The policies that provide this special treatment are known as 'tax expenditure programs' (TEPs) in that they result in the 'expenditure' on a designated program of revenues that would otherwise be received by the state. TEPs largely come in the form of tax credits (a direct reduction in taxes owed) and income deductions (a reduction in income subject to the tax). Certain other TEPs include provisions such as accelerated depreciation, preferential tax rates, income disregards, or similar programs. TEPs result in a substantial reduction in the amount of revenue that would be received by the state absent the program; for TEPs related to income taxes, the LAO and DOF peg the foregone state revenue in most years at about $35 billion.

The TEP construct draws a parallel between direct expenditures of the state on an activity—for example, funds expended for conducting applied research—and the provision of a tax credit to the private sector for engaging in such research activity. Thus, looked at from the taxpayer perspective, elimination of or reductions in TEPs would allow for a broad-based reduction in taxes for all taxpayers while maintaining the same level of revenue. Generally, TEPs are of two types; those that are designed to give taxpayer relief (for example, the dependent exemption credit under the PIT) or provide an incentive for certain behavior deemed beneficial (for example, the research and development [R&D] tax credit under the CT and PIT).

Unlike direct spending, TEPs do not come through the legislative budget process, and thus, are not regularly evaluated as to their appropriateness or effectiveness. Although some TEPs are of limited duration ('sunsetted') or limited as to the aggregate amount ('capped'), TEPs are embodied in the tax code and typically allowed to grow much like an entitlement. Absent a cap or sunset, eliminating or limiting a TEP is generally considered a tax increase. As a result, TEPs are on the equivalent of 'automatic pilot.' One example is the R&D credit. Although many economists and tax analysts recognize the value of the R&D credit, there has been no methodical evaluation of its effectiveness or efficiency in achieving its designated objective—stimulating additional R&D activity. The credit continues to grow; in 2012-13, it resulted in a reduction in combined PIT and CT revenues of $1.5 billion.

One area that has grown significantly over the years involves the state's various EZ programs, which are implemented through the PIT and CT. This TEP includes a number of related policies that are designed to encourage business activity and employment in particular designated geographic regions. The largest component of the EZ program is the hiring credit, which provides a direct tax offset initially equal to 50 percent of wages paid to qualified employees. The Governor proposed eliminating the EZ program in 2011-12, in order to direct funds to core government programs such as education, but the effort was unsuccessful.

Significant weaknesses of the EZ program relating to its effectiveness as an economic incentive have been identified and addressed as part of the Governor's Budget (discussed above). Even more fundamentally, the great preponderance of research indicates that policies such as the state's EZ program do not result in additional overall economic activity in the state, but simply shift business activity and employment around. In some cases, the program may simply result in a reward for behavior that would have occurred irrespective of the program.

Meanwhile, the resource commitment to and budgetary impact of this program has grown quickly and is substantial. According to LAO, the combined PIT and CT impact of EZ and related credits was $169 million in 2001 and had grown to $528 million by 2005. Despite the impacts of the deepest economic downturn since the Great Depression, by 2011 the annual revenue impact of the EZ program had risen to $763 million—more than the proposed funding increase for UC and CSU. Over the last decade increases in EZ costs have been greater than 16 percent annually. An alternative business development policy might be to reduce the revenue impact of the EZ program and use the 'freed-up' revenues to fund more effective economic growth measures, such as the reduction or elimination of SUT on manufacturing equipment (see discussion below) or funding additional vocational education programs in distressed areas.

Sales Tax Base and Services

Over the last several decades, the SUT has become increasingly detached from the overall structure of the economy. The SUT—both state and local portions—is levied on the sale of tangible personal property, or goods. Originally intended to approximate a tax on consumption (except food and certain other necessities), a large proportion of personal consumption is now on services and intangibles. To the extent this has occurred, the base of the SUT has become narrower and narrower relative to the underlying economy. This not only puts upward pressure on tax rates, but also causes economically inefficient distortions.

In addition to this increasingly narrowed base, some suggest that the SUT base could simultaneously be too broad in certain respects, since the SUT is levied not only on the sale of goods to consumers, but also sales to businesses. To the extent that goods sold to businesses are subsequently incorporated in goods that are later sold and subject to the SUT, there is an argument that this results in double taxation—or 'tax pyramiding.' Partially to address this issue and provide an investment incentive for certain sectors, the state several years ago had a manufacturing investment credit (MIC) that was implemented through the state's income tax programs.

On the other hand, if subsequent sales are not taxed, it may be appropriate to treat some business purchases as final consumption. Finally, it should be noted that the taxation of business purchases of goods is a substantial portion of the SUT base, representing roughly one-third of the total in recent years. Thus, any measures to address perceived weaknesses or inconsistencies in the SUT base must be mindful of the potentially significant budgetary and fiscal impacts.

Revenue Volatility

The PIT is a relatively volatile revenue source, in that revenues from this source grow faster than the economy during periods of expansion and decline more abruptly during periods of economic contraction. Because the share of state revenue derived from the PIT has increased over the years, this has had the impact of increasing the volatility of the tax system. The reasons for PIT volatility are several, but generally they relate to the fact that the top income earners that contribute a significant share of PIT revenues are taxed at the highest rate and receive a large proportion of their income through capital gains, dividends and bonuses. The sharp increase in these types of income during good times and the sharp drop in bad times, leads to a volatile revenue stream.

Volatility creates problems at the state level because it adds substantial complexity and stress to the budgeting process. The sharp drop in revenues beginning in 2008 meant that the legislature and the administration had to address frequent revenue shortfalls and adopt multiple mid-year budget adjustments in order to maintain a balanced approach. The volatile nature of the revenue stream complicated this process. In addition, at the location of service delivery—whether at the state or local level—abrupt changes in the level of the resource commitment lead to uncertainty and confusion.

While there has been and always will be some volatility in the state's tax system, the increasing volatility in the PIT is a characteristic that has developed most acutely in the last two decades. The result has generally been tax cuts and program expansions in good times and program cuts couple with occasional tax increases in bad times. Some have proposed altering the tax system itself, to make it inherently less volatile. For example, the report from the Commission on the 21st Century Economy in 2009 proposed adopting a new and untried tax that would more closely reflect the underlying economy, replace the CT and reduce reliance on the PIT.

Other more measured approaches have included subjecting volatile components of the PIT to a lower tax rate, resulting in less reliance on those sources but potentially necessitating increases in other taxes. Since the state also benefits from an 'elastic' revenue stream, a more methodical and consistent approach that would retain these potential benefits involves reserving a portion of revenues received during good years in order to provide for an adequate budget reserve for use during bad years. Revenues equating to amounts received from particularly volatile sources could be designated for this purpose. Alternatively, the LAO has suggested that the Legislature might earmark such volatile revenues for one-time expenditures.

Revenue Forecasts and Tax Collections

Tax payments and refunds are examined monthly to assess the accuracy of the revenue forecast. The Governor's Budget revenue forecast is the annual starting point; LAO releases an updated revenue forecast in February; the Governor releases an additional revenue forecast with the May Revision. Subsequent revenue forecasts benefit from additional months of actual tax collection and refunds. The State Controller and DOF release updates on tax collection in the first half of each month. General Fund projections displaying point-in-time estimates are provided in the Appendix of this *Overview*.

Taxes are remitted in through different means. Employment wages and bonuses are part of employer PIT withholding, which the employer remits to the state, while estimated quarterly payments are required for taxpayers that have capital gains or other significant income outside of wage earnings. The SUT is remitted in monthly payments by retailers. Businesses paying the CT make quarterly tax payments. Tax refunds are also tracked in monthly data for taxpayers who overpaid their tax. The following are some of the key tax dates that occur and inform the budget deliberations:

- **January 15—**l Final quarterly estimated payments for PIT are due for the 2011 tax year.
- **January 31—**Final SUT payments are due from retailers for the fourth quarter of 2011.
- **March 15—**Tax filing deadline for those subject to the CT.
- **April 15—**Tax filing deadline for the PIT for the 2012 tax year, and due date for the first quarterly estimated payment for the 2013 tax year. For corporations that use calendar years for reporting, the first quarterly CT payment is due.
- **April 30—**Final SUT payments are due from retailers for the first quarter of 2013.

Redevelopment

BACKGROUND:

Since the Governor initially proposed eliminating redevelopment agencies (RDAs) as a key component of the 2011-12 Budget, the Legislature has been grappling with the issues related to their dissolution and associated concerns regarding community development. The Governor's initial proposal was anchored by the perspective that the diversion of over $5 billion in property taxes to RDAs was no longer feasible and such resources should be more effectively channeled to cities, counties, schools and other local governments. After consideration of the Governor's proposal, the Legislature altered the approach by developing legislation that addressed the state's budgetary requirements while accounting for a continuing need for local economic tools.

The Legislature's approach, incorporated in the 2011-12 budget agreement, established a alternative voluntary redevelopment program pursuant to AB 27 X1, (Chapter 6, Statutes of 2011), but eliminated RDAs in AB 26 X1, (Statutes of 2011, Chapter 5) for communities that chose not to participate in the alternative program. RDAs could avoid elimination if the communities that formed them agreed to participate in the alternative voluntary redevelopment program and remit annual payments to K-14 education. The approach provided for significant budgetary relief, by allowing additional revenues to flow to K-14 education, but retained RDA functions for local governments in the long-term. The adopted budget assumed $1.7 billion in RDA payments would offset General Fund spending in the budget year and $400 million annually in subsequent years.

Following the passage of these complementary measures, the California Redevelopment Association challenged the constitutionality of both pieces of legislation. In its December 20011 ruling, the California Supreme Court held that AB 26 X1, allowing for the dissolution of RDAs was valid, but that the companion measure assuring their continuation was invalid. As a result, AB 26 X1 went into effect; RDAs were dissolved as of February 1, 2012, with their affairs, including the disposal of RDA assets, to be resolved by individual successor agencies. As a result of the court decision, property taxes that formerly went to RDAs were directed to existing 'pass-through' requirements for local agencies; successor agencies for the retirement of RDAs' debts and other obligations; and cities, counties, K-14 education and special districts.

The 2012-13 Governor's Budget incorporated the court decision, resulting in revised estimates for the General Fund offset for K-14 education funding requirements. The General Fund savings for 2011-12 was estimated at $1.1 billion (from $1.7 billion), but increased to $1.1 billion (from $400 million) for 2012-13 as a result of increased flow of property taxes. This resulted in a net gain over the two year period from the prior estimate. The 2012-13 Budget assumed that approximately $1.7 billion would be received by K-14 education and serve to offset the state's Prop 98 General Fund obligation, with an additional $1.4 billion to be received from freed-up former RDA cash and cash-equivalent assets during the budget year.

As part of the 2012-13 Budget, AB 1484 (Chapter 26, Statutes of 2012) provided additional tools for successor agencies, oversight boards, and the Department of Finance (DOF) to facilitate the orderly wind-down of RDA activities. AB 1484 created a process to: transfer former RDA housing assets to housing successor entities; require audits of various RDA funds and accounts to identify unencumbered funds that should be remitted to local taxing entities; and require the completion of a long-range property management plan to facilitate the disposition of RDA properties. The legislation also allowed local communities that received a 'finding of completion' from the DOF additional discretion regarding former RDA real property assets, loan repayments to the local community, and the use of proceeds from bonds issued by the former RDA. The finding of completion is an indication that all amounts determined to be due from the former RDA have been paid and satisfied

GOVERNOR'S PROPOSAL:

The Governor's Budget includes no new initiatives regarding RDA dissolution or alternative community development approaches, but the ongoing procedures for existing policies represent a substantial commitment of resources. The process of winding-down a $5.0 billion annual program administered, controlled and implemented at the local level has proven to be exceedingly complex and time-consuming, in addition to being highly contentious. Thus, the central thrust of the Governor's proposal is to continue the process of unwinding the RDAs and facilitating the flow of additional property tax dollars to local governments, while maintain payments on existing obligations.

Ongoing workload related to the winding-down of RDAs involves the generation, submittal, and review of hundreds so-called Recognized Obligation Payment Schedules (ROPS) each with a multitude of entries. Every six months, successor agencies must submit to DOF their ROPS, which indicates their proposed payments for the next payment cycle. The DOF reviews each ROPS to determine whether the identified payments are enforceable obligations. The successor agencies are then provided property tax allocations to pay the approved enforceable obligations. Any property tax revenue remaining after the enforceable obligations are paid is distributed to the affected taxing entities based on their property tax share. The additional property tax revenue received by local schools generally offsets the state's Proposition 98 General Fund costs.

As the background discussion suggests, accurately estimating the property tax revenue available for local governments has been a significant budgetary challenge. This is mainly because comprehensive information concerning the amount of property taxes required by RDAs for paying enforceable obligations was not available early on, nor was consistent data on cash assets available. Now that three payment cycles worth of information is available and cash assets are more apparent, more accurate estimates are possible. The Governor's Budget includes Proposition 98-related General Fund savings totaling $2.1 billion in 2012-13 and $1.1 billion in 2013-14. This is revised downward from the 2012 Budget Act estimate of $3.2 billion in 2012-13 and $1.6 billion in 2013-14, and accounts for both on-going revenues and the one-time distribution of cash assets. Going forward, the obligations of the former RDAs will continue to decline as debts are paid off and the ongoing savings to the state will increase. It is estimated that by 2016-17 approximately $1 billion in ongoing savings will be achieved.

ISSUES TO CONSIDER:

RDA Dissolution Issues

In its February 9, 2011 publication *Should California End Redevelopment Agencies*, the LAO was prescient when it declared that, "Dissolving redevelopment will be complicated and disruptive." Program changes of this magnitude inevitably pose administrative, policy, and legal difficulties. Many communities had significant numbers of complex projects currently funded by property taxes revenues, as well as plans for additional redevelopment expenditures. A significant portion of former RDA funds are committed to the payment of existing obligations and, as a result, drafting a plan for local governments to unwind their RDA programs and successfully navigate the many legal, administrative, and financial factors has been complex. In particular, many communities have raised concerns regarding the completion of planned or partially finished projects. Given this, there may be steps the Legislature should take to address the unwinding of RDAs to ensure that local communities and projects get a 'fair shake.' In addition, more direction might be given to the use of former RDA physical assets for those communities that have access to them.

Local Development Financing

The end of RDAs has prompted interest in developing a replacement program and a discussion of important elements that such a program might contain. AB 1484 provided some additional tools for local communities, in that localities that comply with RDA dissolution requirements can retain and develop existing assets as well as use bond proceeds from prior bond issues. These are short-term. Other existing programs include: business improvement districts (BIDs), infrastructure improvement districts (IFDs), property tax debt overrides, Mello-Roos financings, assessment levies and other parcel taxes. None of these current local financing tools have all of the elements that made redevelopment so attractive and valuable to California cities and counties. Specifically, RDAs provided the sponsoring government with considerable resources and did so without requiring the approval of local voters or business owners, directly imposing increased costs on local residents or business owners, or requiring additional voter approval prior to issuing debt. Of course, they also caused a substantial diversion of property taxes from local schools and increased pressure on the General Fund.

Alternative Community Development Programs

There may be other suitable options for new programs that allow local discretion in community development efforts and provide accompanying fiscal tools. Such programs could eliminate the fiscal exposure to the state while allowing communities to control the tools for new development. Two recent measures, described below, were vetoed by the Governor on the basis that the time was not right, given the continuing RDA dissolution process. SB 1156 (Steinberg) would have allowed cities and counties to use tax increment financing along with other financing tools to support the goals various environmental and planning goals. While school districts were excluded from participating, it allowed other taxing agencies, such as cities and counties, to participate. AB 2144 (Perez, et al), would have created financing districts that included a broader range of capital and infrastructure investment than current IFDs and lowered the vote approval threshold to 55 percent. Under the proposal, the property taxes of local governments that decided not to participate in the district would not be affected.

State Support for Local Development

Potential state support must ultimately hinge on getting the state's budget on a strong fiscal track and be measured against other budgetary demands. In some cases an argument may be made for state support for projects of a regional or statewide benefit—such as transportation improvements or open space—or joint projects that benefit local schools in some manner. Such state support could be based on grants or loans, or possibly using a portion of the school-related property tax increment, or an equivalent amount derived from state resources. Projects eligible for some degree of state support could be selected based on the degree to which they meet a certain level of state or regional impact—with greater support for those with a higher degree of regional or state impact. In addition, such support could be tied to the paying-down of existing RDAs' enforceable obligations, which frees-up additional property taxes for schools.

Affordable Housing

Current law enacted in AB 1484 provides for the retention of some housing assets and subsequent development for affordable housing by transferring housing assets to the housing successor agency. In addition, the law allows repayment of loans made from the low and moderate income housing fund and the use certain bond proceeds for affordable housing projects. These are short-term policies to address the issue of affordable housing in the state. The state also administers a variety of programs to reduce housing costs for low- and moderate-income individuals through the allocation of federal and state housing credits. These may be insufficient to address needs in the affordable housing area which might require additional support.

Public Private Partnerships

BACKGROUND:

In November of 2012, the Legislative's Analyst's Office (LAO) published a report, *Maximizing State Benefits From Public-Private Partnerships*, that detailed California's recent experience with Public-Private Partnership (P3) projects and made recommendations with respect to the state enhancing its ability to carry-out future P3 endeavors.

State Project Background

In most instances, such as for court facilities and state office buildings, the Legislature must approve and appropriate funds for a state project. Projects also must receive approval from the State Public Works Board at various subsequent stages. The exception to this approval process is the California Transportation Commission (CTC), which approves most state projects related to transportation.

State law specifies three general types of procurement approaches—design–bid–build, design–build, and P3—that state departments can use to deliver infrastructure projects that have been approved for construction. Each of these procurement approaches involves varying ways of contracting with the private sector for a project, as outlined in the following table.

State Construction Project Approaches	
Design-Bid-Build	Under this approach, the work for each stage of a project is performed separately. For example, a state department will generally first award an architectural/engineering contract to design the project. After detailed project plans and drawings are completed, the department then selects a contractor to perform the construction work (based on competitive bid). Once construction is completed, the state department is responsible for operating and maintaining the facility. The state pays for the cost of design–bid–build projects either up front with state funds or over time by selling general obligation bonds or lease–revenue bonds.
Design-Build	With design–build, the department typically contracts (competitive bid) with a private general contractor to both design and build the infrastructure project. The general contractor is responsible for subcontracting with other entities for design and various construction work. Under design–build, the state maintains responsibility for financing, operating, and maintaining the project.
Design-Build	Another type of design–build involves the state transferring design and construction risks to a specialized construction manager (construction manager at-risk), rather than a general contractor. With construction

	manager at risk, the state awards a contract based on a fee. The construction manager designs the project and solicits bids from subcontractors and suppliers. The sum of these bids plus a surcharge determines how much the state will pay.
P3	While there can be varying degrees of P3s, the type of P3 most recently used in California is when a single contract is entered into with a private partner (often a consortium of several companies) for the design, construction, finance, operation, and maintenance of an infrastructure facility. In order for a private partner to be willing to finance these costs, the contract must specify a mechanism for repaying the partner. In many cases, this involves a revenue source created by the project (such as a toll or user fee on the infrastructure facility), with the private partner taking on the risk that the projected revenues will materialize at the level anticipated. Alternatively, the state can commit to making annual payments to the partner from an identified funding source, such as tax revenues.

Recent California P3 Projects. Current state law authorizes three state departments—Caltrans, the Administrative Office of the Courts (AOC), and the High–Speed Rail Authority (HSRA)—to use some form of a P3. In recent years, California has used this authority to enter into P3s with private partners for two state infrastructure projects. Specifically, to build and operate the Presidio Parkway transportation project in San Francisco (also known as Doyle Drive) and to build and maintain a new courthouse in Long Beach. Each of these agreements is for a period of about 30 years, with a combined estimated cost to the state of about $3.4 billion. HSRA has yet to enter into any P3 contracts.

In January 2011, Caltrans entered into its first P3, under expanded authority that was granted in 2009, for the Presidio Parkway project (Caltrans previously undertook two P3 projects pursuant to more limited authority initially granted in 1989). This particular P3 requires the private partner to complete the second phase of the design and reconstruction of the southern approach to the Golden Gate Bridge and to operate and maintain the roadway for 30 years. In exchange, the state will make payments estimated to total roughly $1.1 billion to the private partner over the life of the contract.

The 2007-08 Budget Act directed the AOC to gather information regarding the possible use of a P3 for the replacement of the Long Beach courthouse. In December 2010, the AOC entered into a P3 that requires a private developer to finance, design, build, operate, and maintain the Long Beach courthouse over a 35–year period in exchange for payments from the state totaling $2.3 billion. At this time, the Long Beach courthouse is the only project that the AOC has procured using a P3.

GOVERNOR'S 2013-14 BUDGET PROPOSAL:

The Governor's budget proposes $34.8 million from the Immediate and Critical Needs Account (one of the two main court construction funds) to fund the new Long Beach Courthouse service fee payment for the budget year.

ISSUES TO CONSIDER:

The LAO Found that the State's Use of P3s Falls Short of Best Practices. As part of the LAO's examination of the P3 approach, they reviewed international research and interviewed experts in the field. Based on their review, they identified a set of best practices that have been found to maximize the potential benefits of P3s and minimize its potential limitations. These best practices include:

- Establish Overall P3 Policy and Implement Transparent Processes
- Adopt Criteria to Determine Good Candidates for P3 Projects
    - Government Benefit From Using Nonpublic Financing
    - Technically Complex
    - Ability to Transfer Risks to Partner
    - Revenue Source to Repay Financing
- Conduct a Rigorous Value for Money Analysis (VFM)
- Adopt and Implement Project Approval Process
- Establish Government Expertise in P3s

In analyzing the use of P3 authority for the projects mentioned above, the LAO generally found that the practices of Caltrans and AOC are not necessarily aligned with P3 best practices. Their analysis indicates that these departments did not use clear P3 processes and appear to have selected projects not well suited for a P3 procurement. Their findings are as follows:

- **State Lacks Transparent P3 Processes.** The LAO found that the state's use of P3 procurement for the Presidio Parkway and Long Beach courthouse projects lacked transparent frameworks and clear processes. For example, when Caltrans used a P3 procurement for the Presidio Parkway, the department lacked a transparent framework for selecting the project and conducting a VFM analysis. It did not release a draft P3 program guide until December 2011, one year after signing the agreement for Presidio Parkway. While the guide addresses many procedural questions regarding the department's future use of P3s, it does not establish a consistent process for evaluating potential P3 projects through the use of a VFM analysis, which is important to ensure that projects are evaluated on a consistent basis using reasonable assumptions. The Caltrans draft P3 program guide also does not address how project evaluation, review, and procurement responsibilities will be carried out when the state partners with local transportation agencies.

  Similarly, AOC did not use a transparent framework in selecting the Long Beach courthouse to be a P3 project. The AOC did not develop guidelines for selecting potential P3 projects and conducting VFM analyses.

- **Selection Criteria for Recent Projects Not Aligned to Best Practices.** According to Caltrans staff, the Presidio Parkway project was selected as a P3 candidate primarily based on two criteria: (1) an estimated project cost of more than $100 million and, (2) a completed environmental impact review. However, according to the identified best practices, these two factors alone do not constitute a robust set of screening criteria (risk-transfer, state financing benefit, etc.). The LAO analysis indicates that if Caltrans utilized such criteria in its selection process, the Presidio Parkway project would have been found to be inappropriate for P3 procurement.

  According to AOC staff, the Long Beach courthouse project was selected as a P3 candidate based primarily on two criteria: (1) it was one of the largest court construction projects considered at that time and, (2) the Long Beach area has a competitive market for the type of property management staff needed to operate a P3. Similar to the selection of the Presidio Parkway project, the selection process for the Long Beach courthouse project did not include much of the recommended best practice criteria. Accordingly, the LAO's analysis indicates that if AOC utilized best practice criteria in its selection process, the Long Beach courthouse project would have been found to be inappropriate for P3 procurement.

- **VFM Analyses Based on Assumptions That Favored P3 Procurement.** Both Caltrans and AOC contracted with private consultants to perform VFM analyses for the Presidio Parkway and Long Beach courthouse projects. Specifically, the analyses compared the costs of constructing the project under a more traditional approach to a P3 approach. The VFM analyses found that the state would benefit financially if the Presidio Parkway and Long Beach courthouse projects were procured as P3s—meaning it would be cheaper to have a private developer build and operate the planned facility. The LAO's review of these particular analyses, however, indicates that both VFM analyses were based on several assumptions that are subject to significant uncertainty and interpretation and tended to favor a P3 procurement. If a series of different assumptions were made, the VFM analyses would have shown that the P3 procurement on the Presidio Parkway and Long Beach courthouse projects would be more expensive in the long run than a more traditional procurement.

  Some of the key assumptions made by Caltrans in the VFM analysis of the Presidio Parkway project that tended to favor P3 procurement include: a relatively high discount rate, unjustified federal tax adjustment, assumed early payment of cost overruns, and failure to account for competitive bidding environment. The LAO's analysis indicates that utilizing a different set of assumptions (such as a discount rate of 5 percent, instead of 8.5 percent that was used, and excluding the assumed tax adjustment) would result in the cost of the Presidio Parkway project being less—by as much as $140 million in net present value terms—in the long run under a traditional procurement approach than the chosen P3 approach.

  Some of the key assumptions in the VFM analysis of the Long Beach courthouse that tended to favor P3 procurement include: unjustified tax adjustment, overstated cost overruns, additional space leasing, and project completion timeframes. The LAO's analysis indicates that utilizing a different set of assumptions than those mentioned above (such as excluding the assumed federal tax adjustment and leasing costs) would result in the cost of the Long Beach courthouse project being less—by as much as $160 million in net present value terms—in the long run under a traditional procurement approach than the chosen P3 approach.

- **State Law Lacks Thorough Project Approval Processes.** The LAO's analysis found that for both the Presidio Parkway and Long Beach courthouse projects, the state did not utilize a thorough process for selecting P3 projects. Having thorough processes in place could have prevented Caltrans and AOC from entering into a P3 agreement for each project, or at least required changes to negotiate lower prices and better ensure that the intended P3 benefits are achieved.

- **State Lacks P3 Expertise.** Experts recommend that government entities develop expertise regarding P3s in order to better protect public resources when entering into large contracts with private developers. Such expertise within state government has not been sufficiently developed in California.

- **No Systematic Approach for Reviewing Lessons Learned.** The LAO's review also finds that the state does not have a systematic process for identifying and applying lessons learned from prior P3 projects. Although Caltrans is the only state agency to have entered into multiple P3 agreements, it currently lacks a formal process for reviewing past P3 projects in order to maximize benefits and avoid repeating past mistakes. The AOC is currently developing a review and reporting process for the Long Beach courthouse project. Once completed, these reports may provide helpful lessons learned about AOC's use of P3 procurement.

The Legislature May Wish to Consider the LAO's Recommendations for Maximizing State Benefits From P3s. Based on the LAO's extensive review and findings, they identified several opportunities (detailed below) for the state to further maximize its benefits when deciding to procure a state infrastructure project as a P3.

- **Specify P3 Project Selection Criteria.** The LAO found that the state's processes for selecting P3 projects are inadequate and not necessarily based on selection criteria identified in the research as best practices. Accordingly, the LAO recommends that the Legislature adopt legislation requiring that each state department with P3 authority utilize certain criteria when evaluating whether a particular project should be procured as a P3. According to the research, these selection criteria should not be highly prescriptive, but rather should provide general guidance regarding the selection of potential P3 projects. The selection criteria should include (1) being a technically complex project and, (2) a project that can transfer risks to a private partner and benefit from non–state financing. In addition, the Legislature may want to specify whether P3 projects must have a revenue source, such as a user fee.

- **Require Analysis of a Range of Procuremen t Options.** In order to determine which procurement approach would most effectively benefit the state, the LAO recommends that the Legislature adopt legislation requiring a comparative VFM analysis of a range of procurement options (including design–bid–build, design–build, and P3) for all potential P3 infrastructure projects. The benefit of evaluating only two procurement approaches, as was done by Caltrans and AOC, can be limited. The LAO also recommends that the Legislature specify in statute that such VFM analyses:
  - ***Exclude Federal Tax Adjustments.*** Increased federal tax revenues do not directly benefit the state and should not be included in a VFM analysis.
  - ***Apply Costs to Expected Year of Expenditure.*** Project costs should be accounted for in the year they are likely to be incurred in order to effectively estimate the project's likely total cost in the long run.
  - ***Use Current Construction Cost Estimates.*** Construction cost estimates should be based on the current bidding environment in the state.
  - ***Include a Sensitivity Analysis.*** A sensitivity analysis can help to indicate how the results of the VFM analysis might change with a different set of assumptions.

- **Modify Structure a nd Responsibilities of Public Infrastructure Advisory Commission (PIAC) .** In order to help ensure that PIAC (the board charged with assembling research, best practices, and lessons learned from transportation P3s around the world) effectively carries out its duties, the LAO recommends the Legislature adopt legislation to:
  - ***Expand PIAC's Authority.*** Require the commission to approve all state P3 projects and expand the scope of PIAC to all types of infrastructure projects, rather than only those related to transportation. Having the commission involved in all types of P3s will further the state's P3 expertise. To reflect this broader scope, the LAO also recommends making PIAC an independent commission, rather than part of the BT&H Agency.
  - ***Direct PIAC to Evaluate Other Departments for P3 Authority.*** Direct PIAC to review the types of projects planned by other state departments and recommend to the Legislature whether P3 authority should be granted to additional state departments.
  - ***Broaden PIAC's Expertise.*** The Legislature should appoint some of the commissioners and, in addition to P3 experts, the commission should include the Director of the Department of General Services (or a representative), and the State Treasurer (or a representative). The Legislature could also consider reducing the number of commissioners on PIAC to a more manageable size.
  - ***Require PIAC to Develop and Implement Best Practices.*** Require PIAC to (1) develop a set of best practices for P3 projects in California, (2) provide state departments specific steps for implementing those best practices, and (3) provide technical assistance to state agencies planning to pursue a P3.

- **Improve Consistency of Stat e's P3 Approval Process.** Adopt legislation to make the process for reviewing and approving P3 projects consistent and thorough across those state departments authorized to pursue such projects.

Given the significant financial commitments realized from the two P3 projects outlined by the LAO and the critical role all state projects play in providing for an effective and appropriate state infrastructure, consideration of the LAO's findings and recommendations should, at the very least, facilitate a discussion regarding how California can better position itself to evaluate and carry-out future infrastructure projects.

Performance-Based Budgeting

BACKGROUND:

Performance-based budgeting is an approach that creates incentives for agencies to produce measurable results that lead to defensible spending levels. Although the interest in this form of budgeting has waxed and waned over the past several decades, the most recent period of budget stress has generated increasing interest among state legislators and the executive branch. A performance-based budgeting approach provides for budget allocations based on defined performance measures and allows for adjustments based on these pre-established metrics. The procedures can also facilitate examining internal allocations within budgets.

GOVERNOR'S PROPOSAL:

The Governor's 2013-14 Budget draws upon the performance-based budgeting approach and highlights a multi-year plan that has been developed by the Department of Consumer Affairs (DCA) and the Department of Finance (DOF) to modify programs within the DCA to achieve more efficiency and transparency. This plan stems from an Executive Order, issued by Governor Brown in 2011, which directed the DOF to modify the state budget process in order increase efficiency and focus on accomplishing program-related goals.

CASE STUDIES:

There are a number of states that currently utilize performance-based budgeting to allocate their state's financial resources. While some states have slowly integrated performance-based budgeting into their budgeting process, other states have adopted performance-based budgeting for all of their agencies at once. The results are varied, and there is no single determining factor as to why a particular approach results in success or failure. Nor does the source of the reform appear to be of consequence. There are examples of state legislatures establishing performance-based budgeting policy, and there are examples of performance-based budgeting efforts led by the executive branch.

In Louisiana, a form of performance-based budgeting has been in statute since 1977, when the first system was approved by the Legislature. The initial objectives were focused on eliminating wasteful state spending. Later additional funding provided for efforts to achieve specified performance metrics. Specified metrics are approved by a Joint Legislative Committee on the Budget and are updated quarterly. As part of the process, the Executive Branch and its departments issue performance reports which are then matched with annual performance standards. Variations from the standards are reported and a system of budgetary rewards and penalties are incorporated as part of the process.

New Mexico established a performance-based budgeting system in 1999, which is jointly administered by the Executive and Legislative branches. The defined objectives of the system in New Mexico are to enhance accountability while also improving the quality of information provided to decision-makers who manage the state's budget. The information is typically reviewed on a quarterly basis. Some attribute the modest surplus in New Mexico's 2011-12 Budget to the utilization of a performance-based budgeting system.

Virginia is also utilizing a performance-based budgeting system that can be used to analyze data and information not only by agency, but by region of the state. The program was developed by then in 2002, and has been in continuous operation since that time. In this state's approach, each individual agency consults with the Executive Office and establishes milestones with specific goals. The program was developed with assistance from the private-sector.

Oregon has also implemented a performance-based budgeting system, and unlike many other states, the state created a separate entity with the sole responsibility of managing the data and measurement metrics for state agencies and departments. The Oregon Performance Board, as it is known, has not received any funding for several years as a result of budget cuts. As a result, the data provided by the board is now outdated, and unreliable as a basis for budgetary decision-making.

ISSUES TO CONSIDER:

Moving forward, the state has an opportunity to draw from the experience of other states that have implemented a performance-based budgeting process. Each state that has implemented a performance-based budgeting system faced a different set of budgeting challenges. In 2011, the California Legislature passed a measure (SB 14) that would have placed in statute many of the budget reforms highlighted in the Executive Order. The measure was vetoed by the Governor.

California can utilize the lessons learned from many other states that have implemented some form of performance-based budgeting and apply the measures that best suit the state's needs. However, in order for the process to achieve any level of success, it is important that the Legislature and the Executive Office place value in the data derived from the process. Over the next few years, if the data does not generate results that benefit the state's budget-related decision-makers, the exercise in performance-based budgeting will be of limited value.

Veterans

BACKGROUND:

The state performs three primary functions to support the needs of California's approximately 1.9 million veterans and their families: guidance and representation through the disability and benefits claims process; direct loans for farms and homes; and long-term residential and medical care at California Veterans Homes. The California Department of Veterans Affairs (CDVA) is designed to support the efforts of the United States Department of Veterans Affairs (USDVA) in providing healthcare and a wide array of other benefits to eligible veterans including educational benefits, disability compensation, pensions, and guarantees on home loans for eligible veterans. The state and local governments have long played an integral role in assisting the state's veterans access benefits provided by the USDVA and, in some cases, provide additional benefits to returning service members. Recognizing that the state can provide an important service to veterans, the state has set aside funds to support the efforts of the USDVA and provide additional benefits, such as long-term residential care and the farm and home loan program.

California remains home to the largest population of veterans in the country. A September 2010 study conducted by the USDVA found that:

- 1,942,775 veterans are living in California.
- 418,775 veterans sought treatment at a Veterans Health Care facility in 2010.
- Approximately $4.5 billion in compensation and pension is distributed to California's veterans annually.

The Governor's Budget proposes total spending of $386.9 million ($316.3 million General Fund) for the CDVA. This proposal reflects a $58.3 million dollar increase over expenditures for 2012-13.

Summary of Expenditures
(Dollars in Thousands)

Program	**2012-13**	**2013-14**
Farm and Home Loans to Veterans	$68,277	$65,506
Veterans Claims and Rights	12,525	11,350
Care of Sick and Disabled Veterans	247,812	310,032
Total	**$328,646**	**$386,911**

Veterans Homes of California

A significant portion of CDVA's mission, and budget, is dedicated to providing the state's eligible residents with rehabilitative, residential, medical, and support services in a home-like environment. In fact, over 80 percent of the Governor's proposed budget is dedicated to the care of sick and disabled veterans. Currently, CDVA maintains campuses in Barstow, Chula Vista, Lancaster, Ventura, West Lost Angeles, and Yountville. Additionally, the construction of new homes in Redding and Fresno were completed in the spring of 2012. General Fund resources of $4.3 million were provided in the 2012 Budget Act (Chapters 21 and 29, Statutes of 2012) in order to staff the veterans' homes. The admissions process for residents is expected to begin in the fall of 2013.

Each campus is capable of providing varying levels of care, in accordance with USDVA standards, ranging from domiciliary care to a skilled nursing facility. Overall, there are approximately 2,200 licensed beds, and CDVA maintains a physical capacity of almost 3,000 beds. However, projected census totals show that there will be slightly less than 2,000 residents within the CDVA Veterans Homes network. The table below provides a more in-depth break down of the capacity and care level of each campus:

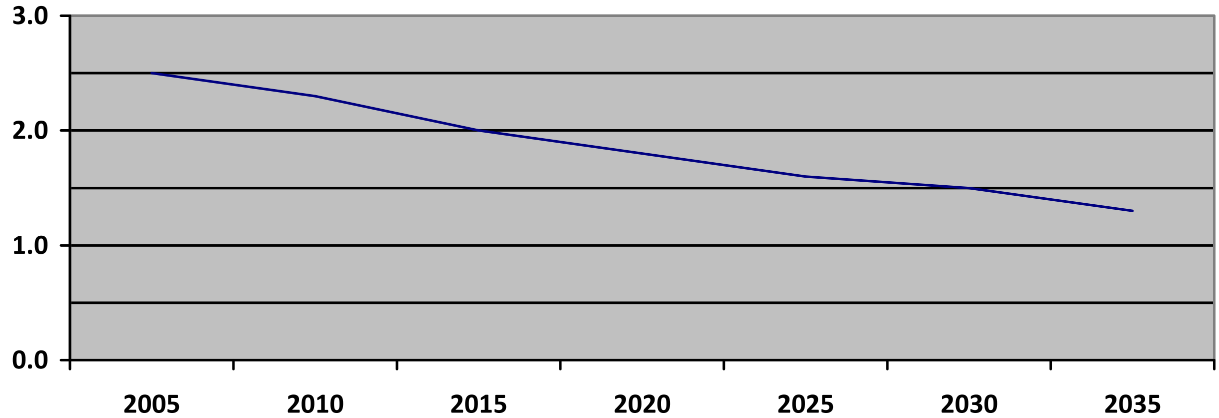
Veterans Homes of California
Census and Level of Care Summary

Campus	Physical Capacity	Licensed Beds	Projected 2013-14 Census	Skilled Care	Intermed. Care	Residential Care	Domiciliary Care
Yountville	1,229	1,203	994	x	x	x	x
Barstow	400	344	212	x	x	x	x
Chula Vista	400	400	290	x		x	x
West LA	396	156	279	x		x	
Ventura	60	60	60			x	
Lancaster	60	60	60			x	
Redding	150	x	32	x		x	
Fresno	300	x	32	x		x	
TOTAL	**2,995**	**2,223**	**1,959**	**617**	**151**	**341**	**849**

In addition to the services highlighted above, the CDVA has been working to provide adult day-health care services in the future at some of the facilities within the CDVA Veterans Homes network. While CDVA currently does not offer Community-Based Adult Services (CBAS), the Lancaster and Ventura Veterans Homes are equipped to provide CBAS.

With the addition of two new veterans' homes in Redding and Fresno, the CDVA is projected to have a physical capacity of nearly 3,000 beds. However, the number of eligible veterans in California continues to decline. This mirrors a trend at the national level. Barring any future conflicts that would require large scale troop commitments, estimates conducted by the U.S. Department of Veterans Affairs have shown that by the year 2035 California will be home to slightly over 1 million veterans. This would represent a significant drop in the overall population of veterans living in California.

Projected U.S. Veteran Population 17 years and Older
2005 to 2036
(In Millions)



Figures extracted from U.S. Department of Veterans Affairs 2011 Veterans Population Model

Veterans Claims and Rights

Veterans currently living in California were provided with disability compensation and/or pension benefits totaling $4.5 billion dollars in 2011. As noted earlier, one of CDVA's primary missions is to assist eligible veterans, and their dependents, in obtaining federal and state benefits by assisting the veteran with a specific claim. CDVA maintains a small number of staff (53.8 PY's) to assist the state's veterans with benefit representation. However, much of the claims representation process is managed by County Veterans Service Officers (CVSO). Historically, the Governor's Budget has provided $2.6 million in General Fund to support the efforts of the CVSOs (there are currently CVSOs in 54 of California's 58 counties.)

Historically, veterans in California have received less than the national average in compensation and pension benefits. Nationally, veterans receive an average of $2,104 per month, while veterans in California received slightly below that at $1,929. While improvements have been made, California is still trending behind other states that have large veteran populations, such as Texas and Florida. To address this, the Legislature amended the funding distribution formula (Chapter 401, Statutes of 2012) for determining veterans' compensation and benefits. Funding to support the CDVA will not change, but each county may receive a different level that more accurately reflects the level of compensation provided to the veterans that they serve. The CDVA has been charged with identifying a disbursement formula that more accurately accounts for the value of the return to the individual veteran, with expectations that this change will be fully implemented within a couple of years.

Additionally, CDVA has progressed towards the development of CalVet Connect, which is an off the shelf product that serves as both a database and a communication platform for the numerous County Veteran Service Officers located throughout the state. The Legislature included funding ($500,000) to develop CalVet Connect in the 2012 Budget Act. The initiative is largely a response to a 2009 report conducted by the California Bureau of State Audits that found that the department offered a limited number of direct services to the state's veterans and had a limited amount of contact information for veterans living in the state.

CDVA has also collaborated with the California Department of Motor Vehicles (DMV) to further expand their outreach capabilities. In 2010, a Memorandum of Understanding (MOU) was signed between CDVA and the DMV that would allow veterans to self-identify their veteran status when applying for a driver's license in the state. As a component of the agreement, the DMV will pass along the veteran's information to CDVA, which would provide outreach services to the individual veterans and claim representation if needed.

ISSUES TO CONSIDER:

While the CDVA manages a large number of programs and services directed to benefit veterans, there are also a number of other state and federal agencies that provide veteran related benefits and resources. A collaborative effort is needed to ensure that veterans are receiving the maximum level of compensation and benefits available.

A recent example of collaboration between two state agencies is that between the Department of Health Care Services (DHCS) and the CDVA. DHCS conducted a two-year Public Assistance and Reporting Information System (PARIS) pilot program to improve the identification of veterans (or their dependents) receiving high cost services, and to assist them in obtaining health benefits from the USDVA. The advantages are that the health benefits provided at the federal level potentially provide greater asset protection to the veteran and the state is able to redirect savings to the Medi-Cal program. This collaboration was done on a pilot basis and affected a small number of counties within the state.

The PARIS is an information-sharing data match system that is managed by the U.S. Department of Health and Human Services. The database is accessible to certain state agencies that are impacted by Medicaid eligibility. DHCS was responsible for administering a veterans' specific PARIS query with the federal government, filtering match results, and sending outreach referrals to CDVA. CDVA selected which counties (Fresno, San Bernardino, and San Diego) were included in the pilot. CDVA utilized their network of County Veteran Services Officers, which are active in 54 out of the 58 counties in the state, and the results were relayed to the DHCS

Recognizing the benefits of a collaborative effort, Governor Brown established the Interagency Council on Veterans in 2011. The primary mission of the Interagency Council is to coordinate with all levels of government to ensure that needs of veterans are being addressed. The Legislature may want to explore more areas of state government that can benefit the state's veteran population.

Local Mandates

BACKGROUND:

The proposed funding for non-education mandate payments to local governments is included in the budget of the Commission on State Mandates (Commission). The Commission is responsible for determining whether a new statute, executive order, or regulation contains a reimbursable state mandate on local governments, and establishing the appropriate reimbursement to local governments from a mandate claim. The Constitution generally requires the state to reimburse local governments when it mandates that they provide a new program or higher level of service. Activities or services required by the Constitution are not considered reimbursable mandates. The Constitution, as amended by Proposition 1A of 2004, requires that the Legislature either fund or suspend local mandates. Payments for mandate costs incurred prior to 2004 are one exception noted in the Constitution and such pre-2004 mandate costs can be repaid over time. Another exception in the Constitution is for mandates related to labor relations. In these cases, the state can defer payment of these mandates and still retain the mandate's requirements. In most cases, if the Legislature fails to fund a mandate, or if the Governor vetoes funding, the legal requirements are considered suspended pursuant to the Constitution.

Mandate reimbursement claims are filed with the Commission for the prior fiscal year—after that fiscal year is completed and actual costs are known. The state pays the mandate claims in the following fiscal year. For example, local costs incurred in 2011-12 are reported and claimed in 2012-13, and the state will reimburse locals for these costs as part of the 2013-14 budget. Suspending a mandate does not relieve the state of the obligation of reimbursing valid claims from prior-years, but it does allow the state to defer payment. For example, several elections-related mandates were suspended for the first time in the 2011-12 budget. This means the activities for locals were optional in 2011-12 and locals cannot claim reimbursement for any new costs incurred in 2011-12. However, the mandate claims for these costs in 2009-10 and 2010-11 are still due—either over time or all at once in a year when the mandate suspension is lifted.

The state owes local governments approximately $1.8 billion in non-education mandate payments. Of this, about $900 million is associated with pre-2004 mandate claims.

GOVERNOR'S PROPOSAL:

Funded Mandates

The Governor's mandate proposal is a continuation of the status quo in terms of mandates in effect and mandates not in effect The Governor's Budget proposes expenditures of $52.9 million ($50.2 million General Fund) related to non-education mandates, which includes $1.9 million for the staff of the Commission. The Governor's budget would continue to fund the 13 mandates that were kept in force for 2012-13, the payments on which constitute the bulk of the General Fund cost. These mandates all relate to public safety or property taxes and are listed in the following table.

Mandate Funding in Governor's Budget
General Fund
(Dollars in Thousands)

Mandate Title	Amount
Allocation of Property Tax Revenue	$520
Crime Victim's Domestic Violence Incident Reports	175
Custody of Minors-Child Abduction and Recovery	11,977
Domestic Violence Arrests and Victim's Assistance	1,438
Domestic Violence Arrest Policies	7,334
Domestic Violence Treatment Services	2,041
Health Benefits for Survivors of Public Safety Officers	1,780
Medical Beneficiary Death Notices	10
Peace Officer Personnel Records	690
Rape Victim Counseling	344
Sexually Violent Predators	21,792
Threats Against Police Officers	3
Unitary Countywide Tax Rates	255
Total	**$48,359**

Budget Savings
The Governor's Budget incorporates a total of $880 million in savings from maintaining mandate suspensions or deferring payment of claims. The savings breakdown is as follows: (1) $301.8 million from deferring payment of post-2004 mandate claims for mandates that have since expired or otherwise not in effect; (2) $408.7 million by continuing the suspension of certain local mandates; (3) $66.0 million from deferring payment on employee-rights mandates in effect; and (4) $103.8 million by suspending four mandates with newly adopted statewide cost estimates (discussed below). As part of last year's budget, the Governor proposed to repeal 32 of 56 currently suspended mandates. Repealing mandates does not offer any additional budget savings relative to suspension; however, if the mandate will otherwise be suspended indefinitely, the repeal of statutory provisions cleans up the code and provides more certainty to local governments. No such repeal is proposed in the Governor's Budget.

'Reserve Builder' Mandates
The Governor's Budget incorporates a reserve of approximately $1.0 billion. The proposed reserve has several components—among them is the immediate suspension of four new mandates with recently adopted statewide cost estimates, for a total of $103.8 million in savings. The four new mandates (and related savings) are: Modified Primary Election ($1.7 million); Domestic Violence Background Checks ($18.2 million); Permanent Absentee Voter ($4.6 million); and Identity Theft ($79.2 million). There are an additional five local requirements that have been identified by the Commission as reimbursable mandates but for which statewide cost estimates have not been adopted. These five mandates relate to: disclosure of public records, local agency ethics training, tuberculosis control, child abuse and neglect reports and voter ID procedures. The Administration proposes to suspend these mandates as well, although the savings are not presently known.

ISSUES TO CONSIDER:

Determining whether a particular requirement is a state-mandated local program and the process by which the reimbursable cost is determined is an extensive, time-consuming, and multi-stage undertaking. State and local officials have expressed significant concerns about the mandate determination process, especially its length and the complexity of reimbursement claiming methodologies.

According to an LAO review a few years ago, it took the Commission over five years to complete the mandate determination process for a successful local government test claimant. The review of new mandates claims found that the Commission took almost three years from the date a test claim was filed to render a decision as to the existence of a state-reimbursable mandate. The Commission took more than another year to adopt the mandate's claiming methodology and almost another year to estimate its costs and report the mandate to the Legislature. Because of the current backlog, the delay can be even longer. The Commission has submitted a budget change proposal for 2013-14 to address the backlog issue and speed up the mandate process but the resulting improvements are still not expected to meet the statutory time frame.

This lengthy period presents several difficulties that affect both the state and local governments. Among the most important are flip sides of the same coin, specifically:

- Local governments must carry out the mandated requirements without reimbursements for a period of some years, plus any additional time associated with development of the mandate test claim, appropriation of reimbursement funds, and the issuance of checks.
- State mandate liabilities accumulate during the determination period and make the amount of state costs reported to the Legislature higher than they would be with an expedited process. Policy review of mandates is hindered because the Legislature receives cost information years after the debate regarding its imposition.

In addition to the delays that characterize the review and determination process, there are other significant issues. On the cost determination side, since most mandates relate to expanding existing programs (rather than instituting completely new ones), local governments have difficulty in measuring the marginal costs. The complexity of the claiming methodologies means local governments' claimed costs frequently are not supported by source documents showing the validity of such costs or are not allowable under the mandate's reimbursement methodology. Accordingly, the State Controller's Office has disallowed a significant number of all reimbursement claims over the last few years, leading to frequent appeals, more uncertainty and mounting bills.

The Administration indicates in the Governor's Budget that it will pursue policies to improve the mandate process, including deferring decisions to local government decision-makers and allowing for maximum flexibility. In addition, LAO has in the past recommended a 'best practices' approach for various local activities and requirements. The Legislature could consider these approaches and compare their advantages with policies adopted at the state level and the likely costs of such mandated programs.

General Obligation Bonds

BACKGROUND:

The state uses general obligation bonds (GO bonds) to borrow funds for spending—primarily for infrastructure and other capital investments. Bonds must be approved by voters and bond proceeds are either continuously appropriated (immediately available for expenditure) or require an appropriation from the Legislature. All bond debt service is continuously appropriated and, therefore, not appropriated in the annual budget bill. According to the State Treasurer's Office, the state has $79.6 billion in outstanding GO bond debt (including self-liquidating bonds such as the Economic Recovery Bonds [ERBs]). Another $33.2 billion in bonds are authorized, but remain unissued. In most instances, bonds are sold at different lengths of maturity such that repayment is spread over about 30 years. The chart below indicates the authorized but unissued reservoir of bonds.

General Obligation Bonds Authorized and Not Issued
(Dollars in Millions)

Authorized Bond Program	Unissued Amount
Prop 1B of 2006: Transportation	$10,275
Prop 1A of 2008: High Speed Rail	9,449
Prop 55 of 2004 & Prop 1D of 2006: Education Facilities	2,442
Prop 84 of 2006: Safe Drinking Water	2,957
Prop 71 of 2004: Stem Cell Research	1,767
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,819
Prop 46 of 2002 & Prop 1C of 2006: Housing	1,259
All other	3,240
Total $33,208	

The state generally goes to market to sell GO bonds twice annually—once in the spring and once in the fall. Bond structures are often tailored to meet market demand and investor appetite. This tailoring includes tinkering with variables such as fixed and variable rates, call features and premiums, and various security enhancements. Bonds are sold in amounts necessary to meet expenditure needs plus an additional cash cushion to account for flexibility regarding how fast projects will expend funds and uncertainty about the timing of the next bond sale. As of December 2011, about $9.7 billion in bond cash was on-hand from prior bond sales. The following table shows cash on-hand by bond for some of the major bond acts.

General Obligation Current Cash Proceeds
(Dollars in Millions)

Authorized Bond Program	Bond Proceed Cash Remaining as of Nov 2012
Prop 1B of 2006: Transportation	$1,026
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,187
Prop 84 of 2006: Safe Drinking Water	951
Prop 1C of 2006: Housing	633
Prop 1D of 2006: Public Education Facilities	611
Prop 50 of 2002: Water Security	458
Prop 13 of 1996: Clean Water and Watershed	223
All others	916
Total	**$6,005**

GOVERNOR'S PROPOSAL:

Expenditure of bond proceeds is reflected in the budgets of individual departments, with the payment of bond debt service consolidated in Item 9600 in the Governor's Budget. It is the repayment of bond debt that is reflected as a General Fund expense. Some bond costs are offset by special funds or federal funds. Other bonds are 'self-liquidating,' or have their own dedicated revenue. For example the ERBs receive a quarter-cent of the sales tax as a component of the 'triple flip' enacted as part of the 2004 budget package.

The Governor's Budget includes $5.1 billion in General Fund costs for GO bond debt service and related costs, or a total of $6.6 billion when the debt service costs of the ERBs are included. In addition to this amount, $1.1 billion in debt costs are scheduled to be funded from special funds. Finally, federal bond subsidies, through the Build America Bonds (BABs) program, will provide $352 million in 2013-14 providing for a reduction in General Fund expenses. The Governor's proposed budget includes $98.5 billion in General Fund available resources (not including carry-over balances), so the net General Fund bond debt service as a percentage of General Fund resources is about 5.0 percent.

Governor's Budget for GO Bond Debt
(Dollars in Millions)

Category	2011-12 Actual Cost	2012-13 Estimated Cost	2013-14 Forecasted Cost
General Fund cost	$4,390	$4,292	$5,071
Other funds cost	894	765	1,082
Federal subsidy (Build America Bond Program)	300	352	352
Total Debt Service	**$5,584**	**$5,409**	**$6,505**
Economic Recovery Bonds (ERBs, not included above because indirect GF cost)	$1,025	$1,399	$1,543

The ERBs are not included directly in General Fund costs for bond debt service. As noted above, repayment of those bonds is financed from a quarter cent sales tax that was temporarily redirected from local government. Local government revenue is backfilled through a diversion of property tax revenues and an increase from the state General Fund in Proposition 98 education funding. The Governor's Budget reflects special fund expenditures of $1.5 billion for ERB debt service in 2013-14, and the Proposition 98 budget reflects increased General Fund expenditures of $1.5 billion.

The budget plan includes an assumption that $3.7 billion in GO bonds will be sold in the spring of 2013, and that $2.0 billion more will be sold in the fall of 2013. Among these planned sales are $3.4 billion for transportation and related capital facilities and $1.9 billion for various education facility bonds.

ISSUES TO CONSIDER:

Budget and Bonds

Paying GO bond debt is a significant General Fund expense; however, the use of bonds to accelerate capital projects is a commonly-used practice of government entities. State and federal tax exemptions for interest income received by investors ensure that GO bond debt is a low-cost financing alternative. To the extent bond costs do not exceed a government's long-term ability to fund other commitments, bonds allow the public to enjoy the benefits of infrastructure investment more quickly than would otherwise be the case. The LAO indicates that the state's debt service requirements will climb steadily over the next several years to about $7.3 billion in 2017-18. As a percent of General Fund revenues, however, debt service should remain at about the 6.0 percent level.

Voters approved over $40 billion in new bonds on the 2006 ballot, just prior to the national recession. The bonds have allowed the state to invest in infrastructure while the need for economic stimulus is most acute, while borrowing costs are low, and while construction procurement is favorable. Despite the benefits of bonds, they come with the cost of many years of debt service. A $1 billion bond generates annual bond debt costs of about $65 million over a 30-year period. That bond cost crowds out alternative expenditures over the life of the bond. The Legislature can prioritize or limit bond funding through the budget process as overall expenditures are prioritized. This question may be particularly acute as the economy begins to recover and interest costs climb as result of increased demand for capital.

Infrastructure Planning

California's needs related to new capital investment and maintenance are significant, and the state has struggled to keep up with the backlog of projects through the bond program. On the transportation side alone—a significant proportion of the total—the California Transportation Commission (CTC) has identified $538 billion in in total infrastructure needs, including $172 billion in highway and intercity rail needs. A transportation workgroup is expected to explore long-term funding options, including pay-as-you-go, as a means of dealing with the needed projects.

In addition, the Administration will release the 2013 Five-Year Infrastructure Plan later this year. The plan is expected to lay out the Administration's infrastructure priorities for the next five years for major state infrastructure programs, including high-speed rail and other transportation projects, resource programs, higher education, and K-12 education. Given the state's increased debt burden and General Fund constraints, the plan will examine agencies' reported needs assessments, analyze the use of General Fund-backed debt, and explore alternatives to the reliance on voter-authorized GO bonds. The Legislature could balance the various options according to a matrix of considerations including financing costs, ease of implementation, project flexibility and assumed risk.

Bond Management

As the state's cash situation deteriorated with the most recent recession, the Administration changed the methodology for managing bond cash. Prior to the recession, reserve cash funded project costs in advance of bond sales, and then bond sales replenished cash reserves. When reserve cash declined, the state had to instead sell bonds in advance of expenditures. Due to project expenditures occurring slower than anticipated at the time of bond sales, large bond cash balances developed—about $9.7 billion as of December 2011. Last year, the Administration implemented a plan to utilize commercial paper to aid cashflow, and reduce the need to carry large bond cash balances. Progress has been made to reduce bond cash, and the cash reserves have dropped to about $6.0 billion currently. At budget hearings, the Administration could be asked to discuss their management of bond proceeds, forecasts of project expenditures and the optimal level of cash balances.

Budgetary Borrowing and Loan Repayment

BACKGROUND:

Through budget actions over the last decade, the state has borrowed from special funds and deferred various payments in order to close budget deficits. By the close of 2010-11, the Department of Finance (DOF) indicates a total of $34.7 billion in loans and deferrals had accumulated and remained unpaid. The Governor defines this as the 'wall of debt,' and includes in his definition adjustments related to his budget proposals. This amount largely represents the debt overhang from prior year budgets adopted under the previous administration. By 2012, this amount had been whittled down to $33.0 billion and by the end of the current year, is expected to be reduced further to $27.8 billion.

Some obligations included in the wall of debt have required repayment in specified years due to constitutional requirements or due to scheduled bond debt service. Examples of rigid remittance requirements are a payment of $1.9 billion scheduled for June 2013 for 'Proposition 1A' local-government borrowing and annual Economic Recovery Bond (ERB) payments of approximately $1.5 billion through 2016-17. Other debt payments are more flexible, for example school payment deferrals and special fund loans can be repaid over time as the budget situation allows. In either case, the wall of debt represents a budget challenge, as payments on these accumulated debts restrict legislative discretion and displace funding for ongoing or expanded program costs. The Administration indicates that the plan for paying off the wall of debt corresponds to the period that the temporary taxes are in place.

GOVERNOR'S PROPOSAL:

The Governor proposes to pay down $4.2 billion of the remaining $27.8 billion wall of debt in 2013-14. In addition, the Governor's multi-year budget plan proposes to almost fully repay wall of debt obligations by the end of 2016-17. The amount remaining at the end of that period would be unpaid education and local government mandate costs, deferred Medi-Cal costs, and deferred state payroll costs, totaling approximately $4.3 billion. Assuming this plan is adhered to, the 2017-18 budget and ongoing budgets would be increasingly free of these debt pressures and expenditures would be more in line with annual revenues. The estimated wall of debt as of the close of 2012-13 is presented in the following table. Additional detail is provided in the Appendix to this *Overview*.

Governor's Wall of Debt and Proposed Repayment
(Dollars in Millions)

Wall of Debt Item	Outstanding Balance Close of 2012-13	Proposed Repayment in 2012-13
Deferred Payments to Schools and Community Colleges	$8,205	$1,950
Economic Recovery Bonds	5,150	1,474
Loans from Special Funds	4,101	561
Mandate Debt to Local Governments	4,914	0
Underfunding of Proposition 98	2,365	0
Deferred Medi-Cal Costs	1,664	130
Deferral of State Payroll Costs	718	0
Deferred Payments to CalPERS	440	0
Proposition 42 Borrowing from Transportation Funds	251	83
Total $27,808		**$4,198**

The planned payments for ERBs and Proposition 42 borrowing are constitutionally required or dictated by bond debt service. The repayment of the Proposition 1A borrowing from local governments will be completed in the current year. The payment of loans from special funds is more discretionary. As long as the borrowing does not interfere with the activities that the special fund supports, the repayment of these loans is on a flexible schedule. The amount of special-fund loans proposed for repayment in the Governor's Budget is $561 million, plus total interest costs of $31.5 million. The Administration indicates repayment of these loans is necessary to support 2013-14 activities of those departments that are paid for with the associated special fund resources. Interest is required on most special fund loans and is paid when the principal is repaid.

Governor's Proposal for Repayment of Special Fund Loans
(Dollars in Millions)

Affected Department and Special Fund	Principal Amount
Justice—National Mortgage Special Deposit Fund	$100.0
Consumer Affairs—Real Estate Appraisers Regulation Fund	8.1
General Services—Public School Planning, Design and Construction Review Revolving Fund	15.0
Transportation—State Highway Account, State Transportation Fund	50.0
Energy Commission—Renewable Resource Trust Fund	20.0
Resources—California Beverage Container Recycling Fund	89.4
Resources—Glass Processing Fee Account	39.0
Resources—PET Processing Fee Account, California Beverage Container Recycling Fund	27.0
Agriculture—Department of Food and Agriculture Fund	15.0
Public Utilities Commission—Utilities Reimbursement Account	25.0
Public Utilities Commission—California High Cost Fund B Administrative Committee Fund	75.0
Public Utilities Commission—California Advanced Services Fund	75.0
Other Departments, Funds and Accounts	22.9
Total	**$561.4**

ISSUES TO CONSIDER:

The Governor's emphasis on repaying budgetary debt over the next four years is sound fiscal policy. The repayment over the next several years is timed to coincide with the state's receipts of revenues from temporary taxes established by Proposition 30 approved in November 2012. The Governor's multi-year plan calls for the wall of debt to be largely retired once the temporary taxes expire. Given that the next four budget years call for wall of debt payments of between $4.1 billion and $7.3 billion annually, adhering to this plan will free-up substantial room in the budget. While some of the Governor's debt repayment in 2013-14 is mandated, other debt can be considered within the context of the Legislature's other budget priorities. However, due to the narrowly balanced budget, it would be difficult to accelerate debt repayment beyond the level proposed by the Governor. In considering repayment of special fund loans in 2013-14, and beyond, the Legislature should examine the expenditure needs of the affected departments and programs. Some departments may have deferred capital projects or maintenance that can be accelerated by early loan repayments. Other departments may not have spending pressures, and funds from repaid loans may result in surplus reserves over a period of many years.

Cash Management

BACKGROUND:

The state's receipts and disbursements of cash occur unevenly throughout the fiscal year. As a consequence, the General Fund borrows for cashflow purposes in most years, even though each budget is balanced when enacted and funds are repaid within the fiscal year. Given that the state receives revenues on an uneven basis throughout the year, the state's cash position varies, with the typical low points occurring in July, October and November. Maintaining an adequate cash balance allows the state to pay its bills in a timely fashion. Interest is paid on both internal borrowing (such as cashflow loans from special funds) and for external borrowing (such as Revenue Anticipation Notes [RANs]). For the current year, the state issued Series A and B RANs in August of 2012 sized together at $10 billion. The RANs are payable in May and June and carry an expected interest cost of $48 million.

Last year, an additional eight special funds were made eligible for cash borrowing, which provided about $865 million of new borrowable resources. Five of the eight added funds were transportation special funds and the remaining three were the Condemnation Deposits Fund, the Health Care Deposit Fund, and the Litigation Deposit Fund. Total monthly borrowable internal resources from some 700 plus funds are typically in the range of $20 billion. The state also established a new cashflow tool in the form of the Voluntary Investment Program (VIP). This measure provided an additional means to assure cashflow continuity by establishing a new account for voluntary participation by local governments, but was not required in the current year. Another cash management tool of the state is the State Agency Investment Fund (SAIF) which attracts deposits from entities not otherwise required to deposit funds with the state. During the current year, there were deposits totaling approximately $1.7 billion combined from University of California (UC) and the California State University (CSU) systems.

An additional tool in managing cash is deferrals of payments within the fiscal year to higher and K-12 education, local governments, and other entities. In recent years, flexible deferrals have been enacted in statutes that allow specified deferrals if necessary to maintain a prudent balance for bond debt and other priority payments. For the current year, there were deferrals allowed for K-12 education, higher education and local government payments. The fiscal impact of these deferrals varies from entity to entity depending upon their own cash positions.

GOVERNOR'S PROPOSAL:

In order to cover the low points in the state's cash position, the Governor's Budget anticipates engaging in internal and external borrowing. The budget reflects the state's moderately improved cash position and includes funding for the interest costs of cashflow borrowing from special funds and from RANs. Given the improvement in the cash status, no new education or other payment deferrals are incorporated in the budget. Based on the cashflow statements of the Administration, the cash low points will occur in July, October and November, when unused borrowable cash resources are estimated to be $3.7 billion, $4.3 billion and $4.0 billion respectively. By way of comparison, and reflective of the uneven flow of receipts and disbursements, the cash and borrowable resources in June of this year are estimated to be $11.0 billion.

Cashflow Borrowing

The state anticipates engaging in its typical internal cash borrowing pattern, with all internal cashflow borrowing managed such that programs supported by the special funds are completely unaffected. In order to supplement the state's internal borrowing within the budget year, the Administration has proposed a RAN initially sized at $7.0 billion. This provides an additional cashflow cushion to the existing availability of internal resources. Without the external borrowing, there would be insufficient cash reserves and other funds during the months of October, November, December and March. In addition, there would be only a narrow 'cushion' during several other months in the fiscal year. The budget includes $150 million General Fund for the interest costs associated with these two borrowing methods—$100 million for the RAN and $50 million for internal borrowing costs. There is no anticipated need for the VIP or the SAIF in the Governor's Budget.

Payment Deferrals and Smoothing

The Administration has not incorporated any new deferrals as part of the budget plan; however, there is the continuation of a $500 million within-the-year deferral to UC and proposed Trailer Bill Language to authorize DOF to defer up to $250 million of CSU's annual General Fund appropriation (the CSU deferral has been included in a separate cashflow bill in previous years). In addition, the Governor's Budget assumes the continuation of smoothing of payments to UC and CSU that have been carried out the last three years. The continuation of this policy, proposed for budget bill language, would smooth payments over ten months with the remaining amount owed remitted in the final two months of the year.

ISSUES TO CONSIDER:

Maintaining an emphasis on cashflow borrowing from special funds is good fiscal policy that reduces the need for more expensive external borrowing. Cash deferrals to other government units are generally among the least desirable of the cash management tools, in that these can cause cashflow stress on other governmental entities. Although this may have been necessary in the past—especially in order to limit the magnitude of external borrowing—not having to rely on this measure in the coming year is a positive development. The Administration's proposal appears to be a suitable approach to cashflow management and the anticipated reduction in the size of external borrowing will reduce the state's interest costs. Nevertheless, the reduction in borrowing does result in a significant decline in the cash cushion during some months compared to the current year. The Governor's plan to reduce the wall of debt will help the state's cash management and reduce the need for payment deferrals in the future.

SUBCOMMITTEE NO. 5

CORRECTIONS, PUBLIC SAFETY, THE JUDICIARY, LABOR and PUBLIC EMPLOYEES

Board of State and Community Corrections

BACKGROUND:

Originally, the Board of Corrections (BOC) was established in 1944 as part of the state prison system. Effective July 1, 2005, as part of the corrections agency consolidation, the Corrections Standards Authority (CSA) was created within the California Department of Corrections and Rehabilitation (CDCR) by bringing together the BOC and the Correctional Peace Officers Standards and Training (CPOST) commission. The reorganization consolidated the duties and functions of the BOC and CPOST and entrusted the CSA with new responsibilities.

Legislation associated with the 2011 Budget Act abolished the CSA and established the Board of State and Community Corrections (BSCC) as an independent entity, effective July 1, 2012. The BSCC absorbed the previous functions of the CSA as well as other public safety programs previously administered by the California Emergency Management Agency (CalEMA). Specific statutory changes included:

- Abolishing the CSA within CDCR and established the BSCC as an independent entity.
- Transferring the powers and duties of the CSA to the BSCC.
- Transferring certain powers and duties from CalEMA to the BSCC.
- Eliminating the California Council on Criminal Justice and assigned its powers and duties to the Board.

Assuming the responsibilities of the CSA, the BSCC works in partnership with city and county officials to develop and maintain standards for the construction and operation of local jails and juvenile detention facilities and for the employment and training of local corrections and probation personnel. The BSCC also inspects local adult and juvenile detention facilities, administers funding programs for local facility construction, administers grant programs that address crime and delinquency, and conducts special studies relative to the public safety of California's communities.

As part of the 2011 Budget Act legislation, the BSCC was tasked with providing statewide leadership, coordination, and technical assistance to promote effective state and local efforts and partnerships in California's adult and juvenile criminal justice system. Particularly, in coordinating with, and assisting local governments, as they implement the realignment of many adult offenders to local government jurisdictions that began in 2011. The intent is for the BSCC to guide statewide public safety policies and ensure that all available resources are maximized and directed to programs that are proven to reduce crime and recidivism among all offenders.

The BSCC is an entity independent from CDCR. However, the BSCC continues to be Chaired by the Secretary of the CDCR, and its Vice Chair is a local law enforcement representative. The BSCC consists of 12 members, streamlined from both its immediate predecessor (CSA), with 19 members, and its former predecessor (BOC), which had 15 members. Members reflect state, local, judicial, and public stakeholders.

GOVERNOR'S 2013-14 BUDGET PROPOSAL:

The Governor's Budget proposes total funding of $129.2 million ($44.3 million GF) and 80.8 positions for the BSCC.

(dollars in millions)

	Funding	Positions
Program 10 - Administration, Research and Program Support	$ 4.0	23.0
Program 15 - Corrections Planning and Grant Programs	99.7	23.8
Program 20 - Local Facilities Standards, Operations and Construction	3.4	21.0
Program 25 - Standards and Training for Local Corrections	22.1	13.0
BSCC Total	**$129.2**	**80.8**

The only major adjustment proposed in the Governor's Budget for the BSCC is an increase of 9 positions, funded from existing resources, for research activities, the administration of the local jail construction financing program authorized by Chapter 42, Statutes of 2012 (SB 1022), and other administrative functions necessary for the Board to operate as an independent entity. These positions consist of 5 research positions (1 Research Specialist V, 1 Research Specialist III, 2 Research Program Specialist I's, and 1 Research Analyst), 3 Associate Governmental Program Analysts, and 1 Executive Assistant.

ISSUES TO CONSIDER:

The BSCC's assumption of new responsibilities appears to be occurring at a pace that could impact the state's ability to appropriately measure the impact of 2011 public safety realignment, particularly concerning collection of data. One of the key drivers in establishing the BSCC was the need for a state/local body that could serve as the backbone of California's public safety continuum. To facilitate local success, California needs to strategically coordinate support, foster local leadership, target resources and provide technical assistance.

As required by statute, the BSCC shall collect and maintain available information and data about state and community correctional policies, practices, capacities, and needs, including, but not limited to, prevention, intervention, suppression, supervision, and incapacitation, as they relate to both adult corrections, juvenile justice, and gang problems. The BSCC shall seek to collect and make publicly available up-to-date data and information reflecting the impact of state and community correctional, juvenile justice, and gang-related policies and practices enacted in the state, as was well as information and data concerning promising and evidence-based practices from other jurisdictions.

At its most recent meeting, January 17th, the BSCC moved to establish The Data and Research Standing Committee in order to benefit the BSCC by providing expertise and stakeholder input in this subject area. In addition, the BSCC reports that it is in the process of realigning staff and resources to be bettered positioned to address high-priority issues. Further, the BSCC reports that it has begun working to establish its data collection and reporting responsibilities associated with 2011 public safety realignment by:

- Collecting and analyzing data received from counties on local jail impact and conducted two site visits to two counties in October 2012 to examine the methods utilized in collecting and reporting data.

- Consulted with the Administrative Office of the Courts, Chief Probation Officers of California (CPOC), and California Sheriffs' Association as required by statute to: 1) define outcome-based measures to collect and analyze with regard to the implementation of county plans for realignment, and 2) support for first phase baseline and ongoing data collection instruments to reflect the local impact of realignment.

- Collected and currently analyzing each county's 2012 Community Corrections Program Plan to prepare the report on implementation of those plans, which is required by statute to be submitted to the Governor and Legislature in July 2013.

Notwithstanding the efforts that the BSCC is currently undertaking to establish data collection capabilities, being approximately a year and a half into public safety realignment, the state may be risking opportunity to set and gather baseline and initial metrics and data that will be critical to assessing success and being appropriately informed for future decisions. For instance, while allocation of 2011 public safety realignment funds is a local responsibility, performed at the statewide level by the California State Association of Counties (CSAC), a permanent annual allocation formula is scheduled to be put into place for the 2014-15 fiscal year. The Legislature will likely have to act to codify this formula. Various stakeholders have already begun expressing interests in how the allocation formula should be constructed. However, the data needed to make informed and objective decisions regarding local public safety resource needs, in setting a permanent allocation schedule, may not be available.

Is the BSCC the appropriate entity to perform data collection responsibilities associated with the 2011 public safety realignment? Although the BSCC was established on July 1, 2012, as mentioned above, the BSCC's predecessor agencies had historic responsibilities centered on standards for the construction and operation of local jails and juvenile detention facilities and for the employment and training of local corrections and probation personnel, facility inspection, and grant administration. The majority of the BSCC's personnel carried over from the CSA and have experience and core competencies in these historic responsibilities. In addition, the BSCC has assumed an increase in responsibilities related to local facility construction and grant management. In assessing the BSCC's assumption of responsibilities related to 2011 public safety realignment data, the Legislature may wish to consider whether they are indeed the appropriate entity to perform these functions.

There has been significant interest in researching and reporting on aspects of the 2011 public safety realignment from within academic and private foundations, communities, and other public entities. Projects of note include:

- The Partnership for Community Excellence (The Partnership) established by California Forward, has developed as a “hub” to coordinate efforts to assist local governments in implementing public safety realignment.

- The Stanford Criminal Justice Center is undertaking a number of research projects aimed at better understanding the implementation and effect of California’s Public Safety Realignment legislation. In particular, through four research projects, they are analyzing the extent to which California’s move to downsize state prisons through 2011 public safety realignment has changed the decision-making and resource allocation of the primary actors in the criminal justice system.

- The Center on Juvenile and Criminal Justice continually publishes reports regarding the state’s criminal justice system, including 2011 public safety realignment.

- The Public Policy Institute of California has also published reports related to 2011 public safety realignment and is working toward assisting in the establishment of a cost/benefit tool for assessing public safety rehabilitative programs.

- CPOC has established “Dashboards” to display data that they have collected related to 2011 public safety realignment and maintains a webpage that contains various information regarding realignment.

It may be worth exploring whether the state may be better suited to contract or enter into a partnership for data collection and services. Alternatively, California may wish to consider moving this responsibility to the Legislative Analyst’s Office. Washington State uses the Washington Institute for Public Policy, its non-partisan research arm, to conduct extensive research of criminal justice issues, including cost-benefit analyses of programs.

Armed Prohibited Persons System

BACKGROUND:

Beginning in 1999, the California Department of Justice (DOJ)—Bureau of Firearms began to study some of California's high-profile shootings in an effort to determine if there were remedial measures that could be enacted to curtail instances of gang violence and other similar violent events. The study found that many of the offending individuals were law-abiding citizens when they purchased the firearms, and were subsequently prohibited from gun ownership due to a variety of reasons spelled out in California's Penal Code. Persons prohibited from gun ownership ('prohibited persons') are designated as such for various reasons, including for a criminal conviction, juvenile adjudication, addiction to narcotics, defined mental health conditions, restraining or other court orders, or specified terms or conditions related to probation.

At the time of the study, the DOJ lacked the capacity to determine whether or not an individual who had legally purchased a firearm, and subsequently became prohibited from such ownership, was still in possession of a firearm. In addition, even if such a determination could have been made, the DOJ lacked the authority to retrieve that weapon from the prohibited person. SB 950 (Chapter 944, Statutes of 2001) provided the DOJ with the authority to cross-reference their database of individuals who own handguns with their database listing of prohibited individuals. The 2002 Budget Act included General Fund support of $1.0 million for DOJ to develop the Armed Prohibited Persons System (APPS). The database was complete in November 2006, with continued funding to support the program provided from the General Fund. Further legislation, SB 819 (Chapter 743, Statutes of 2011), allowed the department to utilize funds within the Dealers Record of Sale Account (DROS) for firearm enforcement and regulatory activities related to the Armed Prohibited Persons System.

ISSUES TO CONSIDER:

According to the DOJ, there are on average 4,500 newly-identified automated armed and prohibited persons included in the system on an annual basis. Additionally, there are over 444,000 historical files that need to be manually processed into the database within the next several years. According to the DOJ's workload estimates, it will have the capacity to process and investigate a total of 2,772 names in the budget year. Additionally, it is estimated that there are approximately 3,200 names that are purged annually because of court dispositions, death, orders that reinstate firearms, or prohibition expiration dates. The estimated workload capacity of the department's investigators is well below the number of individuals that are added as armed and prohibited persons on an annual basis, and current resources are inadequate to address any of the backlog. The workload estimates are broken down in the following table.

Armed Prohibited Persons
Workload History

Fiscal Year	Armed and Prohibited Persons Identified	APPS Investigations Processed
2007-08	8,044	1,620
2008-09	11,997	1,590
2009-10	15,812	1,763
2010-11	17,606	1,700
2011-12	18,668	1,716
2012-13	21,252	2,772
2013-14	22,780	2,772

Local law enforcement agencies are provided monthly information regarding the armed and prohibited persons in the agency's jurisdiction. Given this access, once the armed and prohibited person is identified, DOJ and local agencies could coordinate to confiscate the weapons. However, at the present time, many agencies do not have the resources or personnel to work the APPS cases, and rely on assistance from DOJ's criminal intelligence specialists and special agents to support such activity. When local agencies confiscate weapons, notice is sent to DOJ so that the individual can be removed from the list. Given the current status of local law enforcement budgets, as well as constraints of state enforcement, the Legislature may want to explore other avenues for carrying-out the requirements of the law regarding armed prohibited persons.

There has been a continued and substantial increase in gun purchases nearly every year. For example, between fiscal year 2010-11 and fiscal year 2011-12, gun purchases rose by 25 percent in California. It is anticipated that the increase in gun purchases will continue unabated for the near term. Additionally, in accordance with recent legislation (AB 809, Statutes of 2011) the DOJ will be required to account for long guns as well as handguns. The table that follows illustrates the annual number of overall purchases of firearms in the state.

Firearms in California
Purchases and Denials

Year	Hand guns Purchased	Hand gun Denials	Long guns Purchased	Long gun Denials	Total Guns Purchased	Total Denials
1991	329,133	3,934	160,300	1,925	489,433	5,859
1992	382,122	4,037	177,486	1,726	559,608	5,763
1993	433,822	4,605	208,375	1,904	642,197	6,509
1994	382,085	3,862	217,587	2,564	599,672	6,426
1995	254,626	2,534	157,042	1,672	411,668	4,206
1996	215,804	2,111	138,068	1,531	353,872	3,642
1997	204,409	1,839	150,727	1,615	355,136	3,454
1998	189,481	1,721	153,059	1,596	342,540	3,317
1999	244,569	2,233	268,849	2,546	513,418	4,779
2000	201,865	1,572	184,345	1,903	386,210	3,475
2001	155,203	1,449	198,519	2,158	353,722	3,607
2002	169,469	1,661	182,956	2,172	352,425	3,833
2003	126,233	1,254	164,143	1,774	290,376	3,028
2004	145,335	1,497	169,730	1,828	315,065	3,325
2005	160,990	1,592	183,857	1,878	344,847	3,470
2006	169,629	2,045	205,944	1,689	375,573	3,734
2007	180,190	2,373	190,438	1,926	370,628	4,299
2008	208,312	2,737	216,932	2,201	425,244	4,938
2009	228,368	2,916	255,504	2,221	483,872	5,137
2010	236,086	2,740	262,859	2,286	498,945	5,026
2011	293,429	3,094	307,814	2,764	601,243	5,805

By statute, the DOJ is required to process eligibility background checks within ten days before a firearm is delivered to the purchaser. As noted in the table above, there has been a significant increase in the number of firearms purchased, and the DOJ's personnel resources are being increasingly strained in an effort to meet the statutory requirements. As one means to address this, the Legislature may want to consider extending the mandated turnaround time from ten days to twenty days.

While extending the timeframe might alleviate the current strain placed on DOJ personnel to turn around a background check within ten days, it would not address the workload associated with the 2,600 offenders that are added to the APPS annually. The workload resource gap leaves a large number of offenders that may not be investigated. The Legislature may wish to explore this issue in greater detail to determine how best to address the large number of offenders that could potentially avoid an investigation from the DOJ.

Unemployment Insurance

BACKGROUND:

The Unemployment Insurance (UI) program is a federal-state program, authorized in federal law but with broad discretion for states to set benefit and employer contribution levels. The UI program provides weekly payments to eligible workers who lose their jobs through no fault of their own. Benefits range from $40 to $450 per week for up to 26 weeks, depending on earnings in a 12-month base period. The program is financed by unemployment tax contributions paid by employers, based on the number of employees, on the first $7,000 of taxable wages paid to each employee. The contribution schedule is comprised of seven schedules, ranging from AA to F, with a range of 0.1 percent (the lowest rate on Schedule AA) to 6.2 percent (the maximum rate on Schedule F). Current law also includes a provision to add a 15 percent emergency solvency surcharge when the UI fund reserve is low (Schedule F+). California employers have been on this emergency F+ schedule since calendar year 2004.

The UI Trust Fund (UI fund) became insolvent in January 2009 and ended that year with a shortfall of $6.2 billion. The contributing factors to the insolvency of the UI fund are: (1) significant statutory increases to the UI benefit level that began in 2002 – these legislative changes increased the maximum weekly benefit amount from $230 per week to $450 per week; (2) no change in the UI financing structure despite significant increases to UI benefits – for example, the taxable wage ceiling has remained at the federal minimum level of $7,000 since 1983; (3) the inability of the fund to build a healthy reserve in the last decade – the Employment Development Department indicates that the existing UI financing system can be sustained in the long run only if the state unemployment rate averaged around four percent over time; and (4) the current economy which resulted in increased UI benefit payments and decreased revenues.

With the UI fund insolvent, the state began borrowing funds from the Federal Unemployment Account in order to continue paying UI benefits to qualifying claimants without interruption. The UI fund deficit was $9.9 billion at the end of 2011 and is expected to increase to $10.2 billion at the end of 2013. Generally, loans lasting more than one year require interest payments; the federal American Recovery and Reinvestment Act (ARRA) of 2009 provided temporary relief to states from making interest payments on UI loans through December 31, 2010. With the expiration of the ARRA provisions, interest of $303.5 million was paid in September 2011 and interest of $308.2 million was paid in September 2012. Interest will continue to accrue and be payable annually until the principal on the federal UI loan is repaid. Federal law requires that the interest payment come from state funds. Due to the condition of the GF, both the 2011 and 2012 interest payments were made by borrowing funds from the Unemployment Compensation Disability Fund (DI Fund). Under current law, the 2011 and 2012 loans are to be repaid from the GF to the DI Fund by June 30, 2016, and June 30, 2017, respectively.

The interest payment due to the federal government in September 2013 is estimated to be $291.1 million.

Federal law also includes provisions to ensure that a state does not continue to incur loans over an extended period. Specifically, if a state has an outstanding loan balance on January 1 for two consecutive years, the full amount of the loan must be repaid before November of the second year or employers face higher federal UI taxes.

The full federal unemployment insurance tax rate is six percent. Employers receive a 5.4 percent credit (Federal Unemployment Tax Act, or FUTA, Credit Reduction), resulting in an effective tax rate of 0.6 percent on the first $7,000 of earnings per employee on an annual basis, or $42 per employee. Due to California carrying an outstanding loan balance for two consecutive years, the FUTA credit reduction began decreasing in calendar year 2011, resulting in increased employer costs in calendar year 2012. Each year that the loans remain outstanding, the FUTA credits will continue to decrease by 0.3 percent, resulting in dramatically increasing costs for employers, as displayed in Figure 1 below. These additional federal taxes pay down the principal on the federal loan. Absent any corrective action, the Administration projects that the federal loan will not be fully repaid until sometime after 2020.

Figure 1 – Federal Unemployment Tax Act Credit Reduction

	2012*	**2013***	**2014***	**2015***
Tax Rate	1.2%	1.5%	1.8%	2.1%
Estimated Additional Tax Collections Resulting from the FUTA Credit Reduction per Employee	$24.00	$48.00	$72.00	$100.00
Estimated Additional Tax Collections Resulting from FUTA Credit Reduction	$290 million	$582 million	$894 million	$1.2 billion

*Calendar Year.

GOVERNOR'S PROPOSAL:

The Governor proposes to utilize $291.1 million GF to pay the third interest payment due to the federal government for the quarterly loans the EDD has been obtaining from the federal government since January 2009 to cover the UI Fund deficit and make payment to UI claimants without interruption.

The Budget does not include a proposal to repay all or part of the 2011 and 2012 loans, totaling $611.7 million, made from the DI Fund to the GF to make the required federal interest payments.

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

ISSUES TO CONSIDER:

The Budget Does Not Contain a Comprehensive Solution to the Issue of UI Trust Fund Insolvency. In 2013-14, the state GF will for the first time bear the cost of the interest payments on the federal loans that were necessary to continue paying UI benefits to qualifying claimants without interruption. The budget does not address the other outstanding issues, including: (1) how to repay the $611.7 million owed to the DI Fund; (2) how to fund future interest payments for funds borrowed from the federal government to pay UI benefits; and (3) a proposed solution to address the insolvency of the UI Fund. The Administration indicates that it will initiate a stakeholder process this spring to work towards development of a comprehensive solution, but that it does not expect to advance any solutions during the 2013-14 budget process. Until then, state interest payments remain a significant liability and costs to employers will continue to increase through reduced FUTA credit reductions.

The Underlying Financial Structu re of the UI Trust Fund is Key. One of the contributing factors to the current UI fund insolvency is the inability of the fund to build a healthy reserve in the last decade. In prior decades, the fund balance built sufficient reserves during times of economic expansion so that the lowest tax rate schedule could be used before entering a period of economic contraction. This pattern ended in the 1990s. In the years leading up to the recession of the early 2000s, the UI fund was unable to build a high enough reserve to safely cover the next recession. Employers were still on schedule C in the late 1990s and in the early 2000s, as the state entered into a brief recession. Soon after, benefits levels were increased with no changes to the revenue structure. As the state entered this most recent recession in 2008, in which the unemployment rate hit record highs, the fund had an insufficient reserve, even though employers had been on the highest state tax rate schedule F+ since 2004. The EDD estimates that even as more firms pay higher rates under the F+ schedule, the current system can only generate about $6 billion in annual revenues. The situation in the late 1990s and early 2000s suggests that the UI financing system was not robust enough to build sufficient reserves. According to EDD estimates, the existing UI financing system can be sustained in the long run only if the state unemployment rate averaged around 4 percent over time. Such low rates of unemployment have been historically rare in California.

LAO Identifies Potential Solution s to UI Trust Fund Insolvency. As the LAO noted in its October 2010 report entitled, *California's Other Budget Deficit: The Unemployment Insurance Fund Insolvency*, the Legislature essentially has three main choices for returning the UI fund to solvency – reducing benefit payments, increasing employer tax contributions, or adopting some combination of the two. To assist the Legislature, the LAO examined multiple scenarios for achieving solvency and found that: (1) decreasing UI benefits alone cannot address the fund insolvency in the near future; (2) options involving UI tax increases could quickly improve the fund condition; (3) employer tax increases could hurt California's competitiveness; and (4) the UI financing structure is not sufficiently robust. The LAO recommended a balanced approach of tax increases, benefit reductions, and eligibility changes to address the long-term financial health of the UI program. In January 2013, the LAO reported that these policy options are still viable, and could be phased-in over several years if the goal were to minimize the potential adverse economic effects of such proposals on UI beneficiaries and employers.

APPENDIX

TIMELINE FOR THE 2013-14 BUDGET BILL

Tuesday	January 10	Governor submits State Budget to the Legislature.
Tuesday	January 10	Committee releases *Quick Summary of Governor's Proposed Budget.*
Wednesday	January 15	Legislative Analyst submits *Overview of the Governor's Budget.*
Thursday	January 24	Committee conducts overview hearing of the budget. Department of Finance presents budget and the Legislative Analyst provides initial review.
Monday	February 4	Committee releases *Overview of the 2012-13 Governor's Budget.*
Thursday	February 14	Full Budget Committee holds oversight hearing on Governor's Higher Education Reform Proposals.
Thursday	February 21	Full Budget Committee holds oversight hearing on Governor's Health Care Proposals.
Thursday	February 28	Full Budget Committee holds oversight hearing on Governor's K-12 Budget Proposals.
Monday	March 4	Subcommittee hearings may begin.
Thursday	March 21	Spring Recess begins.
Monday	April 1	Department of Finance submits Finance Letters.
Monday	April 1	Legislature reconvenes from Spring Recess.
Wednesday	May 1	Department of Finance submits final capital outlay revisions.
Tuesday	May 14	Governor delivers May Revision to the Legislature.
Saturday	June 15	Legislature must pass budget to meet constitutional deadline for passage of the budget.

Staff Assignments

Budget Condition	Mark Ibele Keely Bosler
Corrections/Public Safety	Joe Stephenshaw
Education	
K-12	Kim Connor
Higher Education	Kris Kuzmich
Child Care	Kim Connor Keely Bosler
Energy	Catherine Freeman
Environmental Protection	Catherine Freeman
Judiciary	Joe Stephenshaw
Labor & Employee Compensation	Kris Kuzmich
Local Government	Mark Ibele
Health	Michelle Baass
Human Services	Jennifer Troia
Resources	Catherine Freeman
Revenues	Mark Ibele
State Administration	Brady Van Engelen Mark Ibele Keely Bosler
Transportation	Mark Ibele
Veterans Affairs	Brady Van Engelen
Committee Assistant	Glenda Higgins
Receptionist	Mary Teabo

CALIFORNIA STATE BUDGET HISTORY

Fiscal Year	Bill and Chapter No.	Date Passed	and Chaptered	Total Budget ($ Billions)
1965-66 AB	500/757	6-18	6-30	4.0
1966-67[a]	SB 1XX/2	6-30	6-30	4.7
1967-68 AB	303/500	6-29	6-30	5.0
1968-69 SB	240/430	6-28	6-29	5.7
1969-70 SB	255/355	7-3	7-3	6.3
1970-71 AB	525/303	7-4	7-4	6.6
1971-72[b] SB	207/266	7-2	7-3	6.7
1972-73[c] SB	50/156	6-15	6-22	7.4
1973-74 AB	110/129	6-28	6-30	9.3
1974-75 SB	1525/375	6-28	6-30	10.3
1975-76 SB	199/176	6-26	7-1	11.5
1976-77	SB 1410/320	7-1	7-2	12.6
1977-78 AB	184/219	6-24	6-30	14.0
1978-79 AB	2190/359	7-5	7-6	18.8
1979-80 SB	190/259	7-12	7-13	21.5
1980-81 AB	2020/510	7-16	7-16	24.5
1981-82c SB	110/99	6-15	6-28	25.0
1982-83 AB	21/326	6-30	6-30	25.3
1983-84 SB	123/324	7-19	7-21	26.8
1984-85c AB	2313/258	6-15	6-27	31.0
1985-86c SB	150/111	6-13	6-28	35.0
1986-87c AB	3217/186	6-12	6-25	38.1
1987-88 SB	152/135	7-1	7-7	40.5
1988-89 AB	224/313	6-30	7-8	44.6
1989-90 SB	165/93	6-29	7-7	48.6
1990-91 SB	899/467	7-28	7-31	51.4
1991-92 AB	222/118	6-20/7-4	7-16	55.7
1992-93 AB	979/587	8-29	9-2	57.0
1993-94 SB	80/55	6-22	6-30	52.1
1994-95 SB	2120/139	7-4	7-8	57.5
1995-96 AB	903/303	8-2	8-3	56.8
1996-97 SB	1393/162	7-8	7-15	61.5
1997-98 AB	107/282	8-11	8/18	67.2
1998-99 AB	1656/324	8-11	8-21	71.9
1999-00 SB	160/50	6/16	6/29	81.3
2000-01 AB	1740/52	6/22	6/30	99.4
2001-02 SB	739/106	7/21	7/26	103.3
2002-03 AB	425/379	9/1	9/5	98.9
2003-04 AB	1765/157	7/29	8/2	98.9
2004-05 SB	1113/208	7/29	7/31	105.3
2005-06 SB	77/38	7/7	7/11	117.3
2006-07 AB	1801/47	6/27	6/30	131.4
2007-08 SB	77/171	8/21	8/24	146.5
2008-09	AB 1781/268 & AB 88/269	9/16	9/23	144.5
2009-10	SBx3 1/Ch 1 & ABx4 1/Ch 1	2/20	7/28	119.2
2010-11	SB 870/Ch 712	10/7	10/8	125.3
2011-12	SB 87/Ch 33	6/28	6/30	129.5
2012-13	AB 1464/Ch 21 & AB 1497/Ch 29	6/15	6/27	142.4

[a] *1966 Second Extraordinary Session.*
[b] *First year budget was to be enacted by June 15.*
[c] *June 15 constitutional deadline met (6).*

GENERAL FUND MULTI-YEAR PROJECTION at 2013-14 Governor's Budget

(Dollars in Millions)

	2012-13	2013-14	2014-15	2015-16	2016-17
RESOURCES:					
Prior Year Balance	-$1,615	$785	$1,636	$1,683	$2,097
Revenues/Transfers	$95,394	$98,501	$105,853	$111,283	$117,341
Total Resources	$93,779	$99,286	$107,489	$112,966	$119,438
EXPENDITURES:					
Proposition 98	$37,507	$40,870	$45,333	$47,995	$50,898
Non-Proposition 98	$55,487	$56,780	$60,473	$62,874	$65,449
Total Expenditures	$92,994	$97,650	$105,806	$110,869	$116,347
FUND BALANCES:	$785	$1,636	$1,683	$2,097	$3,091
Reserve for Encumbrances	$618	$618	$618	$618	$618
Special Fund for Economic Uncertainties	$167	$1,018	$1,065	$1,479	$2,473
Operating Surplus	$2,400	$851	$47	$414	$994

Wall of Debt

2013-14 Governor's Budget

(Dollars in Millions)

		Outstanding (as of end of 2012-13)	2013-14 impact	2014-15 impact	2015-16 impact	2016-17 impact	Remaining Amount
1	Deferred Payments to Schools and Community Colleges	$8,205	$1,950	$2,986	$3,137	$132	$0
2	Economic Recovery Bonds	5,150	1,474	1,558	1,664	293	0
3	Loans from Special Funds	4,101	561	795	2,188	557	0
4	Unpaid Costs to Local Governments, Schools and Community Colleges for State Mandates	4,914	0	0	152	2,270	2,492
5	Underfunding of Proposition 98	2,365	0	247	0	2,118	0
6	Deferred Medi-Cal Costs	1,664	130	286	119	0	1,129
7	Deferral of State Payroll Costs from June to July	718	0	0	0	0	718
8	Deferred Payments to CalPERS	440	0	0	0	440	0
9	Borrowing from Transportation Funds (Proposition 42)	251	83	83	85	0	0
10	**Total**	**$27,808**	**$4,198**	**$5,955**	**$7,345**	**$5,810**	**$4,339**

Projections of 2013-14 General Fund
(Dollars in Millions)

	Projections at:				
	2013-14 Governor's Budget	2012 Budget Act	2011 Budget Act	2010 Budget Act	2009 Budget Act
Total Revenues and Transfers	$98,501	$96,117	$93,747	$100,304	Not Available
Total Expenditures	97,650	96,089	99,440	112,632	Not Available

This information is provided in compliance with SB 15 (Chapter 737, Statutes of 2011), which requires that the projection of the 2013-14 General Fund total resources and total expenditures be accompanied by the projections for the same year from the previous four budget acts. Each forecast is based on the assumptions in place at that time.

The 2013-14 Governor's Budget multi-year projection is based on existing state and federal law adjusted for any proposals for changes included in the 2013-14 Governor's Budget. It reflects various assumptions depending on the particular program regarding changes in enrollment, caseload, and population. The projections also use various cost escalation and COLA factors depending on the particular program.