The 2014-15 Budget:

Overview of the Governor's Budget

MAC TAYLOR • LEGISLATIVE ANALYST • JANUARY 13, 2014

LAO

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EXECUTIVE SUMMARY

The Governor's Budget Proposal

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

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

LAO Comments

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

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

OVERVIEW

The Governor's Budget Proposal

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

Administration's Budget Forecast

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

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

Figure 1

Governor's Budget Expenditures

(Dollars in Millions)

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

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

Figure 2

Governor's Budget General Fund Condition

Includes Education Protection Account (In Millions)

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

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

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

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

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

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

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

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

Major Features of the Governor's Budget

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

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

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

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

Figure 3

Major Features of the Governor's Budget

Reserve/Rainy-Day Fund

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

Paying Down State Debts (One-Time Costs)

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

Education

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

Health and Human Services

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

Infrastructure

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

Cap-and-Trade

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

Water

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

Judiciary and Criminal Justice

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

Other Programs

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

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

Includes $11.8 Billion for Proposition 98 Above* 2013-14 Budget Act *Levels. The Governor's budget includes $11.8 billion in Proposition 98 spending increases—$7.6 billion attributable to 2014-15, $3.7 billion attributable to 2012-13 and 2013-14, and $503 million for earlier years. Of the $11.8 billion, $6.8 billion is designated for one-time purposes and $5 billion for ongoing purposes. Most of the one-time funding is allocated for paying off the school and community college deferrals ($6.2 billion). Of the ongoing funding, $4.5 billion is for the school district Local Control Funding Formula (LCFF).

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

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

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

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

The Administration's Multiyear Forecast

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

LAO Comments

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

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

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

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

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

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

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

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

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

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

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

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

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

ECONOMY AND REVENUES

Administration's Economic Forecast

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

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

Figure 4

Comparing Administration's Economic Forecast With Recent Forecasts

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

NA = Not applicable.

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

Administration's Revenue Forecast

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

Key Points

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

Figure 5

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

General Fund and Education Protection Account Combined (In Millions)

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

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

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

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

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

Personal Income Tax

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

Figure 6

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

General Fund and Education Protection Account Combined (In Billions)

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

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

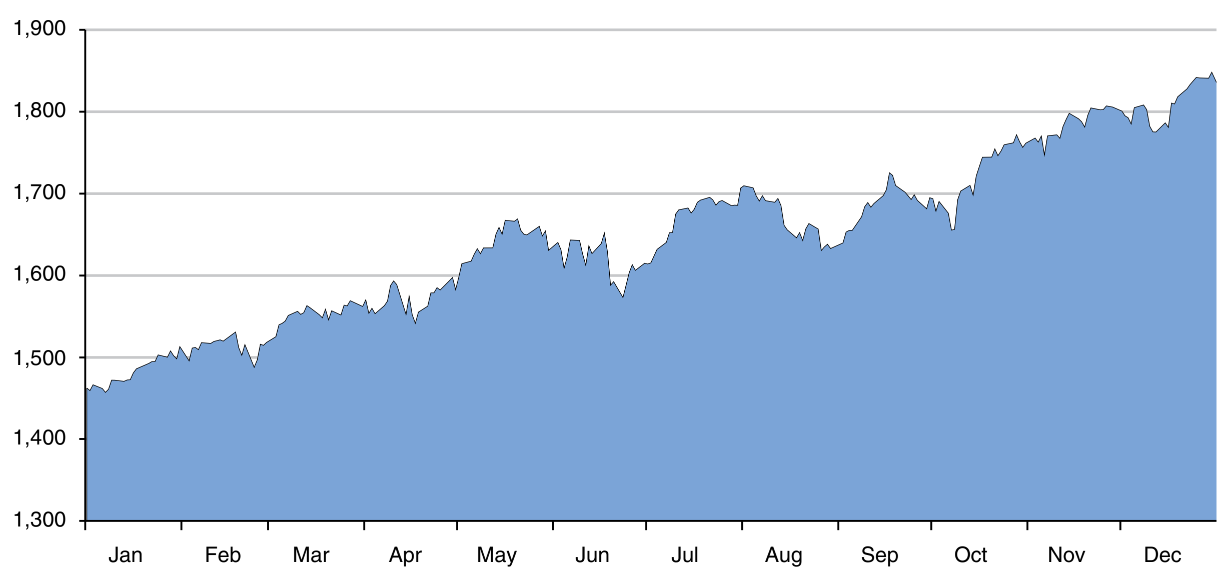
tax is paid on realized capital gains, principally from the sale of stocks, bonds, and real estate. These types of assets are concentrated among high-income taxpayers in the state's top marginal income tax brackets. The 1 percent of taxpayers with the most income typically have paid around 40 percent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

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

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

Figure 7

S&P 500 Index Rose Notably During 2013



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

GOVERNOR'S MAJOR PROPOSALS

Rainy-Day Fund

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

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

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

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

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

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

Governor's Proposal

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

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

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

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

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

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

LAO Comments

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

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

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

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

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

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

How Should the Legislature Proceed?

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

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

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

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

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

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

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

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

CalSTRS

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

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

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

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

Proposition 98

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

Changes to the Minimum Guarantee

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

Figure 8

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

(In Millions)

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

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

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

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

Wall of Debt Proposal

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

Figure 9

Proposition 98 Funding

(Dollars in Millions)

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

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

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

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

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

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

Other Major Proposition 98 Proposals

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

Figure 10

Governor Proposes to Pay Down All Outstanding K-14 Deferrals

(In Millions)

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

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

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

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

Figure 11

Increases in 2014-15 Proposition 98 Spending

(In Millions)

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

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

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

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

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

Governor's Overall Proposition 98 Plan Reasonable

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

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

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

Higher Education

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

Major Higher Education Proposals

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

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

Figure 12

Higher Education General Fund Support

(Dollars in Millions)

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

[a] Includes health benefit costs for CSU retired annuitants.

[b] Includes Quality Education Investment Act funds.

[c] Includes federal Temporary Assistance for Needy Families funds and monies from the Student Loan Operating Fund—both of which directly offset General Fund expenditures for Cal Grants.

[d] Amounts, which include debt service on general obligation, lease-revenue, and UC general revenue bonds, are shown for reference only, as they already are reflected in the lines above.

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

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

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

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

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

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

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

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

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

Mixed Review of Governor's Proposals

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

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

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

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

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

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

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

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

Health and Human Services

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

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

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

Status of Medi-Cal Provider Payment Reductions

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

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

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

CalWORKs

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

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

Developmental Services

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

In-Home Supportive Services (IHSS)

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

Infrastructure

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

Deferred Maintenance

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

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

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

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

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

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

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

Figure 13

Administration's Deferred Maintenance Proposal

(In Millions)

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

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

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

School Facility Funding

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

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

CSU Capital Outlay Process

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

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

Jail Construction

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

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

Resources and Environmental Protection

Cap-and-Trade Expenditure Plan

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

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

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

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

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

Water Action Plan

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

Figure 14

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

(In Millions)

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

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

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

Figure 15

Budget Proposal for Water Action Plan Addresses Multiple Water Issues

(In Millions)

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

[a] Proposal totals $400,000.

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

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

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

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

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

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

Judicial and Criminal Justice

Trial Court Funding

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

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

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

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

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

Meeting Court-Ordered Prison Population Cap

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

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

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

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

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

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

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