Highlights and Analysis of the Governor's 2012-13 May Revision

May 18, 2012
SENATE REPUBLICAN FISCAL OFFICE

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SENATE REPUBLICAN FISCAL OFFICE

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May 18, 2012

Executive Summary

In July 2011, the Governor and legislative Democrats claimed that their "honest and balanced" majority-vote budget closed a $26.6 billion budget gap, and reduced the structural budget gap for fiscal year 2012-13 to $3.1 billion. Then, in January 2012, the Governor suggested that the budget deficit was really $9.2 billion. Now, the Governor acknowledges that the budget deficit is at least $15.7 billion.

The $6.5 billion increase in the size of the deficit is largely attributable to unrealistic revenue assumptions ($4.3 billion) and phony spending reductions ($1.7 billion) that the Governor and legislative Democrats conceived in order to pass their majority-vote budget last year. The bogus budget solutions were also part of an effort to ensure legislators would get paid despite Proposition 25 (2010) provisions that prohibit the legislature from being paid until a balanced budget is passed. ***Republicans did not support the budget last year and have consistently raised concerns that the level of gimmicks included in the budget posed a serious threat to the state's fiscal stability and credibility in the financial marketplace.***

The Governor claims that the May Revision budget plan is balanced with a $1 billion reserve. He categorizes his solutions as balanced by proposing $8.3 billion of expenditure reductions; $5.9 billion in new tax increases and other revenues; and $2.5 billion of "other" solutions that primarily include special fund loans and transfers. However, a closer review of these solutions reveals that about $4 billion of expenditure reductions are actually fund shifts and deferrals such as:

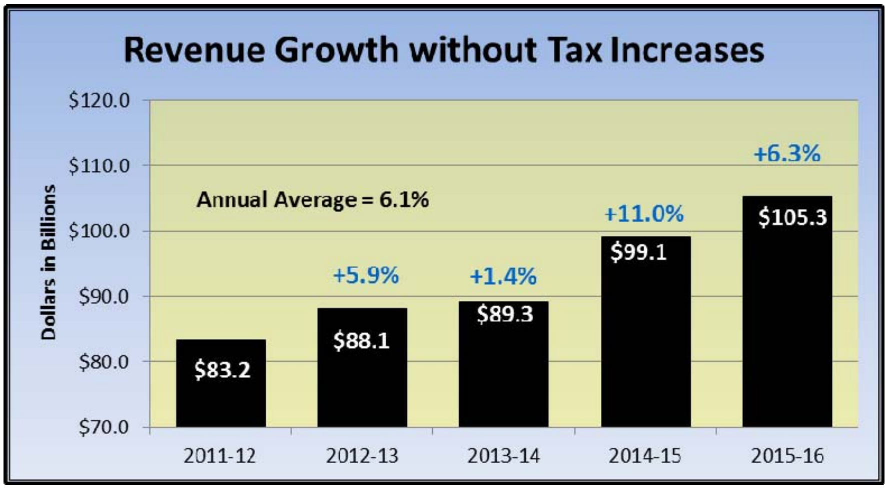
1) $1.4 billion shift of Redevelopment Agency assets,
2) $544 million fund shift of trial court reserves,
3) $293 million fund shift of mortgage settlement proceeds,
4) $663 million deferral of Medi-Cal provider payments, and
5) $830 million to defer/repeal state mandates,

Also, it is clear that the Governor's tax increase is expected to generate $8.5 billion of revenue, yet the Governor suggests that it only provides a $5.6 billion of budgetary solution because he spends $2.9 billion for K-14 education programs. The true solution mix is about $4.3 billion of expenditure reductions, $8.8 billion of tax increases and revenues, and $6.5 billion of "other" fund shifts, loans and deferrals. Less than a quarter of the solutions are spending reductions while nearly half are new tax increases and revenues.

Clearly, the Governor's budget math is just as fuzzy as the bogus solutions that were used to "solve" last year's deficit. It should come as no surprise that Standard and Poor's is concerned that the Legislature will "…rely on budget maneuvers that may be politically expedient but fiscally unreliable when devising deficit solutions."

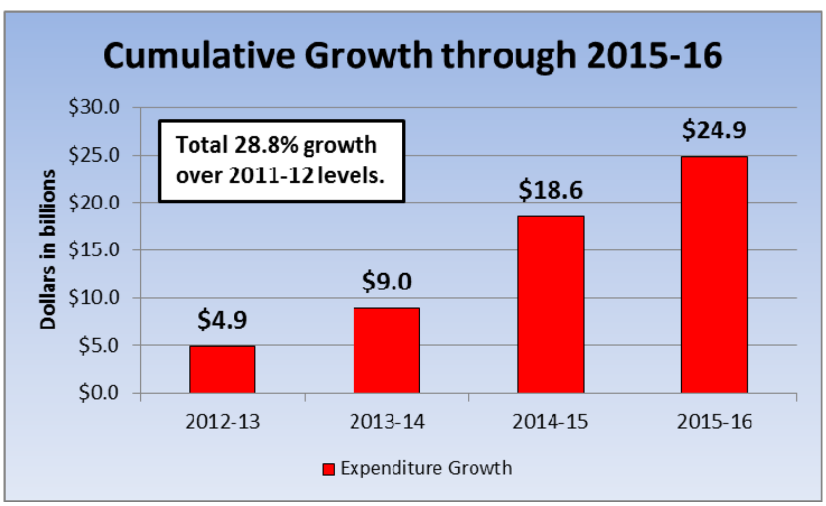
Key Points:

Robust Revenue Growth. State revenues are projected to grow by nearly $5 billion from 2011-12 to 2012-13 without the Governor's proposed sales and income tax increases. The following chart reflects the baseline revenue projections without the Governor's tax increase initiative through 2015-16. The simple story told by this chart is the strength of General Fund revenue growth projected in the out years, ***even without tax increases.*** Average annual revenue growth over the forecast period (6.1 percent) exceeds historic revenue growth over the past 30 years of about 5.1 percent.



Source: Governor's May Revision Multi-year Back-up Document- "Problem Definition"

Substantial Spending Growth. General Fund expenditures grow by nearly $5 billion (from $86.5 billion to $91.4 billion) in 2012-13 (*see detail Expenditures on Page 7*). **This equates to a 5.6 percent growth in expenditures at the same time the Governor believes an $8.5 billion tax increase is necessary to balance the state budget**. In fact, according to the Governor's projections, his proposed sales and income tax increase would **fund a $24.9 billion (28.8 percent) state spending increase** by 2015-16 (*see chart below*). Cumulatively, the Governor's proposed tax increase generates $47 billion of revenue over seven years while state spending increases by $57.4 billion over four years. Effectively, this budget plan would increase state spending by an amount substantially greater than the tax increase revenues. Fundamentally, you can't balance the budget, even with tax increases, if the money is spent faster than it comes in.

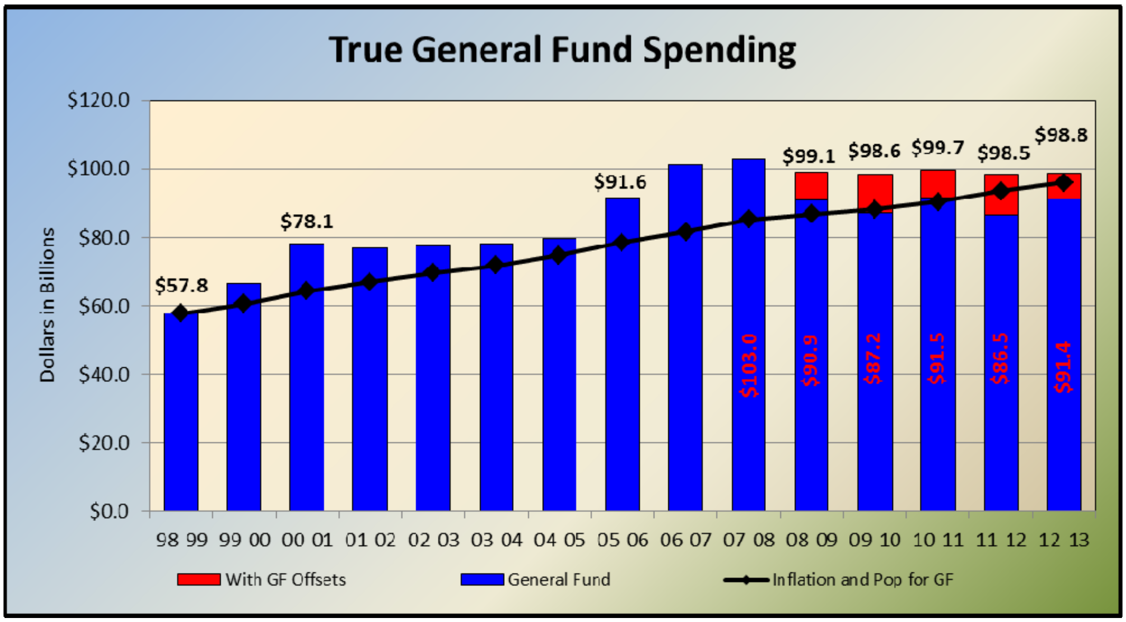


Source: Governor's May Revision Multi-year Back-up Document- "Balanced Budget and Pay Down Debt"

True General Fund ProgramSpending. Legislative Democrats frequently claim that state spending has been slashed by $40 billion. This claim is based upon an old projection from the 2008-09

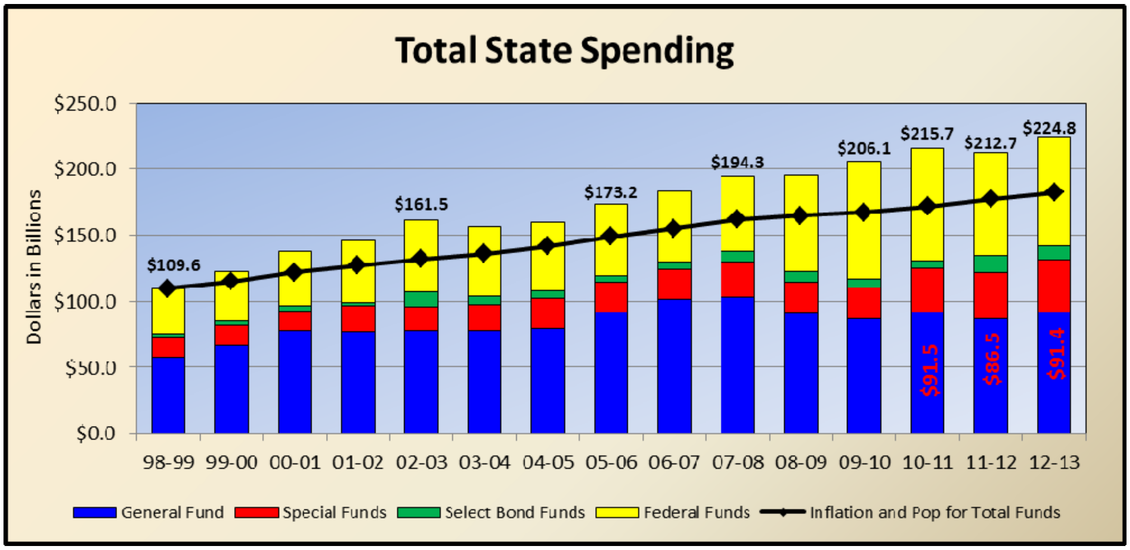
Governor's Budget that suggested spending, unchecked, would grow to about $124.5 billion by 2011-12. Since current year General Fund spending is now $86.5 billion, they calculate that spending is almost $40 billion lower than it should have been if it had continued growing at a record pace. However, their logic is faulty at best. The reality is that state General Fund spending peaked in 2007-08 at $103 billion and various accounting gimmicks, borrowing and fund shifts have effectively allowed the state to maintain General Fund program spending at around the $100 billion level each year since spending peaked in 2007-08. The 2012-13 budget plan includes a $5.9 billion shift of funds associated with Governor's Realignment scheme, $2.4 billion from Redevelopment Agency funds, plus about $4 billion of other fund shifts that backfill General Fund programs such AB 32 fees, trial court reserve fund, federal funds, and transportation weight fees. Once these General Fund-like program expenditures are added to the other $91.4 billion in 2012-13 expenditures it becomes clear that state General Fund program spending hasn't been reduced much at all.

As noted in the chart below, the "true" underlying General Fund expenditure level (red bar), which recognizes the "offsets" discussed above, shows that actual General Fund-like spending is still hovering near the $100 billion mark and is slightly greater than population and inflation growth.



Source: (1) Department of Finance Schedule 9, (2) LAO - February 17, 2012 Letter to Senator Huff regarding Underlying State Spending, (3) Governor's May Revision Back-up Document- "Solutions Spreadsheet"

Total State Spending. Under the Governor's May Revision **total state spending will have increased by nearly $31 billion since the "great recession" began after 2007-08**. General Fund spending tends to be the focus of state budget conversations, but it can be misleading because of all the fund shifts and "budgetary backfills" that have occurred but are not reflected in General Fund spending totals. As the chart on the next page demonstrates, total state spending from all fund sources continues to far outpace population and inflation. Even with the recent recession, the proposed 2012-13 spending level still exceeds population and inflation growth by $42.7 billion ($182.1 billion vs. $224.8 billion). The Governor and legislative Democrats argue that state spending has been *drastically reduced* in the wake of the "great recession," but the truth is that California continues to spend significantly more than it did before the recent economic downturn (*$194 billion in 2007-08 compared to $225 billion proposed for 2012-13*).



Source: Department of Finance Schedule 9

No Credibility on Trigger Cuts. Last year's budget included $2.5 billion of trigger reductions that were supposed to occur if revenues fell $4 billion short. Well, revenues have fallen short of projections by more than $5 billion since July, yet less than $1 billion of trigger cuts have actually occurred. Now, the Governor is using California students as hostages to force voters to support his seven-year, $46.8 billion tax increase. Of the proposed $6.1 billion of new trigger cuts, about 99 percent of those reductions are targeted at K-14 and Higher Education (*see Trigger reductions on Page 49*). However, it is difficult to believe that the Governor will not find a new "trap door" to avoid those reductions. More notable is that legislative Democrats have refused to adopt the Governor's reductions to welfare programs, and have not acted to protect California students. In March 2012, Republicans proposed over $4 billion in alternative budget solutions to avoid reductions to vital education programs and stop college tuition/fee increases.

Governor's Tax Increase Provides Little Help for Schools. Under the Governor's budget plan, state programmatic funding for K-12 education would remain roughly flat from 2011-12 ($44.6 billion) to 2012-13 ($44.8 billion) despite raising taxes by $8.5 billion. This is because only one-third ($2.9 billion) of the new tax revenue are used for school funding while the tax initiative also shifts about $2.4 billion of existing funds (sales tax revenue) that would have gone to education to instead support his public safety realignment scheme. Thus***, the tax initiative appears to provide little benefit to school funding.*** Of course, the Governor threatens to cut K-12 school funding by $5.5 billion if voters don't approve his sales and income tax increases.

Spending Not at 1970's Levels. The Governor and legislative Democrats have been throwing around statistics to fool Californians into believing state spending per $100 of personal income is at the lowest level since the 1970's. The truth is that for all state fund sources, at nearly $8 per $100 of personal income, ***it is higher than it was in 2008-09*** and is entirely in line with historic norms.

Legislative Democrats' Failure Increased Need for Cuts. According to the Department of Finance, an additional $400 million of spending reductions were necessitated by the Democrats' failure to adopt the welfare-to-work reforms and current year spending reductions proposed by the Governor in his January budget plan. If their excuse or intent was to reduce the level of "harm," it is clear that they actually made the situation worse and inflicted additional damage on a fragile state budget

Conclusion

The Governor's May Revision plan does include some real programmatic spending reductions, but General Fund program spending has not been significantly reduced and total state spending is proposed to reach a new record high. In addition, his $47 billion seven-year tax increase plan fuels a

$57.4 billion four- year spending increase, which demonstrates that the Governor and legislative Democrats plan to spend money faster than they can raise taxes.

Furthermore, the Governor's tax increase proposal does not really provide additional funding for K-14 education programs, but he does use school children as hostages by making education programs the target for 99 percent his trigger cuts. Voters will see through this **"hostage taking"** approach because the money is really being used to fund future government growth, not reduce college fees or protect classroom funding.

The real question is whether the Governor can get his fellow legislative Democrats to make meaningful spending reductions and adopt the pension, education, and welfare-to-work reforms that Republicans and the Governor agree on. Legislative Democrats blame the voters (initiatives), federal courts, and Republicans for their failure to fix the state budget. But it's clear that they have said "NO" to the Governor's bi-partisan pension and welfare-to-work reforms, which would have saved billions of dollars. Democrats also rejected the Governor's call for early spending reductions, and have defeated all efforts to improve California's hostile business climate and job creation measures. Unfortunately, the Governor now seems afraid or unwilling to fight for the necessary reforms and spending reductions that he proposed. Republicans stepped up to support him, and he turned his back and walked away from his own proposals.

Expenditures

The Governor's May Revision proposes revised total General Fund expenditures of $86.5 billion for 2011-12. This is approximately the same level of expenditures proposed in the Governor's Budget, following $980.8 million of current year reductions that were triggered in December 2011 due to lower-than-anticipated revenues. Then, General Fund expenditures are projected to grow by an additional $4.9 billion (from $86.5 billion to $91.4 billion) in 2012-13. **This equates to a 5.6 percent growth in expenditures, while at the same time revenues are growing by nearly 5.9 percent on the natural (without tax increases).** The following table compares the Governor's newly proposed budget to the previous two fiscal years.

General Fund Expenditures By Agency
(dollars in millions)

Agency	Actual 2010-11	2011-12 Budget Act	Revised 2011-12	Proposed 2012-13
Legislative, Judicial, Executive	$3,054	$3,151	$2,541	$2,074
State and Consumer Services	$548	$624	$619	$689
Bus, Trans, and Housing	$424	$603	$573	$448
Resources	$1,913	$1,946	$1,933	$1,921
Environmental Protection	$70	$51	$51	$46
Health and Human Services	$26,825	$23,043	$26,772	$25,963
Corrections and Rehabilitation	$9,649	$9,821	$8,082	$8,889
K-12 Education	$35,236	$34,302	$34,038	$38,540
Higher Education	$11,569	$10,248	$9,770	$9,516
Labor and Workforce Development	$48	$371	$354	$342
General Government	$2,213	$1,777	$1,767	$2,959
Total, General Fund Expenditures	**$91,549**	**$85,937**	**$86,500**	**$91,387**
Year-Over-Year Change		-$5,612	$563	$4,887
- As a Percentage		-6.1%	0.7%	5.6%

Source: Department of Finance Schedule 9

Legislative Democrats frequently claim that state spending has been slashed by $40 billion. This claim is based upon a projection from the 2008-09 Governor's Budget that suggested spending, unchecked, would grow to about $124.5 billion by 2011-12. Since current year General Fund spending is now $86.5 billion, they calculate that spending is almost $40 billion lower than it should have been if it had continued growing at record pace. However, their logic is faulty at best. The reality is that state General Fund spending peaked in 2007-08 at $103 billion and various accounting gimmicks, borrowing and fund shifts have effectively allowed the state to maintain General Fund program spending at around the $100 billion level.

The table at the top of the next page reflects offsets included in the May Revision to maintain General Fund programs and mitigate General Fund dollar reductions. These offsets include additional federal funds for various health and human services programs, UC and CSU and Judicial and Criminal Justice services, Proposition 1A borrowing from local governments, fund shifts from redevelopment agencies to schools, payment deferrals for Proposition 98, Medi-Cal and state worker pay, using Propositions 10 and 63 funds to support existing programs, provider fees, fund shifts and the realignment of various public safety program to the local level.

Underlying General Fund Program Spending (dollars in billions)						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Schedule 9 Expenditures	**$103.0**	**$90.9**	**$86.6**	**$91.5**	**$86.5**	**$91.4**
"Offsets" to Maintain General Fund Program Levels*	--	$8.2	$11.4	$8.2	$12.0	$7.4
Total, General Fund Program Expenditures	**$103.0**	**$99.1**	**$98.0**	**$99.7**	**$98.5**	**$98.8**
Percentage Below Peak 2007-08 General Fund Spending		-3.8%	-4.8%	-3.2%	-4.4%	-4.1%

Source: (1) Department of Finance Schedule 9, (2) LAO - February 17, 2012 Letter to Senator Huff regarding Underlying State Spending, (3) Governor's May Revision Back-up Document- "Solutions Spreadsheet"

The fact is that California has relied on "short-term" solutions to solve the annual budget gaps, which does little to address the state's structural budget deficit. In the 2011-12 Governor's Budget summary, Governor Brown noted that the structural deficit continued largely "because of an overreliance on temporary remedies and savings proposals that did not materialize." According to the Department of Finance, **about 85 percent of the solutions included in the 2009-10 and 2010-11 state budgets did not materialize or were short term** in nature, thus allowing state spending and budget deficits to continually re-emerge.

What the Future Holds

The Governor's Budget now proposes to grow state General Fund spending by 28.8 percent over a four-year forecast, from $86.5 billion in 2011-12 to $111.4 billion by 2015-16. The average annual growth rate for expenditures (6.6 percent) actually exceeds the 6.1 percent average annual growth rate of baseline revenues. For the most part, ***the Governor's May Revision is not relying on new tax increases to fund basic programs, but to fund new state government growth***.

Wall of Debt

One final note on the Governor's spending plan relates to his intention to reduce the so-called "wall of debt" (approximately $32.7 billion), which includes budgetary borrowing solutions from the past (Economic Recovery Bonds, loans from special funds, borrowing from transportation funds, etc.), borrowing property tax revenue from local governments (under Proposition 1A of 2004), deferred payments to schools, community colleges, Medi-Cal, CalPERS, and payroll, and underfunding Proposition 98. The Governor's Budget in January proposed to fully pay down all budgetary borrowing debt by 2015-16. Now, it seems that even though the Tax Initiative will yield more revenue than anticipated in January, ***the higher revenues are insufficient to keep up with the growth in state expenditures.*** The May Revision continues the Governor's intent to reduce the "wall of debt" however; absent a constitutional spending limit with a requirement to use excess revenue to pay down debt, the Governor has no ability to get legislative Democrats to go along with his plan to pay down debt.

Taxes & Revenues

The Governor’s May Revision estimates baseline General Fund revenues, based on existing law tax, structure to be $83.2 billion in 2011-12 and $88.1 billion in 2012-13. Due to unrealistic revenue assumptions relied upon in the Governor's Budget, this baseline revenue has been revised downward by about $4.3 billion over the two years from $86.3 billion and $89.3 billion for 2011-12 and 2012-13, respectively. To close the budget gap, the May Revision proposes $11.1 billion of new “revenues,” including about $8.5 billion of new revenue from his Tax Initiative proposal (*See Governor’s Tax Initiative on page 13*) and about $2.6 billion of transfers and other revenues (mostly transfers and borrowing from special funds).

These amounts do not include tax revenues (1.0625 percent of the state sales and use tax (SUT)) that were redirected to local governments as a part of the 2011 Public Safety Realignment proposal ($5.1 billion in 2011-12 and $5.4 billion in 2012-13). The following table identifies where revenues are projected to increase and decrease, and compares them to estimates prepared for the 2012-13 Governor's Budget.

General Fund Revenue Projections

(dollars in millions)

2010-11 Revenue Source	Governor's Budget Baseline	May Revision Baseline	Forecast Change	%△	May Revision Forecast		
Personal Income Tax	$49,491	$49,445	-$46	-0.1%	$49,445		
Sales & Use Tax	$26,983	$26,983	$0	0.0%	$26,983		
Corporation Tax	$9,614	$9,614	$0	0.0%	$9,614		
Insurance Tax	$2,077	$2,077	$0	0.0%	$2,077		
Other Revenues	$3,836	$3,836	$0	0.0%	$3,836		
Transfers	$1,488	$1,488	$0	0.0%	$1,488		
Total Revenue	**$93,489**	**$93,443**	**-$46**	**0.0%**	**$93,443**		
2011-12 Revenue Source	**Governor's Budget Baseline**	**May Revision Baseline**	**Forecast Change**	**%△**	**May Revision Forecast**	**Change**	**%△ to base**
Personal Income Tax	$51,937	$49,803	-$2,134	-4.1%	$52,958	$3,155	6.3%
Sales & Use Tax	$18,777	$18,921	$144	0.8%	$18,921	$0	0.0%
Corporation Tax	$9,479	$8,208	-$1,271	-13.4%	$8,208	$0	0.0%
Insurance Tax	$2,042	$2,148	$106	5.2%	$2,148	$0	0.0%
Other Revenues	$2,688	$2,768	$80	3.0%	$2,789	$21	0.8%
Transfers	$1,386	$1,390	$4	0.3%	$1,784	$394	28.3%
Total Revenue	**$86,309**	**$83,238**	**-$3,071**	**-3.6%**	**$86,808**	**$3,570**	**4.3%**
2012-13 Revenue Source	**Governor's Budget Baseline**	**May Revision Baseline**	**Forecast Change**	**%△**	**May Revision Forecast**	**Change**	**%△ to base**
Personal Income Tax	$56,025	$55,495	-$530	-0.9%	$60,268	$4,773	8.6%
Sales & Use Tax	$19,595	$19,997	$402	2.1%	$20,605	$608	3.0%
Corporation Tax	$9,342	$8,488	-$854	-9.1%	$8,488	$0	0.0%
Insurance Tax	$2,179	$2,089	-$90	-4.1%	$2,089	$0	0.0%
Other Revenues	$2,709	$2,621	-$88	-3.2%	$2,750	$129	4.9%
Transfers	-$529	-$554	-$25	4.7%	$1,489	$2,043	--
Total Revenue	**$89,321**	**$88,136**	**-$1,185**	**-1.3%**	**$95,689**	**$7,553**	**8.6%**
Three-Year Total			**-$4,302**			**$11,123**	

Source: (1) Department of Finance Schedule 8, (2) Governor’s May Revision Summary Publication

The table on the previous page provides a significant amount of information. Note the following main points:

- Unrealistic revenue estimates included in the Governor's Budget resulted in the need to reduce baseline General Fund revenues by $3.1 billion in 2011-12 and 1.2 billion in 2012-13.
- Governor's Budget revenues include ***$8.5 billion of tax increases*** over 2011-12 and 2012-13 based on speculation that the voters will approve personal income tax increases on high-income earners and a quarter cent increase in the state sales and use tax. It would be much wiser to make reductions first, and then restore spending levels **IF** voters approve tax increases.
- ***As noted above, state revenue projections for 2011-12 and 2012-13 no longer include sales and use taxes that were redirected to local governments to fund the 2011 Public Safety Realignment ($5.1 billion in 2011-12 and $5.4 billion in 2012-13).***

Facebook IPO (Initial Public Offering)

One potentially bright star on the short-term horizon is the anticipated IPO for Facebook, Inc. The May Revision estimates increased revenues of $500 million in 2011-12 and $1.4 billion in 2012-13, with approximately 79 percent ($1.5 billion) being generated under existing tax law and 21 percent ($400 million) under the Governor's Tax Initiative.

According to the Legislative Analyst's Office (LAO), state Personal Income Tax revenues will be generated from the following types of IPO-related financial transactions: (1) settlement of options-like assets known as "restricted stock units" (RSUs) by Facebook employees and others beginning late in 2012, (2) options transactions by Facebook's founder and chief executive officer, Mark Zuckerberg, both at the time of the IPO and at some other points in time over the next three years, and (3) various other stock and options transactions, principally by current Facebook "insiders" (investors, employees, and former employees), over the next few years.

The LAO has raised numerous issues and concerns about relying on the accuracy of these numbers, given the myriad of unknowns associated with the IPO. For example: (1) we do not know what the IPO share price will be; (2) we do not know what the company's share price and market capitalization will be six months from now; (3) we don't know the extent to which RSU, options, and other transactions will occur for individuals who are obligated to report income to California versus other states; and (4) we do not know the extent to which Facebook insiders have or will undertake other transactions that would result in extraordinary deductions, credits, or other reductions to reported California taxable income.

We already know of at least one person choosing to avoid paying taxes on this IPO, which will likely effect any estimates. Rather than staying in the U.S., Eduardo Saverin, co-founder of Facebook, has traded his citizenship for citizenship in Singapore. Saverin stands to gain $4 billion from Facebook's IPO, which makes Singapore's tax laws enticing. Surely, Saverin is not unique. According to the LA Times, "The number of Americans renouncing their citizenship grew from 238 in 2008 to 1,534 in 2010. This sixfold increase no doubt includes a hefty portion of super-rich cosmopolitans."

That said, hedging on the belief that state revenues could be hundreds of millions below their estimate or $1 billion to $2 billion above their estimates in 2012-13, the LAO has also provided its estimate of revenues that could be generated by the Facebook IPO. The LAO estimates increased revenues of $500 million in 2011-12 and $1.6 billion in 2012-13, with approximately 76 percent ($1.6 billion) being generated under existing tax law and 24 percent ($500 million) under the Governor's Tax Initiative. A comparison of revenue estimate by the Department of Finance and the LAO is included below.

	2011-12	2012-13	2013-14	2014-15	Total
Finance	$500	$1,400	$80	$80	$2,060
LAO	$500	$1,600	$650	$150	$2,900

Dollars in millions

Governor's Tax Increase Proposals

The May Revision, similar to the Governor's Budget, relies heavily on the passage of a voter initiative in November 2012 to increase personal income taxes and sales and use taxes. In addition to the Governor's Budget, the May Revision also proposes other revenue-related solutions. A summary of all revenue-related proposals is included below.

1) Tax Increase Initiative: <u>Subject to Voter Approval on the November 2012 ballot</u>

- **Personal Income Tax (PIT) Rate Increase:** The Administration estimates that this initiative would generate revenues of $3.1 billion in 2011-12 and $4.7 billion in 2012-13. *Additional detail on the Governor's Tax Initiative, including the new tax brackets, can be found on Pages 13 and 14*.
- **Sales and Use Tax Increase:** Effective January 1, 2013 through January 1, 2017, imposes an additional quarter cent tax on the sale of all tangible personal property sold or used in California. The Administration estimates that this proposal would generate first year (half-year) revenues of $600 million 2012-13 (annual revenues of approximately $1.2 billion).

2) Additional Revenue Proposals:

- **Change Rules Regarding Franchise Tax Board Wage Garnishment:** The Governor proposes to allow the FTB to issue a wage garnishment against a delinquent tax debt without requiring FTB to record a tax lien. Apparently, this would be a benefit to individuals with outstanding tax debts because it would remove the incentive for FTB to record a lien. It is not clear how this is a budget issue, other than the fact that the Administration estimates that it would generate additional General Fund revenues of $11 million in 2011-12 and $27 million in 2012-13. Two prior conformity bills were vetoed by Governor Schwarzenegger due to the inclusion of this provision. Tax credit consultants are concerned about how this provision will impact Enterprise Zone credit claims.
- **Penalty for Fraudulent Claim for Refund:** The Governor proposes to generate $1 million General Fund in 2011-12 and $3 million General Fund in 2012-13 by creating a penalty for filing a fraudulent claim for refund. It is intended to deter taxpayers from filing amended returns that claim credits that are not substantiated. Each year this issue is identified as one that would increase General Fund revenues without requiring a 2/3 vote of the Legislature. Though the amount of estimated revenue associated with this issue is miniscule, this issue should be pursued through the normal policy bill process.

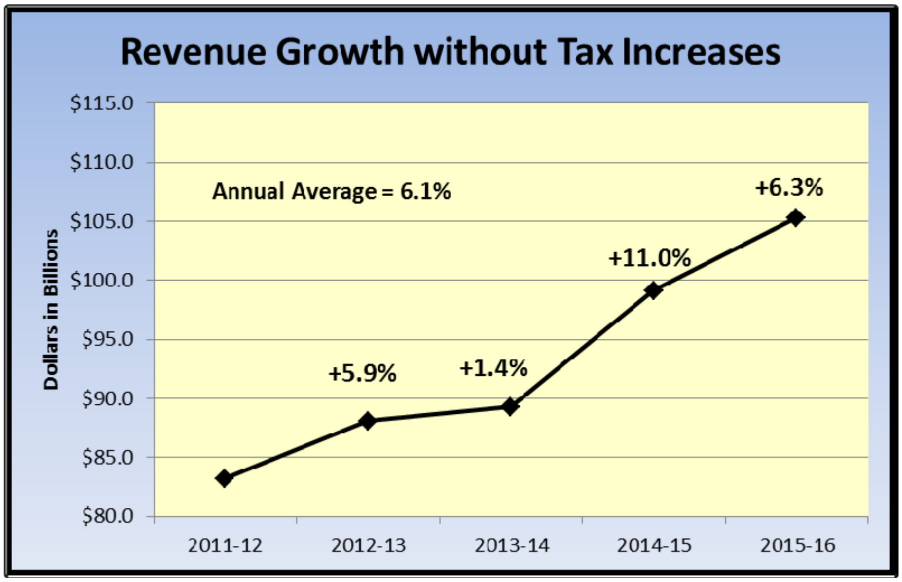
3) Other Tax Policy:

Under the façade of "Job Creation," the Administration indicated in the Governor's Budget that it would propose legislation to reform the enterprise zone program and move to a mandatory single sales factor for apportioning multistate business income in California. At this time, the Governor has yet to submit a formal proposal to do either of these things, but continues to vilify businesses for taking advantage of net operating loss, hiring, sales tax, research and development, and other credits, claiming that the use of those credits is the reason corporate profits have been revised downward relative to the Governor's Budget forecast. A convenient excuse to ignore California's worst-in-the-nation business climate and 11 percent unemployment rate since the Governor has no real job creation proposals.

No "Need" for Tax Increases

As we evaluate whether the state really needs to increase taxes, a clear trend is emerging that would argue otherwise. The following chart reflects baseline revenue projections based on the Governor's

"Problem Definition" without the Governor's tax increase initiative through 2015-16. The simple story told by this chart is the strength of General Fund revenue growth projected in the out years, ***even without tax increases*.**



Source: Governor's May Revision Multi-year Back-up Document- "Problem Definition"

Revenues May Be Stronger Than They Appear:

The chart above shows that General Fund revenues will grow on average by about 6.1 percent annually through 2015-16. Over the past 30 years, following the passage of Proposition 13, the state has experienced average annual revenue growth of about 5.1 percent. Since revenue growth is projected to be almost 20 percent stronger than historical revenue growth figures, a strong case may be made that the state continues to over spend resources provided by California taxpayers.

Governor's Tax Initiative

Governor Brown's 2012-13 budget plan initially relied on the passage of $7 billion in temporary tax increases that he intended to place before California voters in November 2012. This initial temporary tax increase was projected to raise $31 billion over five years. On March 14, 2012, the Governor and the California Federation of Teachers (CFT) announced a new "compromise" tax scheme. The May Revision estimates $8.5 billion in new revenue for the current state budget, and **$46.8 billion total over the next seven years**. This new tax increase plan reduces the Governor's original sales tax increase by half (from 1/2 down to 1/4 percent), and would include a ***larger income tax increase on California's top earners for a longer "temporary" period of time*** (seven years instead of five years). The joint Brown-CFT tax initiative includes the following major components:

- ***$5.6 billion Realignment Shift.*** Places much of the 2011 Realignment Legislation into the Constitution, including constitutional protection for the shift of 1.0625 percent of the state sales and use tax ($5.1 billion in 2011-12 and $5.4 billion in 2012-13) to local governments to fund local public safety programs scheduled for Realignment beginning July 1, 2011. These revenues would no longer be considered General Fund revenues for the purpose of calculating General Fund Proposition 98 obligations, **essentially redirecting about $2.4 billion away from K-14 education**.

- ***$8.5 billion Tax Increase.*** Adds three new personal income tax brackets (effective for seven years beginning January 1, 2012) for both single and joint taxpayers, and increases the state sales and use tax by 0.25 percent (effective for four years beginning January 1 2013). New tax brackets and rates are included (in yellow) in the table at the top of the next page. Additional revenues generated by this tax increase would be considered General Fund revenues for the purpose of calculating General Fund Proposition 98 obligations. **The May Revision estimates $2.9 billion of this tax increase would go to Proposition 98.**

- ***Education Protection Account.*** Tax increase revenues would be deposited into this account with 89 percent allocated to the Superintendent of Public Instruction for K-12 education and 11 percent allocated to the Board of Governors of the California Community Colleges. Although 100 percent of this new revenue would be allocated to K-14 education, nothing in this initiative prohibits commensurate, offsetting reductions to existing General Fund for K-14 education. **This "loophole" would allow the redirection of revenue to continue funding and expanding other fast-growing, non-education programs, such as welfare and state employee pension benefits.**

Three new tax brackets and rates are identified in yellow:

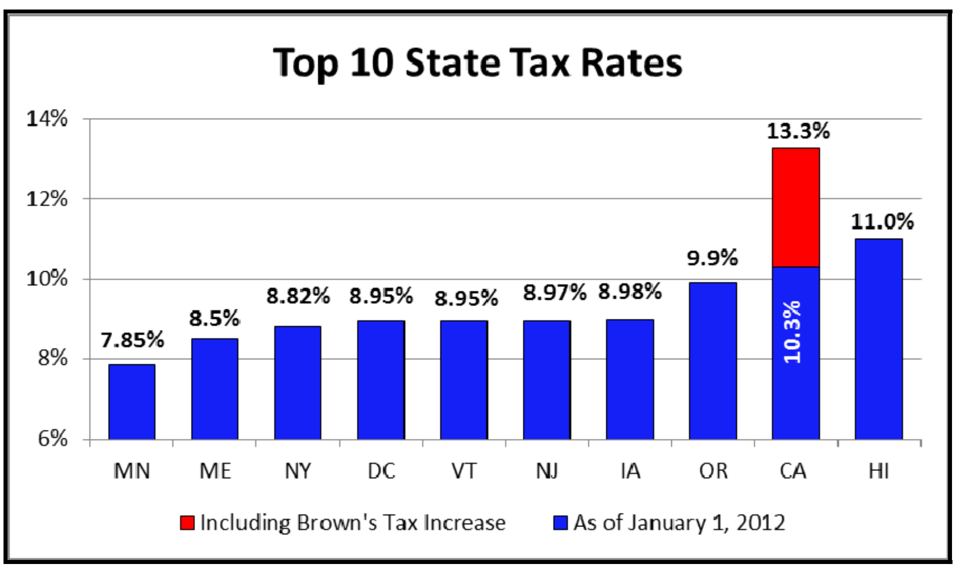
Taxable Income - Single			Taxable Income - Joint			Taxable Income - Head of House		
Min	Max	Rate	Min	Max	Rate	Min	Max	Rate
$0	$7,316	1.0%	$0	$14,632	1.0%	$0	$14,642	1.0%
$7,316	$17,346	2.0%	$14,632	$34,692	2.0%	$14,642	$34,692	2.0%
$17,346	$27,377	4.0%	$34,692	$54,754	4.0%	$34,692	$44,721	4.0%
$27,377	$38,004	6.0%	$54,754	$76,008	6.0%	$44,721	$55,348	6.0%
$38,004	$48,029	8.0%	$76,008	$96,058	8.0%	$55,348	$65,376	8.0%
$48,029	$250,000	9.3%	$96,058	$500,000	9.3%	$65,376	$340,000	9.3%
$250,000	$300,000	10.3%	$500,000	$600,000	10.3%	$340,000	$408,000	10.3%
$300,000	$500,000	11.3%	$600,000	$1,000,000	11.3%	$408,000	$680,000	11.3%
>	$500,000	12.3%	>	$1,000,000	12.3%	>	$680,000	12.3%

Source: LAO Analysis of "The Schools and Local Public Safety Act of 2013 – ver. 3" – March 16, 2012

In addition to the above rates, all income in excess of $1 million is subject to one percent surcharge to fund the Mental Health Services Act, pursuant to Proposition 63 (November 2004). Even without this additional one percent surcharge, California will have the highest personal income tax rates in the country. (*See Top 10 State Tax Rates chart below*)

Impact on Schools. Although this initiative technically requires that all of the revenues raised by the proposed tax increase be directed to schools, it provides a clever "loophole" that allows the state to reduce existing General Fund spending on K-14 education to offset the 100 percent General Fund spending increase required by this initiative. Bottom line is that instead of receiving $8.5 billion over the 2011-12 and 2012-13 fiscal years, K-14 education would only receive about $500 million of new revenue, above what they would get under existing law. **The Governor and Legislative Democrats make it clear that this additional revenue will fund all of state government.**

State Personal Income Tax Rate Comparison. If this initiative passes on the ballot in November 2012, **California would have the highest personal income tax rates in the nation**, far exceeding tax rates imposed by any other state in the nation. The table below includes the top 10 state personal income tax rates in the country under existing law, compared to California's tax rate if this initiative passes.



Source: (1) www.taxadmin.org/fta/rate/ind_inc.pdf, (2) LAO Analysis of, "The Schools and Local Public Safety Act of 2013 – ver. 3" – March 16, 2012

Comparison of Fiscal Estimates. The Legislative Analyst's Office (LAO) indicates that due to the high level of volatility associated with high-income taxpayers, revenue estimates will vary greatly and could come in significantly lower than the Governor's estimate. The following table compares estimates provided by both Finance and the LAO. As you can see, the estimate from Finance is much more optimistic ($11.2 billion more optimistic).

Department of Finance	**2011-12 & 2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**Total**
Sales Tax Increase	$0.6	$1.3	$1.4	$1.5	$0.8	$0.0	$0.0	**$5.6**
PIT Increase	$7.8	$5.0	$5.7	$6.1	$6.6	$7.1	$2.9	**$41.2**
Total	**$8.4**	**$6.3**	**$7.1**	**$7.6**	**$7.4**	**$7.1**	**$2.9**	**$46.8**
Legislative Analyst's Office	**2011-12 & 2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**Total**
Sales Tax Increase	$0.6	$1.3	$1.4	$1.5	$0.8	$0.0	$0.0	**$5.6**
PIT Increase	$6.2	$3.8	$4.1	$4.4	$4.6	$4.9	$2.0	**$30.0**
Total	**$6.8**	**$5.1**	**$5.5**	**$5.9**	**$5.4**	**$4.9**	**$2.0**	**$35.6**

Source: Back-up Data provided by the Department of Finance and Legislative Analyst's Office (dollars in billions)

Government Reforms and Protections not included. Absent from the Governor's tax initiative are much needed spending protections and government reforms such as pension reform and a spending limit that utilizes excess revenues to build a reserve and pay down budgetary debt.

K-14 Education

The Governor's May Revision proposal fully funds the 2012-13 Proposition 98 guarantee for K-14 education at $53.7 billion (up from $52.5 billion in January, and $5 billion above the 2011-12 final Budget Act level), contingent on voter approval of an $8.5 billion tax hike in November. The $1.2 billion increase in the 2012-13 minimum guarantee is mostly driven by two factors: first, the November tax hike would drive a $2.9 billion increase in the guarantee[1], and second, a drop in 2012-13 revenues along with an even deeper drop in 2011-12 revenues together increase the state's year-to-year revenue growth rate, requiring a higher 'maintenance factor' repayment and thus increasing the guarantee even further. Most of the $1.2 billion increase in Proposition 98 spending would be used to unwind additional deferrals, permanently restore home-to-school transportation funding, and fund the Quality Education Investment Act (QEIA) program with Proposition 98 dollars in 2012-13.

In contrast to the higher 2012-13 guarantee, the drop in estimated current-year revenues has *lowered* the 2011-12 minimum guarantee, such that the existing funding level of $47.8 billion exceeds the minimum guarantee by about $785 million. Because that $785 million is no longer required to satisfy the guarantee, the May Revision would score it in satisfaction of existing one-time state obligations ($450 million toward the settlement of *CTA v. Schwarzenegger* (QEIA) and $335 million toward other past-year settle-up obligations).[2] The chart below displays Proposition 98 funding levels proposed by the May Revision:

Proposition 98 Funding at 2012-13 May Revision

Source: Legislative Analyst's Office

($ in millions)	2010-11	June 2011 2011-12	May 2012 2011-12	May 2012 2012-13
K-12 education				
General Fund	**$31,291**	**$29,328**	**$29,268**	**$34,021**
Local property tax revenue	**$12,084**	**$13,823**	**$12,436**	**$13,713**
K-12 subtotal 1/	**$43,376**	**$43,151**	**$41,704**	**$47,735**
California Community Colleges				
General Fund	**$3,885**	**$3,466**	**$3,162**	**$3,628**
Local property tax revenue	**$1,959**	**$1,949**	**$2,076**	**$2,293**
CCC subtotal	**$5,844**	**$5,415**	**$5,238**	**$5,922**
Other Agencies	**$87**	**$85**	**$83**	**$79**
Total Proposition 98 1/	**$49,306**	**$48,651**	**$47,024**	**$53,735**
General Fund	**$35,263**	**$32,879**	**$32,512**	**$37,729**
Local property tax revenue	**$14,044**	**$15,772**	**$14,512**	**$16,007**
Prop 98 per-pupil funding (K-12) 1/	**$7,337**	**$7,232**	**$6,986**	**$7,969**

1/ Absent the shift of $1.055 billion in child care funding out of Prop 98, Prop 98 spending as of the 2011-12 Final Budget Act would have been about $49.705 billion and per-pupil funding would have been about $7409.

If the voters reject the November tax hike, the 2012-13 minimum guarantee would fall $2.9 billion, to $50.8 billion. The Governor would abandon his proposed $2.8 billion deferral buy-down proposal and would shift about $2.7 billion in 'Early Start' (a Department of Developmental Services program) and

[1] Up from $2.5 billion in January, based on higher revenues expected from the tax hike.
[2] The existing use of the funds would not change.

K-14 facilities bond debt service into Proposition 98, thus creating the same amount of non-98 General Fund savings by displacing existing K-12 revenue limit and Community College apportionment spending. Were this to happen, K-12 schools would be authorized to reduce their costs by shortening the school year by up to 15 days and Community Colleges would likely offer fewer course sections in the spring. Districts that prudently build their 2012-13 budgets assuming the post-trigger funding level would be less affected.

Deferral buy-down. The May Revision proposes to increase the January 2012-13 inter-year deferral buy-down proposal by $446 million, to $2.8 billion (about $2.5 billion for K-12 schools and about $300 million for Community Colleges), contingent on voter approval of the November 2012 tax initiative.

K-14 mandate reform. The May Revision continues a January proposal for a new mandate incentive block grant program totaling $200 million, to replace the existing mandate claiming process, along the same lines as a measure authored by Senator Emmerson in 2011, SB 887. The proposal would continue about half of the state's K-12 mandates and eliminate the others and would provide equitable funding of $28 per student to all K-14 agencies.[3] The six highest cost K-12 mandates would be repealed in 2012-13, and others slated for elimination would be suspended pending legislation to repeal them. Two pending Community College mandates ('Minimum Conditions for State Aid' and 'Community College Construction') would be folded into the block grant, and another ('Discrimination Complaint Procedures') would be suspended.

Redevelopment Agency (RDA) revenues. The May Revision proposes to offset Proposition 98 General Fund costs by $818 million in 2011-12 and $981 million in 2012-13 in recognition of tax increment funds that will now flow to schools rather than RDAs. In addition, $1.4 billion in liquid assets from RDAs would be allocated to schools and community colleges in 2012-13, and $600 million in 2013-14, for one-time General Fund savings.

Home to School Transportation. In a move likely to be welcomed by both sides of the aisle, the May Revision would permanently restore $496 million in 2012-13 Proposition 98 home to school transportation funding which had been proposed for elimination in January.

Weighted Pupil Formula. The May Revision continues the January proposal to reform K-12 school funding to permanently increase flexibility and local control by collapsing most categorical programs and existing revenue limit funding into a single funding stream known as a weighted pupil formula (WPF), but proposes several revisions to the original proposal:

- Increases the 'base' per-student amount from $4,920 to $5,421, and reduces supplemental funding for poor and English learner students from 37 percent to 20 percent of the base amount.
- Establishes differing weights for different grade spans, and rolls the state's $3.2 billion K-3 class-size reduction categorical program funding into the K-3 rate.
- Excludes about $850 million Targeted Instructional Improvement Grant funds and about $500 million in Home-to-School Transportation funds from the new formula, locks in current district allocations for those programs, and 'flexes' those funds.
- Extends the new formula phase-in period from six to seven years. Begins implementation with a five percent shift to the new formula in 2012-13, growing to 100 percent by 2018-19, and holds schools harmless from any loss in per pupil funding due to the initial shift to the WPF in 2012-13.
- Delays implementation, reversing the five percent formula shift in 2012-13, if the voters reject the tax hike in November. Allows future phase-ins (increasing shifts from old to new funding formula) only in years when Prop 98 funding meets certain growth targets.
- Requires districts to use supplemental funding to benefit the low income and English learner students who generate that funding.

[3] The January budget would have provided $30 per pupil to K-12 and $20 to the Community Colleges.

- States intent to restore existing revenue limit deficit factor reduction before the shift to a WPF is completed.[4]
- Makes continued phase-in of formula in 2013-14 contingent on legislation identifying new indicators for district and school success.

The weighted pupil formula discussion is one worth having, but a WPF will have distributional effects, and if not written carefully could allow new funds to flow into employee salary and benefit expansions rather than into additional services for its target student populations.

Child Care. The Governor's May Revision proposes $1.3 billion in 2012-13 General Fund support for child care provided through the Department of Education (CDE) and the Department of Social Services (DSS), up from $1.2 billion in January. The increase is driven mostly by caseload growth in Stages 2 and 3 and a proposal to spend the savings generated by suspending the Transitional Kindergarten program on new state preschool slots. The Governor continues to propose shifting administration of child care programs other than state preschool away from the Department of Education to the counties, through the Department of Social Services. The May Revision continues to propose savings of about $450 million, the same as in January, but revises the mix of savings proposals in the following ways:

- Withdraws a January proposal to save $180 million by requiring parent recipients to meet federal work participation requirements through unsubsidized work, which would have eliminated families with parents in education programs and subsidized employment, and replaces it with one that generates savings of about $190 million by more steeply reducing child care voucher reimbursement rate ceilings.
- Withdraws the January proposal to reduce the standard reimbursement rate for state preschool programs by 10 percent, but retains the January proposal to apply that same reduction to child care centers.
- Establishes a county child care block grant to ensure that funds proposed to be shifted to DSS and the counties continue to be spent for child care.
- Proposes to preserve child care center infrastructure by requiring county welfare departments to continue to contract for three years with centers for the same number of center-based slots funded 2012-13.
- Shifts some federal 'quality' funding from CDE to DSS and the counties: CDE would continue to oversee activities promoting early learning and school readiness, DSS would oversee those promoting the health and safety of children in child care, and a portion of the federal 'quality' funds would be allocated to counties for local quality activities based on local needs and priorities.
- Authorizes earlier (mid-year 2012-13 rather than 2013-14 commencement of the) transfer of child care funding and oversight responsibility from CDE to DSS and the counties, to the extent that counties are ready to assume the workload by that time.

The Governor's proposal to shift most child care oversight away from the Department of Education is highly supportable, as the department has a long history of indifference to cost considerations.

Transitional Kindergarten. The May Revision continues to propose suspension of the new Transitional Kindergarten program created pursuant to Chapter 705, Statutes of 2010, which Republicans generally opposed based on its creation of a new program during a time when existing educational programs are being cut. However, the proposal has been revised to reduce the estimate of resulting savings by $132 million (from $224 million to $92 million), and to redirect the remaining $92 million in savings to the state preschool program, to 'buy out' a 10 percent reimbursement rate reduction proposed in January and add over 15,000 new slots.

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[4] In 2012-13, the revenue limit deficit factors for school districts and county offices of education are expected to be about 22 percent.

Community Colleges. The May Revision proposes $5.922 billion in 2012-13 Proposition 98 funding for the CCCs, up from $5.784 billion in January. It proposes several changes to the CCC budget, most notably:

- Increases proposed mandate block grant funding by $11.4 million, to support annual reimbursements of $28 per student, up from $20 in January (see K-14 mandate reform section above).
- Increases the proposed 2012-13 deferral buy-down to $313 million, up from $218 million in January.
- Reduces the 2011-12 estimate of revenue from RDA property taxes by $30.8 million and replaces that loss with General Fund.
- Increases the 2012-13 estimate of revenue from RDA liquid assets by $191 million and reduces General Fund support by the same amount.
- Increases the trigger cut that would occur if voters reject the November 2012 tax hike to $325 million, up from $292 million in January,

The Community Colleges would continue to get their full statutory share of Proposition 98 funding (roughly 11 percent). **Student fees would be $46 per credit unit, still among the lowest CCC fees in the nation, and students from families with incomes of up to about $80,000 (roughly 70 percent of CCC full-time-equivalent students) would continue to receive fee waivers.**

Missed Opportunities. Once again, the Governor does *not* propose to bring Proposition 49 before-and after-school programs back 'on-budget' so as to make that $550 million in Proposition 98 funding available for higher priority uses. **Nor does he propose to repeal the restrictions on schools' authority to contract out for non-instructional services originally enacted in SB 1419 (Ch. 894/2002), which could free up several hundred million local dollars each year for higher priority uses, nor to make other needed reforms relative to seniority-driven layoffs, substitute pay, layoff notice deadlines, or employee dismissal for cause.**

Higher Education (non-Proposition 98)

The Governor's May Revision proposes 2012-13 General Fund support for UC and CSU of $2.5 billion and $2.2 billion, respectively. Student fee revenue would bring in another $3.4 billion and $2.4 billion, respectively. The chart below summarizes proposed core funding for these two segments of higher education:

UC & CSU Funding at 2012-13 May Revision

(Selected core funds, in millions)

	Fund	2010-11	June 2011 2011-12	May 2012 2011-12	May 2012 2012-13
UC	**General Fund [1/]**	**$2,911**	**$2,374**	**$2,274**	**$2,535**
	Fees [2/]	**$2,537**	**$3,336**	**$3,320**	**$3,366**
	ARRA	**$107**			
	Lottery	**$27**	**$30**	**$33**	**$33**
	Total UC	**$5,582**	**$5,740**	**$5,626**	**$5,934**
CSU	**General Fund [1/]**	**$2,578**	**$2,141**	**$2,003**	**$2,198**
	Fees [2/]	**$1,819**	**$2,076**	**$2,244**	**$2,442**
	ARRA	**$107**			
	Lottery	**$42**	**$46**	**$48**	**$48**
	Total CSU	**$4,546**	**$4,263**	**$4,295**	**$4,688**
	Total	**$10,128**	**$10,003**	**$9,921**	**$10,622**

[1/] May 2011-12 column reflects 'trigger cuts' of $100 million at each segment. 2012-13 amounts include GO bond debt service of $194 million at UC and $187 million at CSU.

[2/] Includes systemwide fees, nonresident tuition, and foregone revenue for institutional aid programs.

Source: Legislative Analyst's Office

UC and CSU. The May Revision proposal continues to hold UC and CSU harmless from further reductions, assuming voter approval of the Governor's tax hike in November. It continues to propose allowing UC and CSU to set their own enrollment targets, which could result in higher staff, faculty, and executive salaries, but fewer students served. It proposes a variety of other adjustments, most notably:

- Increases the 'trigger cuts' to be imposed on UC and CSU if voters reject the November 2012 tax hike, from $200 million to $250 million each.
- Modifies a January proposal to increase UC's base budget by $90 million in 2012-13 with funding that could be used (or not) to reduce its retirement fund shortfall, to instead provide $52 million in 2012-13 and by another $38 million in 2013-14. **This augmentation is not supportable, as it could be the first step toward eventual massive annual General Fund support of UC's retirement system.**
- Proposes trailer bill language to authorize CSU to negotiate with active employees regarding health benefits, similar to the statutory authority currently held by the Department of Personnel Administration for most state employees. (Currently CSU health benefit rates are set in statute at 100 percent coverage for employees and 90 percent for dependents.) This change is supportable.
- Modifies a January proposal that would have required CSU to begin absorbing all increases in employer contribution rates for employee pension costs, to instead provide a full adjustment in 2012-13, but annual adjustments thereafter only for the unfunded liability portion of these costs. Unfunded liability costs are determined by CalPERS and cannot be controlled by CSU. This change is supportable.

Student Fees. The Governor's January proposal did not acknowledge the CSU Trustees' November 2011 approval of a 2012-13 fee increase, from $5,472 to $5,970. The May Revision proposal now acknowledges that action (see reference in Student Financial Aid below), but assumes no further increases to the 2012-13 annual undergraduate fees already approved by the UC Regents and CSU Trustees ($12,192 and $5,970 respectively).

Student Financial Aid. The State of California spends about $1.4 billion annually on student financial aid. The May Revision continues the Governor's January proposals to raise minimum grade point average (GPA) requirements[5] for CalGrants and reduce maximum awards to students attending private colleges from $9,708 per year to $4,000 at for-profit colleges and $5,472 at independent, non-profit ones, for General Fund savings of about $250 million (down about $50 million from an estimated $300 million in January). Given the low rates of persistence and success in college by students with GPAs of 2.0, the Governor's proposed GPA changes make sense.[6]

In addition to its GPA and maximum award proposals, the May Revision proposes several other adjustments to the budget of the California Student Aid Commission, most notably:

- Uses $804 million (up from $736 million in January) in federal TANF funds to support CalGrants, for General Fund savings of the same amount.
- Uses $60 million in Student Loan Operating Fund to support CalGrants, for General Fund savings of the same amount (up from $30 million proposed in January).
- Augments General Fund support by $27.7 million in 2011-12 and $26.5 million in 2012-13, to allow students who initially were eligible for both CalGrant A and B, but were given a CalGrant B, to switch to a CalGrant A when renewing their awards.
- Augments General Fund support by $31.2 million to cover the increased cost of CalGrant awards resulting from CSU's tuition increase from $5,472 to $5,970 effective fall 2012.
- Modifies maximum CalGrant award calculation methodology for students who apply after July 2012, to conform to federal Pell Grant methodology, for General Fund savings of $93.1 million beginning in 2013-14. Grants would no longer be 'all or nothing' – they would still cover 100% of tuition for the neediest students, but less than 100 percent for those with lower costs of attendance and/or higher family incomes.
- Reduces maximum allowable student loan default rates for institutions participating in the CalGrant program from 24.6 percent to 15 percent and restricts participation to institutions with graduation rates[7] of 30 percent or more, for General Fund savings of $38.4 million.[8] (This makes up for most of the $50 million reduction in the estimate of savings from the January proposals, referenced above.)

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[5] From 3.0 to 3.25 for CalGrant A, from 2.0 to 2.75 for CalGrant B, and from 2.4 to 2.75 for Community College Transfer CalGrants.

[6] The LAO cited an estimate that fewer than 20 percent of CSU students who earned high school GPAs of 2.0 or lower ever graduate from college.

[7] As measured by the graduation rate after 150 percent of the number of years normally spent for the degree, e.g., six years for four-year programs and three years for two-year programs.

[8] CSU's systemwide six-year graduation rate is 55 percent, and UC's is 83 percent.

Health & Human Services

HEALTH

The May Revision proposes a total of $1.5 billion in General Fund solutions related to various health programs, mostly through the Medi-Cal Program. However, because the proposals include fund shifts and a significant cash deferral, actual programmatic reductions are far less. In fact, total spending for departments like Health Care Services and the Department of Developmental Services is projected to reach an all-time high in 2012-13, due to higher spending from federal and other funding sources.

Overall, the May Revision largely fails to redirect existing state resources from Proposition 63, Proposition 10, and Proposition 99 to help meet the state's ongoing funding challenges. As noted in the Republicans' budget alternative, these resources have been used in the current or past years for significant temporary General Fund savings without voter approval. Additionally, the November elections provide an opportunity to seek permanent flexibility from these restrictive propositions, rather than asking taxpayers for an even greater contribution.

Department of Health Care Services (DHCS) – Medi-Cal

Overview. The Governor's May Revision provides $14.4 billion General Fund ($59.7 billion total funds) for Medi-Cal in 2012-13, which represents a net decrease of $395 million General Fund from the January proposal. This net decrease primarily reflects new savings proposals related to hospital and nursing home payments. Also, the proposed level of funding would be $1.1 billion General Fund below the revised estimate for the current year of $15.5 billion, a reduction of 6.8 percent. However, **spending in total funds would increase from the current year to the budget year by $12.8 billion, for an increase of over 27 percent.** The most significant changes and new proposals are discussed in more detail below.

Current Year Savings Erosions and Deficiency. Savings actions enacted by the 2011 Budget Act were originally estimated to reduce General Fund spending by $2.2 billion in Medi-Cal in 2011-12. However, due to a mixture of federal, court, and state administrative decisions, a significant portion of these savings never materialized, including:

- $511 million from Medi-Cal copayments that the federal government did not approve. Savings of only $20 million is now assumed from a drastically scaled-down proposal.
- $347 million in Medi-Cal provider rate reductions that courts enjoined following lawsuits brought by various provider groups.
- $52 million due to an Administration decision to delay transition of the Medi-Cal Adult Day Health Care (ADHC) Program to the new Community-Based Adult Services Program. Advocates also sued to prevent the ADHC elimination, and the Administration settled before a motion regarding the elimination was heard.

These savings erosions have contributed to a $760 million deficiency for DHCS in 2011-12. Existing law allows the Controller to loan funds to Medi-Cal to address deficiencies. The Administration indicates that it will use this loan authority to meet Medi-Cal obligations in May and June of this year, and then seek a supplemental appropriation bill to repay the loan.

New Savings Proposals. The May Revision maintains or revises the major savings proposals presented in January, but adds another $436 million in General Fund savings proposals, largely consisting of fund shifts and rate adjustments for hospitals and nursing homes. Specifically, these proposals include the following:

- *Supplemental Payment Reductions.* $150 million savings by taking hospital fee revenues currently intended to make supplemental payments to private hospitals. An additional $95 million in savings would result in 2013-14 by redirecting funds intended for both private and public hospitals. The legislation authorizing the current fee program, which allows hospitals to draw down substantial federal subsidies, agreed to provide these supplemental payments to hospitals. The state already expects to realize $920 million in General Fund savings from the current fee program through December 31, 2013.
- *Reductions to Large Public Hospitals.* $100 million in savings by requiring major public hospitals to share certain federal waiver funds with the state, rather than retaining the entire amount for themselves. This proposal also requires that these hospitals work with the state to help achieve $400 million in state savings that are already included in the baseline budget but that may not be achieved. Absent this proposal, the $100 million for public hospitals would be an unexpected bonus compared to the original terms of the waiver, and as such, this proposal warrants consideration.
- *Reimbursement Change for Small Public Hospitals.* $75 million in savings by shifting smaller public hospitals (such as district hospitals) to a new reimbursement methodology in which local public authorities would certify their expenditures in order to receive federal matching funds. The proposal would also seek an increase in supplemental federal funds of $60 million to help offset losses for the small public hospitals. The DHCS estimates that the net effect on this group would be a reduction of $28 million in 2012-13 and an increase of $12 million in 2013-14.

  This proposed "certified public expenditure" (CPE) method has been used by major public hospitals, such as the University of California system, since 2005. However, there is no assurance at this time that the federal government would approve more supplemental funding, and even if they do, other Administration proposals to reduce supplemental payments elsewhere demonstrate that district hospitals may be unwise to rely on those funds. In addition, shifting over to CPE reimbursement effectively provides hospitals a payment rate equal to about 50 percent of their costs. It is not clear how many affected hospitals are currently above or below that rate, so this proposal could be either an increase or decrease for individual hospitals. In addition, this proposal would drastically change the reimbursement method for small and often rural hospitals with very little advance notice or time for those hospitals to evaluate the effects.
- *Nursing Home Rates.* $79 million in savings by reducing or freezing rates for these facilities in 2012-13 and redirecting other supplemental payments. These nursing homes operate under the AB 1629 fee waiver program, which has continued under a series of sunset extensions. (The January budget proposed a permanent extension of the program.) The General Fund already realizes substantial savings from this fee program. The nursing homes have expressed concerns that a portion of these savings is actually a rate cut, not merely a delay in supplemental payments.
- *Use of First 5 Funds.* $40 million in savings by seeking a shift of First 5 Commission (Proposition 10) funds to Medi-Cal children's services. This is an appropriate reprioritization of these funds, given the state's fiscal crisis and questionable past uses of First 5 funds by the state and county commissions. However, as Republicans noted in their alternative budget proposal, First 5 previously provided as much as $131 million in recent years for General Fund savings. This proposal still falls short of that mark and should be expanded, although it moves in the right direction. An even more advisable approach would be for the Legislature to submit the redirection of First 5 funds to the voters for approval, including some ongoing First 5 revenue, as Governor Brown originally proposed in January 2011.

"Coordinated Care" Cash Deferral Gimmick. The May Revision updates the January Coordinated Care proposal to deliver long-term care and social support services through Medi-Cal managed care plans for "dual eligible" enrollees. Unfortunately, **the revised proposal is far less likely to achieve real savings, as it would maintain significant flaws in current programs and shift collective bargaining for In-Home Supportive Services (IHSS) to the state.** However, the May Revision continues to propose a Medi-Cal cash payment delay to shift $711 million in spending from 2012-13 to the following year. In the absence of a convincing proposal to achieve real savings, this payment deferral is a mere gimmick of the sort that Governor Brown has derided on various occasions. Also, shifting IHSS collective bargaining to the state will likely result in massive cost increases as it creates a salary “race to the top” fueled by legislative Democrats’ giveaways to public employee unions.

Federal Health Reform Costs. One feature of federal health reform is a mandated increase in Medicaid primary care payment rates to Medicare levels, beginning January 1, 2013. Although health reform proponents claimed that the federal government would fully fund this mandate, the May Revision indicates that various conditions in the law will result in General Fund costs of $77 million in 2012-13 to fulfill this requirement. The federal government will pay an additional $296 million to increase the rates. The state cost results from the provision that the extra federal funds will be available only to increase rates from the June 2010 level, which means the state must retract the provider payment reductions that it otherwise planned to implement for primary care services.

Department of Public Health (DPH)

Overview. The Governor’s May Revision proposes $121 million General Fund ($3.0 billion total funds) for DPH in 2012-13, a decrease of $12 million General Fund or nine percent from the revised 2011-12 spending level. This decrease is largely the result of savings proposals to increase enrollee cost-sharing in the AIDS Drug Assistance Program and to eliminate a public health laboratory training program. Details of these items follow below.

AIDS Drug Assistance Program (ADAP). The May Revision provides $6 million General Fund ($438 million total funds) for ADAP, an increase of $1.4 million General Fund compared with the revised 2011-12 spending level. This spending level continues to reflect a revised January proposal to achieve savings of $11 million General Fund by requiring a share-of-cost for clients with incomes down to the federal poverty level (about $11,000 for one adult), although Senate Democrats already rejected the January proposal in subcommittee. (Assembly Democrats held the item open.) Legislative Democrats also rejected a similar Governor’s proposal for the 2011-12 budget.

Despite legislative Democrats’ unwillingness to support the Governor, this proposal once again makes sense. Cost-sharing in ADAP is now limited to individuals with incomes between 400 percent of FPL (about $43,300) and $50,000 per year, which is the income ceiling for the program. In contrast, 31 other states maintain ADAP eligibility ceilings of 337 percent FPL or less, meaning the program is not available at all to individuals with incomes above that level, let alone being available for free or with limited cost-sharing. In California, programs for other significant life-threatening health conditions, such as breast cancer or prostate cancer, only provide eligibility up to 200 percent of the federal poverty level. The Healthy Families Program, where eligibility also extends down to the federal poverty level, also charges premiums and copayments to all participants.

Laboratory Training Program Elimination. The May Revision proposes savings of $2.2 million General Fund by eliminating the Public Health Laboratory Training Program, which provides grants to subsidize training and education. The Administration reports that 15 individuals currently participate in the program.

Managed Risk Medical Insurance Board (MRMIB)

Healthy Families Program (HFP). The Governor’s revised budget includes $158 million General Fund ($488 million total funds) for HFP in 2012-13, which reflects a decrease of $128 million General Fund (45 percent) from the revised 2011-12 amount. This decrease reflects the proposed shift of HFP enrollees to Medi-Cal and the HFP rate reduction, as discussed further below.

Healthy Families Rate Reduction and Elimination. The Governor's May Revision maintains the January proposal to reduce HFP managed care rates to Medi-Cal levels, transition all HFP kids to Medi-Cal over nine months, and eliminate HFP by July 1, 2013. Savings from the rate reduction is now reduced to $49 million General Fund from $64 million in January, due to an upward adjustment of what costs are expected to be in Medi-Cal.

While Republicans generally support streamlining government operations, MRMIB has generally shown itself to be an efficient operation that uses a small number of state staff and operates a significant portion of its programs through contracts with private vendors such as managed care plans. The program also provides better access to care, particularly specialty care, and maintains a better balance of responsibility by requiring premiums and copayments from enrollee families. In addition, questions remain regarding the overall savings to be achieved by combining the programs.

Managed Care Tax Extension. The May Revision assumes $188 million in savings (primarily in the Medi-Cal budget) by permanently extending the Gross Premiums Tax, but continues to propose eliminating HFP, which the tax is intended to support. **Any Republican support for extending the tax should be conditioned on maintaining HFP for currently eligible children for now, and eventually shifting qualified children to private plans within the Health Benefits Exchange** (instead of to Medi-Cal, as the Governor proposes).

Department of Developmental Services (DDS)

Overview. The Governor's May Revision provides $2.6 billion General Fund ($4.7 billion total funds) for DDS in 2012-13, which represents a slight decrease of $27 million (1.0 percent) compared with the Governor's January budget package. The revised General Fund proposal is also $96 million more than the updated estimate for 2011-12, an increase of 3.7 percent, despite savings proposals totaling $240 million for the budget year. This would set DDS General Fund spending at its highest level ever. The bulk of the proposed savings results from fund shifts or a transition of services to the private sector, rather than from actual service reductions. The significant adjustments and new policies are discussed below.

Earlier Reduction Target Detailed. The January budget package included unspecified savings of $200 million General Fund for DDS, with the intent to develop detailed savings proposals in cooperation with stakeholders. The May Revision now specifies how DDS will achieve that savings amount. Individual proposals of particular note include:

- *Autism Insurance Mandate*—$80 million in General Fund savings are expected to result from a shift of DDS autism treatment costs to private insurance following the implementation of SB 946 (Steinberg, 2011). That bill, which takes effect July 1, 2012, mandates that private health care plans provide behavioral health treatment for pervasive developmental disorder or autism. The department anticipates that 5,500 individuals will begin receiving treatment through their private coverage rather than from a regional center.
- *Increased Federal Funds*—Savings of $61 million by shifting current General Fund costs to federal funds based on the renewed Home and Community-Based Services waiver. This proposal assumes that regional centers will be able to qualify up to 500 consumers a month for the waiver funding. According to DDS, this pace of assumed growth is substantially less than the numbers added in some recent months, which have topped 1,000 at times.
- *Partial Continuation of Rate Reduction*—$31 million in General Fund savings by continuing to reduce payment rates to service providers and regional centers by 1.25 percent. The current reduction of 4.25 percent, which has been in place since July 1, 2010, will sunset June 30, 2012. By retaining only a 1.25 percent reduction, reimbursement will actually increase by $77 million General Fund overall.

- *Redesign Services for Challenging Consumers*—$20 million in General Fund savings, split evenly among regional centers and developmental centers, by implementing a series of significant policy changes designed to limit admission to developmental centers (DCs). These changes include:
  - A moratorium on new admissions to DCs, with limited exemptions for certain criminal cases or individuals in acute crisis who need short-term services.
  - Restrictions on certain other criminal commitments where the safety of other DC residents would be at risk.
  - A requirement that regional centers comprehensively assess all residents who have lived in a DC for over a year, in order to determine whether they can be placed in the community.
  - Expanding the use of specialty care homes in the community (so-called SB 962 homes) on a statewide basis. Legislative Democrats in both houses independently approved a similar policy with respect to SB 962 homes during budget hearings earlier this year.
- *Supported Living Assessments*—$4 million in General Fund savings by eliminating the current requirement for an independent supported living services assessment. This policy would instead incorporate that assessment into the consumer's individual program plan.

Use of First 5 Funds. The May Revision proposes $40 million in savings by seeking a shift of First 5 Commission (Proposition 10) funds to the Early Start Program. Early Start seeks to identify developmental delays in infants and toddlers, and provides a range of interventions to address those conditions. This budget proposal is an appropriate reprioritization of First 5 funds, given the state's fiscal crisis. The state First 5 Commission has provided $50 million to DDS in each of the past three years (including the current year) following pressure from the Legislature and Governor to do so. The May Revision also includes a $40 million First 5 shift in Medi-Cal, as discussed above, for a combined total of $80 million in General Fund savings from fund shifts.

Developmental Centers. The May Revision includes $286 million General Fund ($550 million total funds) for DCs, a decrease of $18 million General Fund from the revised 2011-12 DC budget. With a projected average resident census of 1,544, this equates to a cost of $356,000 (total funds) per resident, an increase of 10 percent of the current year average of $324,000. The resident census represents a reduction of 215 residents, or 12 percent, compared to the updated 2011-12 census. This reduction would result from continuing the closure process at Lanterman Developmental Center, where a decline of 87 residents is projected, and from the proposed restrictions on DC admissions noted above.

The increase in average cost per resident indicates the difficulty in achieving savings for DCs. As the resident census declines, facility costs are spread among a smaller population. It would be prudent to consolidate DCs where possible, while maintaining appropriate consumer protections, in order to avoid consolidating these facility costs even further. For example, more residents could potentially be shifted from Lanterman DC in Pomona to Fairview DC in Costa Mesa, which is a 45-minute drive away, in order to close Lanterman more expeditiously.

Trigger Reduction to Developmental Services. The Governor's revised Trigger Reduction package of $6.1 billion (*discussed further on page 49 of this report*) includes a $50 million unspecified reduction to DDS. No other health programs are proposed for a trigger reduction. In addition, under a trigger proposal for Education, spending of $238 million for the DDS Early Start Program would be counted toward the Proposition 98 funding obligation, but no operational changes to Early Start would occur.

<u>Department of Mental Health/ Department of State Hospitals (DSH)</u>

The May Revision proposes $1.3 billion General Fund ($1.4 billion total funds) for DSH, which is a $17 million increase (1.2 percent) over the revised current year level. Mismanagement of state mental hospitals by DSH (formerly the Department of Mental Health) and related ongoing court cases have created another deficiency for the department (for the third year in a row). The May Revision adjusts the deficiency down from $63 million in January to $42 million now, largely as a result of a decrease in the estimated hospital population. As noted in January, the deficiency originally totaled $180 million, but the Administration, to its credit, implemented various savings actions that helped reduce the net deficiency to the current level. The Administration intends to seek a supplemental appropriation for the remaining deficit.

HUMAN SERVICES

The Governor's May Revision continues to propose significant reductions within the state's human services programs for 2012-13; however, the CalWORKs Refocus proposal included in January has been weakened slightly and would now result in less savings. Program reductions would total $985.1 million General Fund in 2012-13, although certain In-Home Supportive Services (IHSS) proposals discussed below may face legal challenges, which means the savings will not be achieved.

CalWORKs

The May Revision changes the Governor's January CalWORKs proposal in the following way:

- Instead of strict federal conformity, the revised proposal would continue to allow work participation to be met with mental health and substance abuse services, adult basic education, and domestic abuse services (which the federal government does not recognize as legitimate core work activities) for the first 24 months in the program. After 24 months, recipients could stay in the Basic program if meeting work participation requirements through federally allowable activities only (such as subsidized employment and vocational educational training). For the Plus program, recipients must meet work requirements through unsubsidized employment only (consistent with the Governor's January proposal).

- Relative to January, the revised proposal would effectively allow more time on aid through exemptions as it eliminates the retroactive counting of previously exempt and sanctioned months towards the adult recipient's 48-month time limit.

- Adults with two children under the age of six or an adult with one child under the age of two would not be required to participate in their welfare to work activities for an additional 90 days (instead of required participation July 1, 2012 as proposed in January). Beginning in October 2012, a one-year reengagement phase-in process will begin for those who had been granted this temporary exemption.

Thus far Legislative Democrats have failed to approve the Governor's necessary welfare to work reforms.

Child Care

The May Revision continues to propose significant cuts and changes to the administration of subsidized child care programs as contained in his January plan. Proposed reductions to non-Proposition 98-funded child care programs would total $452.5 million in General Fund savings, including CalWORKs Stage 1 programs, resulting in the reduction of 29,600 child care slots.

Reduce Reimbursement Rate Ceiling. Currently, reimbursement rate ceilings for licensed providers in voucher-based child care programs are set at the 85th percentile of the 2005 regional market rate

(RMR) survey, and rate ceilings for license-exempt providers in those programs are set at 60 percent of the licensed-rate. The January budget had proposed $17.1 million General Fund savings by reducing the rate ceilings for licensed providers voucher-based programs to the 50th percentile of the 2009 RMR survey. The May Revision proposes instead to reduce the rate ceilings for licensed providers to the 40th percentile of the 2005 RMR survey and sets license-exempt provider rate ceilings at 71 percent of the licensed rate ceilings, resulting in savings of $184.2 million General Fund in 2012-13.

Subsidized Child Care Eligibility Change. The January Budget had proposed to provide subsidized child care (i.e., general child care outside of CalWORKs) only to those individuals who meet CalWORKs work participation requirements through unsubsidized employment only, whether or not the family ever participated in CalWORKs. The May Revision restores eligibility to non-CalWORKs families who may not be meeting work requirements but are participating in education or training programs, and would limit the amount of time eligible to receive child care to two years, resulting in an erosion of savings from $294 million General Fund included in January to $113.9 million General Fund (increasing costs by $180.1 million General Fund) in 2012-13.

Administrative Restructuring of Child Care. The May Revision continues to propose that county human services departments will assume administration of non-Proposition 98 child care programs beginning in 2013-14 and includes the following changes:

- Establishes a County Child Care Block Grant, separate from the “single allocation” grant provided to counties for administration of the CalWORKs program.

- Requires county human services departments to contract with child care centers that meet certain state requirements (commonly known as Title 5 Centers) as a condition of receiving the County Child Care Block Grant. It provides counties immediate flexibility for 10 percent of the funded child care slots and after three years, would allow counties to reallocate all funds based on local needs. Also, it would require the Title 5 contractors to maintain their designation through annual assessments by the California Department of Education (CDE).

- Moves administration of Quality Improvement funding to the Department of Social Services (DSS), and requires DSS to consult with CDE on the activities to be funded. Quality Improvement funds could be used for various activities such as professional development, stipends for child care providers that pursue additional education, and activities related to health and safety.

- Includes a funding shift from CDE operations to DSS State Operations to transition the child care administrative activities, and includes $26.5 million in funds to county human services departments to build administrative capacity in 2012-13.

<u>In-Home Supportive Services</u>

The May Revision projects the average monthly caseload in IHSS will be 452,438 recipients in 2012-13, an increase 2.7 percent above revised 2011-12 projections. In 2011-12, the average monthly caseload is projected to be 440,223, an increase of 1.7 percent from the prior year. The Governor continues his proposal to eliminate domestic and related services for those recipients living in a shared living environment, and includes a proposal to reduce hours across the board. Both proposals run the risk of litigation, which will jeopardize savings in the budget year. The proposed reductions are as follows:

- Reduces hours across-the-board for IHSS recipients by 7 percent, effective August 1, 2012, for savings of $99.2 million General Fund. An across-the board reduction of 3.6 percent went into effect in February of 2010 and is set to expire on July 1, 2012.

- Continues the proposal to eliminate domestic and related services, as proposed in the January budget, for IHSS consumers residing in a shared living arrangement, revising the savings estimate from $206.2 million to $125.3 million General Fund in 2012-13. This proposal was already rejected by the Assembly Democrats during the Subcommittee process. It is unclear what reductions will be adopted by the Legislative Democrats to make up for this General Fund cost.

Budget Savings Not Achieved. The May Revision includes $101.9 million General Fund in 2011-12 and $212.8 million General Fund in 2012-13 as a result of overstated savings assumptions included in the 2011 Budget. The proposal to require that recipients receive certification by a licensed health care professional prior to enrolling in or remaining on the program did not achieve the level of savings assumed in the budget (an erosion of $44.6 million in 2011-12 and $117.2 million in 2012-13). Additionally, the May Revision no longer assumes implementation of the IHSS provider tax. The Administration indicates that the federal government has not officially made a decision, and believes it is no longer prudent to continue to assume savings. This will result in a General Fund cost of $57.3 million in 2011-12 and $95.4 million in 2012-13.

Risky Federal Funds Projected. The May Revision continues to assume a December 1, 2011 implementation of the Community First Choice Option for the IHSS program pending federal approval, and includes $113.6 million General Fund savings in 2011-12, and $175 million General Fund savings in 2012-13 as a result of the increased federal financial participation rate. It seems unlikely these savings will materialize as the federal government has not given the state any time frame for approving or disapproving the state's proposal, and as such, including savings in the budget will likely lead to a General Fund deficiency in 2012-13.

Integration of IHSS into Medi-Cal Managed Care. The Administration continues its proposed Coordinated Care Initiative (CCI) with several modifications from the January Budget. The May Revision modifies the proposal as follows:

- Reduces the proposed expansion from ten counties to eight counties.

- Delays implementation of the pilot, from January 1, 2013 to March 1, 2013.

- Proposes a maintenance of effort for county expenditures in the IHSS program, at the level estimated if CCI was not implemented.

- Shifts IHSS collective bargaining responsibilities to the State. This change in the proposal is the most troubling. **Creating a statewide collective bargaining process for IHSS providers will increase the cost of providing services because it will create a race to the top of the current county pay scales and Legislative Democrats have shown a willingness to augment union pay.** While Medi-Cal managed care plans would be providing services via a capitated rate per recipient, escalating provider wages will soon lead to inequity between the rate paid and the cost of providing services, likely **a cost shift to manage care plans for higher IHSS salaries**.

Child Welfare Services-Realignment

The May Revision includes trailer bill language related to the Governor's Public Safety Realignment that dedicates a permanent funding source for programs realigned to the counties in 2011 (including child welfare services and foster care). The May Revision also proposes to increase what is considered the "base" funding by $53.9 million for foster care and child welfare programs (on top of the $200 million "promised" for child welfare services base restoration) in 2012-13, 2013-14, and 2014-15. The increase reflects the Administration's intent to fully fund implementation of AB 12 (Beall), Chapter 559, Statutes of 2010, which expanded foster care benefits eligibility up to age 21, and which Republicans generally supported. Natural growth in the base funding for foster care, child welfare services, and adult protective services increased $5.5 million in 2012-13.

Department of Child Support Services

The May Revision proposes to reduce funding for Local Child Support Agencies by $14.7 million ($5 million General Fund) in 2012-13 and continues the Governor's January proposal to suspend the county share of collections, resulting in savings of $31.9 million General Fund in 2012-13.

Public Safety & Judiciary

Department of Corrections and Rehabilitation

The May Revision increases General Fund spending for the Department of Corrections and Rehabilitation (CDCR) to $8.8 billion compared to the Governor's Budget spending level of $8.7 billion. The increase is related to a $128.4 million augmentation to the Receiver's budget (*see 'Restoration of Funding for the Receiver' on page 33*), offset by various spending reductions.

Population Changes. Institutional and parole average daily populations (ADP) are projected to decrease significantly for both adult and juvenile populations, primarily due to the impact of realignment. However, 2012-13 adult parole ADP increases significantly relative to Governor's Budget projections. This is due to a number of factors, including a technical change in the way CDCR counts certain offenders who complete parole revocation terms and are released to county supervision, and a one-month delay in implementing postrelease community supervision for offenders completion revocation terms. Also, the rate of parole revocation has not decreased due to realignment as expected, which results in a longer average length-of-stay on parole than was projected in January.

Projected institutional and parole populations are as follows:

- *Adult Institutions.* Institutional ADP is projected to decrease from 163,152 to 148,669 2011-12 (decrease of 14,483 inmates) and to decrease from 132,167 to 129,961 in 2012-13 (decrease of 2,206 inmates) compared to the Administration's January estimate.
- *Adult Parole.* Parole ADP is projected to decrease from 108,338 to 103,034 in 2011-12 (decrease of 5,304 parolees) and to increase from 56,440 to 65,694 in 2012-13 (increase of 9,254 parolees) compared to January projections.
- *Juvenile Institutions.* ADP is projected to decrease from 1,174 to 1,090 in 2011-12 (decrease of 84 wards) and to decrease from 1,149 to 992 in 2012-13 (decrease of 157 wards) compared to January projections.
- *Juvenile Parole.* ADP is projected to decrease from 850 to 700 in 2011-12 (decrease of 150 parolees) and to decrease from 656 to 450 in 2012-13 (decrease of 206 parolees) compared to the Administration's January projections.

Corrections Blueprint. Three weeks prior to the May Revision, the Administration released a blueprint-like document entitled *"The Future of California Corrections."* The document lays out the Governor's plan to reform CDCR to "save billions of dollars, end federal court oversight and improve the prison system." The blueprint is intended to be the framework under which CDCR achieves the $1.2 billion in 2011 Realignment General Fund savings for 2012-13 assumed in the Governor's Budget. The May Revision includes the following proposals embodied in the blueprint document:

- *Revision of the Inmate Classification System.* This proposal would make arbitrary adjustments to the point system used for inmate security classification. It would increase the number of points required for an inmate to be classified as Level II or Level III in an effort to align the security characteristics of the population with the available number of beds in each security level. The proposal begs the question whether there is any point at all to having a security classification system, if we can simply move the cutoff points with no impact on the safety of the public or the correctional officers and staff at the institutions. Rather than letting the proven classification system determine the security risk of the inmate and thus, where he or she should be housed, this proposal suggests that the type of housing available should determine the security risk of the inmate.

- *Return Out-of-State Inmates.* California currently houses approximately 9,500 inmates in out-of-state facilities operated by private correctional companies. The use of these private facilities has been a cost-effective way to relieve prison overcrowding without having to build costly new prisons. In the face of the federal court's recent population reduction order, which requires California to bring the population of inmates housed within the state's 33 institutions to within 137.5 percent of design capacity by June 2013, the Governor proposes to bring 9,500 more inmates into those institutions. Bringing these inmates back into California would burn bridges with private corrections contractors. Furthermore, because they are not housed in facilities operated by CDCR, these inmates are not currently counted as part of the population included in the reduction order. **The Governor's plan would subject them to the reduction order, creating pressure to release inmates early, relax sentencing laws, etc.** Adding to this pressure, the facilities plan contained in the blueprint would actually result in a net reduction of about 2,000 beds.

- *Expanded Rehabilitative Programming.* The proposal includes system-wide enhancements to academic and career technical education programs and substance abuse treatment, and introduces cognitive behavioral therapies to address criminogenic needs, including anger management, family relationships, and criminal thinking. Reentry hubs would be established to concentrate programmatic resources on offenders who are about to return to their communities. These types of activities have proven effective in other states at reducing recidivism and the cost of corrections. However, early efforts in California have resulted in high costs and abject failure. The success of the blueprint will hinge on CDCR's ability to change its internal culture, to correctly identify criminogenic needs, and deploy effective programming. History suggests this will be a monumental challenge.

- *Standardized Staffing Levels.* Part of the blueprint involves getting rid of the outmoded staffing ratios that have historically been used to provide resources for the Department. CDCR is undergoing a system-wide review of custodial staffing levels. The blueprint would essentially zero-base staffing levels for each institution and standardize future staffing requirements based on the type of facility to be activated.

- *Compliance with Court-Imposed Health Care Requirements.* The blueprint proposes several steps intended to free the state from federal court oversight of its prison dental, mental health, and medical programs. These steps include things like providing resources necessary to provide mental health treatment in a timely manner, improving facilities to provide adequate treatment space, implementing a medical classification system designed to ensure that inmates are housed in facilities appropriate to their individual health care needs, and modifying various systems to account for the reduced population, post-realignment. Also included is a proposal to use existing AB 900 lease-revenue bond (LRB) authority to move forward with a previously-approved project to convert the DeWitt Nelson Youth Correctional Facility in Stockton to a 1,133-bed adult facility and annex it to the new California Health Care Facility to provide health care services to prison inmates. Finally, the blueprint includes a proposal to provide $810 million in new LRB authority to build up to three 800-bed dormitory-style facilities (up to 2,400 total beds) on existing prison campuses to support the delivery of prison medical services.

- *Compliance with Court-Ordered Population Reduction.* Part of the Administration's plan to get out from under federal court oversight is to petition the court to relax the requirements of its population reduction order, allowing the state to operate its prison system at 145 percent of design capacity, instead of 137.5 percent. The plaintiffs in the *Plata* case have already filed a motion requesting the court to order CDCR to submit a revised population reduction plan that meets the original requirement of 137.5 percent by June 2013. When viewed in the context of the above proposal to bring the 9,500 out-of-state inmates back to California prisons, it appears the Governor could be setting the stage for Realignment 2.0, where the federal courts are once again ordering the state to reduce its prison population and the Governor is "forced" to comply. If this were the case, it would give the Governor and legislative Democrats political cover to implement additional policy changes that further erode public safety.

Consolidation of Juvenile and Adult Parole. The May Revision includes a technical adjustment to reflect the consolidation of the Division of Juvenile Parole Operations (DJPO) within the Division of Adult Parole Operations. The consolidation has allowed CDCR to achieve administrative efficiencies, including closing DJPO facilities and avoiding duplication of support and administrative services. The consolidation is consistent with the 2010 shift of offenders released from the Division of Juvenile Justice (DJJ) to the jurisdiction of local probation departments instead of state parole, pursuant to Ch. 729, Stats. 2010 (AB 1628). As the population of juvenile offenders still on state parole dwindled, it became increasingly expensive to maintain separate operations for juvenile parole. Effective October 2011, CDCR consolidated the two divisions.

Cost-Saving Measures In Lieu of DJJ Realignment. The May Revision reverses the Governor's Budget proposal to realign all juvenile offenders to the counties. Instead, the Governor proposes four measures to generate $4.8 million in General Fund savings within DJJ. These proposals include a reduction in DJJ administrative staffing, an acceleration of the termination of state juvenile parole operations, a reduction in DJJ's age of jurisdiction from 25 to 23 for all new commitments, and implementation of a $24,000 per ward fee charged to the county for each ward housed in a DJJ facility.

The population of juvenile offenders that still remains with the state represents the "worst of the worst," as all of the lower-level offenders have already been realigned to the counties. Counties have repeatedly asserted that they lack the resources, expertise, and facilities to deal with these offenders. As such, the May Revision represents an improvement over the previous proposal. **However, two of the Governor's alternative cost-saving options present new problems.** Reducing the DJJ's age of jurisdiction from 25 to 23 will shorten the time that some wards have to complete educational and rehabilitative programming. In fact, DJJ staff have testified in the past that they frequently lack adequate time with their wards to provide effective programming, even with the 25-year age of jurisdiction. This measure, coupled with the plan to terminate state parole supervision of all juvenile offenders 18 months earlier than originally contemplated by AB 1628, would jeopardize public safety by returning many juvenile offenders to their communities before they are rehabilitated.

Sale of Southern Youth Correctional Facility. The May Revision includes trailer bill language that would declare the Southern Youth Correctional Reception Center and Clinic surplus property and authorize the Department of General Services to sell the property to the County of Los Angeles at fair market value. The trailer bill language would allow the sale to occur sooner than it could following the normal state surplus property process. Given the shrinking DJJ population, the fact that the facility was scheduled to be closed in January 2012, and the dire fiscal situation facing the state, the proposed sale makes sense.

Partial Restoration of Funding for the Receiver. The Budget Act of 2010 included an unallocated reduction of $820 million General Fund to the Receiver's baseline budget. The Budget Act of 2011 restored $726 million of that funding, but reduced the Receiver's other budget proposals by a total of $163 million. The May Revision includes a proposal to provide $295.4 million General Fund in 2011-12 and $124.5 million General Fund in 2012-13 to align the Receiver's budget with projected expenditures. The May Revision proposal would restore about half of the remainder of the funding reductions from the past two years.

Implementing the Receiver's Facility Plan. The May Revision includes two proposals, totaling $3.9 million General Fund, to provide staffing for the DeWitt facility ($1.6 million, 11.7 positions) and the Folsom Women's Facility ($2.3 million, 18.9 positions). Activation of both of these facilities is integral to both CDCR's blueprint plan and the Receiver's facility plan.

Undoing AB 900. Included in the May Revision is a proposal to extinguish roughly $4.1 billion of lease-revenue bond (LRB) authority, authorized by the Public Safety and Offender Rehabilitation Services Act of 2007 (AB 900) to fund projects to expand prison capacity through the construction of up to 40,000 new beds. Despite bipartisan support for AB 900, it seems legislative Democrats never intended to allow any significant number of new beds to be built. Initially, the Attorney General's office refused to issue its customary "clean bond opinion," which is needed for the state to sell a bond issue. After several years of machinations, the clean bond opinion was finally issued, at which point legislative Democrats took over via the Joint Legislative Budget Committee (JLBC). The JLBC rejected or delayed project after project, effectively killing projects that would have provided nearly 8,000 additional prison beds. **The Governor's May Revision proposal would essentially put the final nail in the coffin of prison capacity expansion under AB 900.**

<u>Board of State and Community Corrections</u>

Chapter 36, Statutes of 2011 (SB 92) created the Board of State and Community Corrections (BSCC) as an independent government entity, eliminated the Corrections Standards Authority (CSA) from CDCR, and shifted the CSA's duties to the newly created BSCC. The functions of the Office of Gang and Youth Violence Policy, which was formerly part of the California Emergency Management Agency (Cal EMA) and the California Council on Criminal Justice (formerly an independent council funded by grants passed through Cal EMA) were also consolidated within the BSCC. The Governor's Budget proposed total BSCC funding of $16.9 million General Fund and $92.2 million in other, mostly federal funds, the majority of which was shifted from CDCR and Cal EMA.

City Police Grants. The May Revision includes a $20 million General Fund augmentation for the BSCC for a grant program for city police departments. The program would help to mitigate the negative impacts of realignment. So much for realignment saving money.

Local Jail Construction Funding. The May Revision proposes $500 million in new LRB authority for the acquisition, design, and construction of local facilities to help counties manage their offender populations. As the Governor and legislative Democrats were ramming realignment down the throats of Californians, Senate Republicans were warning that local jails would be inadequate to handle the population explosion and longer-term jail sentences that realignment would bring. Fast-forward one year, and the Governor is asking for half a billion dollars more of debt to help local sheriffs deal with the mess created. So much for paying down the wall of debt. So much for realignment saving money. Given the current reality of a post-realignment world, this funding is probably necessary. It is unfortunate, however, that the proponents of realignment were unable to foresee the strain it would put on local jails, despite having been warned repeatedly. Realignment has not actually solved anything. It has merely shifted the problem of prison overcrowding to local jails.

Realignment Support Funding. The Governor's May Revision includes a proposal to provide $750,000 General Fund for the BSCC to provide assistance to local governments with the implementation of realignment. This is on top of the $8.9 million General Fund included in the Governor's Budget for the same purpose. So much for realignment saving money.

<u>California Emergency Management Agency</u>

Withdrawal of Proposal to Relocate California Specialized Training Institute. Cal EMA's California Specialized Training Institute (CSTI) campus in San Luis Obispo provides specialized training to federal, state, and local officials, as well as to the private sector. CSTI courses include emergency management, criminal justice, and hazardous materials instruction. Most of the training is subsidized by the federal government. The Governor's Budget included a proposal to close the campus in San Luis Obispo, shift program administration to Cal EMA headquarters in Mather, and provide training opportunities nearer to major population centers (i.e., Los Angeles and San Francisco) via Joint Powers

Authority (JPA) agreements. The Administration assumed the plan would save $187,000 General Fund in 2012-13 and $377,000 annually thereafter. Questions were raised concerning the state's share of future JPA costs, cleanup costs related to hazardous materials at the existing site, costs to dispose of bulky training materials that included old rail cars, and the economic impact on the local community of closing the facility. The May Revision reverses the Governor's Budget proposal to relocate the CSTI.

Temporary Support for Victim Identification and Notification Everyday Network. The Victim Identification and Notification Everyday (VINE) Network provides a toll-free telephone hotline and a website through which victims of crime and other concerned citizens can check the custody status of offenders. To date, the VINE program has been funded through an American Recovery and Reinvestment Act (ARRA) Justice Assistance Grant (JAG) award received by the California State Sheriffs Association from Cal EMA's ARRA JAG funds. The ARRA JAG was one-time federal funding, and the program has ended. The May Revision proposes $1.8 million Victim-Witness Assistance Fund in both 2012-13 and 2013-14 to continue funding the VINE program for two more years, giving the CSSA, Cal EMA, and CDCR time to identify a permanent funding source.

Department of Justice

False Claims Act Fund Transfer to the General Fund. On May 7, 2012, the Attorney General announced a settlement in a multi-state lawsuit against Abbott Laboratories. California joined other states and the federal government in seeking damages related to false claims made by Abbott Laboratories to Medicaid and other federal healthcare programs. California's share of the damages and penalties is $52 million, which will be divided among various stakeholders, including the U.S. Department of Health Care Services, the California Department of Health Care Services, and the California False Claims Act Trust. The May Revision includes a transfer of $7.7 million in settlement proceeds from the False Claims Act Fund to the General Fund.

Increased Penalty Assessment for Crime Laboratory Operations. The May Revision proposes to eliminate $10 million in General Fund support for the operation of the Department of Justice's (DOJ) forensic laboratories. The proposal would backfill that funding with DNA Identification Fund (DNA ID Fund) moneys and would increase an existing penalty assessment on criminal convictions and traffic violations that feeds the fund. Currently, revenues from two different penalty assessments are deposited in the DNA ID Fund. The first is equal to $1 for every $10 of base fine and is split between the county and the state's DNA ID Fund. The second is equal to $3 for every $10 of base fine. The entire amount of the second assessment is deposited in the DNA ID Fund. The Governor's proposal would increase the second penalty assessment to $4 for every $10 of base fine.

In 2010, the second penalty assessment was increased from $1 to $3 to backfill a $41 million General Fund reduction in crime lab support. Revenues have not come in as expected. One possible explanation is the law of diminishing returns. Today, the total amount one pays when facing a fine for a criminal act or traffic infraction is typically three to four times the amount of the base fine. A simple traffic violation can result in a total payment of $400 to $500 or more. As more and more penalties, fees, and surcharges are assessed, fewer people are able to pay them. When a court finds that a defendant is unable to pay, the fine and any additional assessments can be reduced or eliminated. At some point, the revenue lost due to the reduction or elimination of fines and related charges will exceed the marginal gain due to increasing punitive assessments. If we have not reached that point yet, we may soon.

Judicial Branch

Employee Retirement Contribution Rate Increase. The May Revision reflects $4 million in General Fund savings related to a proposal to align the retirement contribution rates of State Judiciary employees with those of most state civil service employees. Many civil service employees contribute eight percent of their total salaries toward their pensions. Most Judicial Branch employees contribute five percent or less. The Governor's proposal would increase the contribution rate for Judicial Branch employees (excluding employees of the trial courts) from five percent to eight percent. This proposal is in line with Republican priorities related to pension reform, which require employees to pay at least 50 percent of pension costs.

Reduction in General Fund Support for Trial Courts. The May Revision includes $540 million in General Fund savings due to reduction in General Fund support for trial courts operations, all of which is offset by other funding sources in 2012-13. Of the $540 million, $419 million is one time, and $125 million is ongoing. The offsets would come from a requirement that each trial court spend down its reserves ($300 million) and a redirection of court construction funds resulting from a one-year delay in various court construction projects ($240 million). The $125 million ongoing General Fund reduction replaces the proposed trigger reduction of the same amount that was included in the Governor's Budget. It would be partially offset, at least for the next few years, by $50 million in redirected court construction funds, leaving a $75 million permanent spending reduction that the trial courts would have to operationalize, beginning in 2013-14.

Transportation

Violates the Gas Tax Swap Agreement. The Governor proposes to transfer $184 million in 2011-12 and $128.2 million in 2012-13 (and annually thereafter) of gas excise tax revenues that are supposed to go to the State Transportation Improvement Program (STIP), Local Streets and Roads (LSR), and the State Highway Operations and Preservation Program (SHOPP) to the General Fund. AB 105, Statute of 2011, reenacted the "Gas Tax Swap" which changed the tax structure on gasoline and diesel fuels. AB 105 was revenue neutral for consumers but made transportation funds more flexible to fund transportation-related General Obligation debt service, thus offsetting General Fund costs. Another benefit of the Gas Tax Swap was that "Prop 42" funding for highways and local roads was preserved. In his January Budget, the Governor clarified that the "Prop 42" revenue for highways and local roads would be fully funded and not reduced by increases to off-road use, as it was not the intent for the Off-Highway Vehicle Trust Fund, the Harbors and Waterway Revolving Fund, or the Agricultural Fund to receive additional revenues. However, the Controller has been providing additional funding to these programs based upon the interpretation of existing statute pursuant to the Gas Tax Swap. Now, the Governor's May Revise will transfer these gas excise tax revenues to the General Fund from the off-highway accounts.

Therefore, the STIP and LSR will each see a decrease of $81 million in 2011-12 and $56.4 million in 2012-13 and ongoing. The SHOPP will have a decrease of $22.1 million in 2011-12 and $15.4 million in 2012-13 and ongoing. **As a result, neither on-road or off-road transportation will benefit from these gas excise tax revenues.**

Capital Outlay Support Staffing. The Governor's May Revision proposes to decrease the capital outlay support program by a net $14.5 million. This includes a decrease of 330 state staff ($16.4 million) and an increase of $1.9 million in operating expenses.

These changes are due to anticipated reductions in workload as a result of the expiration of federal American Recovery and Reinvestment Act funds. The proposed level of staffing will establish an 89/11 split of state staff to contact staff for architectural and engineering work. The State Auditor had recommended the use of more contract staff to provide more flexibility as workload continues to decrease as Proposition 1B projects near completion so this is a small step in the right direction.

However, the proposal does not go far enough. Overall, the 10,412 proposed staffing level consists of 89 percent state staff and only 11 percent contract staff for the entire capital outlay support and bond-related activities. Proposition 35, passed by the voters in 2000, allows for the state to contract out for Architectural and Engineering (A&E) services in all situations for public works projects rather than only under certain conditions. Since the passage of Prop 35, only ten percent of A&E services have been contracted out in the department. By using contract staff, the state could prevent the build-up of staffing that can take time to reduce once workload declines and could result in projects being completed quicker to the benefit of all Californian motorists.

Proposition 1B. Includes a new appropriation of $1.3 billion in Proposition 1B funds for project construction costs including; $486 million for state-local partnerships, $302 million for corridor mobility, $214 million for trade corridors, $96 for major highway rehabilitation, $70 million for State Route 99, $43 million for grade separations, $35 million for State Transportation Improvement Program, and $15 million for local bridge seismic safety.

Extension of Transportation Loans and New Borrowing of Weight Fees. The May Revise proposes to extend $307 million in transportation related loan repayments due on June 30, 2011 and $135 million due on June 30, 2012. In addition, another $25 million in 2012-13 and $20 million in 2013-14 of weight fees will be transferred to the General Fund until the payment of transportation debt service is required.

High Speed Rail Project. The Governor's proposal includes an increase of $6.9 billion for financial consulting, program management, highway system interface, Northern California Unified Service Implementation, capital outlay funding for the Initial Operating Segment (IOS), Phase 1 and 2 of Environmental and Preliminary Design/Engineering work, and connectivity projects for the High Speed Rail program. Of these funds, $3.63 billion is from Prop 1A and $3.25 billion is from federal funding. In 2013-14, bond debt repayment costs for this project will reach $169 million growing to $409 million by 2016-17. The bond debt is eligible for repayment from weight fee revenues per AB 105 (Gas Tax Swap) of 2011. However, as of 2014-15, there will not be enough weight fees to offset all of the transportation bond debt payments and General Fund will be required to meet costs of approximately $167 million growing to $259 million by 2016-17. The weight fee revenues that will be used to pay for the high speed rail project could be used for other purposes such as highway maintenance, rehabilitation, and construction.

The High Speed Rail Authority issued its latest business plan on April 2, 2012, which now relies on a "blended" system approach to try and reduce costs and increase the project delivery timeline. Phase 1 of the project is now estimated to cost $68.4 billion. Unfortunately, the biggest problem still exists, which is no private sector interest in the project and no additional federal funding commitments. The "blended" system will not produce a statewide high speed rail system, but instead, a rail line though the Central Valley to connect to existing intercity rail lines in the Bay Area and Los Angeles that would be upgraded with Prop 1A connectivity funds. Unfortunately, this segment can't be completed with existing resources since the IOS will need an additional $20 billion to extend the line from Bakersfield to Palmdale which will require federal or private participation. The Governor is proposing to use AB 32 Cap and Trade revenues as a backstop if federal, local, or private support does not materialize. The Legislative Analyst's Office raised concerns in its report, "Funding Requests for High-Speed Rail" due to **an independent study that had determined that the high speed rail project would initially be a net emitter of greenhouse gas (GHG) emissions and it would take approximately 30 years before the project would reduce any GHG emissions. Therefore, use of these funds may be illegal.**

Motor Vehicle Account Loan. The May Revision abandons the Governor's January Budget proposal to provide a $5-per-vehicle discount to vehicle owners who renew their vehicle registration using the less costly online or mail options, and instead proposes using the funds, plus other reserves in the Motor Vehicle Account (MVA), to make a $300 million loan to the General Fund. This is a disappointing change in direction. **There has been a continuing pattern in recent years of increasing fees on motorists, then spending the funds for purposes other than those for which the increases were intended.** Over the past eight years, non-commercial vehicle registration fees have increased 130 percent, commercial fees have increased by 144 percent, and driver's license fees have increased by 107 percent. Last year alone, non-commercial vehicle registration fees were increased by 23 percent. At the same time, hundreds of millions of dollars have been loaned or transferred from the MVA to the General Fund. The Governor's registration renewal discount proposal would have finally given something back to California motorists. Rather than raiding the MVA yet again, motorist fees should be reduced to a level that covers necessary MVA expenditures and nothing more. Allowing California motorists to keep more of their own money would help to stimulate the economy. This is essentially a hidden tax increase.

Resources, Environmental Protection, and Energy

Timber Harvesting Plan Reform. The Governor's May Revision proposes a new lumber assessment applied to retail sales of certain wood products sold in California and uses these funds to support regulatory activities of the Department of Forestry and Fire Protection, Fish and Game, Conservation, and the State Water Resources Control Board for Timber Harvest Plan review. The Administration indicates that the reform would also include the extension of current timber harvest plans from three years to five years, limit damages from wildfire liability, and shorten and streamline the permit process. The retail businesses would be required to remit one-half of one percent of their total gross sales of specified wood products. These costs will likely be passed to the consumer. This new assessment is estimated to provide $15 million in 2012-13 and $30 million ongoing for the program. These revenues would backfill current General Fund and special fund costs associated with timber harvest plan reviews, and provide $4.6 million to the Board of Equalization to implement and collect the new lumber assessment. The timber harvest plan reform may have positive aspects that the timber industry supports, however, the new lumber assessment could have a negative effect on the economy.

New Energy Program Investment Charge (EPIC) Program. The May Revise would impose a ***new tax on ratepayers*** to provide initial funding of $2.1 million to the California Energy Commission to develop and administer the new Energy Program Investment Charge (EPIC) program. This program will cost ratepayers $142 million annually. This new tax will increase positions above those remaining in the Public Interest Energy Research (PIER) program that should have been eliminated due to the sunset of the public goods charge (PGC) in December 2011. In September 2011, the Governor sent a letter to the California Public Utilities Commission (CPUC) requesting that the CPUC take action under its authority to ensure that PGC programs would continue. It should be noted that the PGC was a tax and approved by a two-thirds vote of the Legislature, therefore, this proposal should require the same vote threshold or a violation of Proposition 26 would result.

The CPUC authorized EPIC and has proposed that funds be spent on development and deployment of clean technologies for electricity through 2020. Specifically, this program would include funding for AB 32 and Executive Order S-3-05 goals to reduce greenhouse gas emissions to 80 percent below 1990 levels by 2050, ratepayer and societal benefits, the "loading order" from the Energy Action Plans, low-emission vehicles/transportation, safe, reliable, and affordable energy services, economic development, and efficient use of ratepayer funds. The final CPUC decision on EPIC is scheduled for May 2012.

Boaters Paying for States Obligations under the Davis-Dolwig Act. The May Revise also includes a continuous $10 million annual appropriation from the Harbors and Watercraft Revolving Fund (HWRF) to fund the state's obligation under the Davis-Dolwig Act for recreational, fish, and wildlife enhancements associated with the California State Water Project. The $10 million continuous appropriation from the HWRF would provide funding for operations and maintenance costs, standard capital costs, and the payment of previous state obligations. The state has not been providing its share of the costs (General Fund) for many years and, therefore, the state water contractors have had to absorb these costs and are currently owed over $200 million. Of the $10 million, $2.5 million would go towards repayment of this debt which will take 82 years to repay.

Furthermore, the Governor proposes trailer bill language that would require the Department of Water Resources to seek Legislative approval before incurring costs associated with state water project upgrades or needed improvements that could subject the state to additional recreational costs. This seems prudent; however, it could place continued burdens on the state water contractors to fund the state's share if the state does not provide the funding. It's unclear if the contractors could eliminate the recreational component of a project if the state refused to fund its share again. Furthermore, this proposal would negatively affect the Department of Boating and Waterways' program and **unfairly**

targets boat owners to pay for these General purpose benefits. This proposal may have the support of state water contractors because it provides a steady flow of revenues to meet the state's obligations, however, the impact to the boating program will likely be severe and cause funding reductions for public and private marina loans and boating facility infrastructure.

Increased Redemption Payments. This proposal requires beverage container distributors to submit beverage container redemption payments to the Department of Resources Recycling and Recovery (CalRecycle) by the last day of the first month after sale instead of the last day of the second or third month. These increased payments will mean 13 payments in 2012-13 and 12 payments thereafter per fiscal year. This additional payment in 2012-13 will allow the Administration to decrease the General Fund loan repayment to the Beverage Container Recycling Fund by $161.7 million and only repay $10 million in 2012-13. The remaining loan repayment would be made in 2013-14 ($89.4 million) and 2014-15 (72.3 million). This new requirement could be problematic for distributors because of the increased timeline requirements to get California Redemption Value (CRV) payments from retailers in time to remit to CalRecycle.

Department of Toxic Substances Control Funding Reductions and Redirections. The department is reducing expenditures for the Toxic Substance Control Account by $12.6 million and 59.8 positions ongoing and shifting another $6.2 million and 52.3 positions to federal funds, reimbursements, and other state special funds. These activities will bring the account into a structural balance and ensure full funding for the California Environmental Contaminant Biomonitoring Program. In addition, most existing hazardous waste management programs will become permissive and contingent upon available resources. This will allow a shift of $5.4 million and 39 positions from the hazardous waste management programs to the Green Chemistry Program. Senate Republicans have not been supportive of the Biomonitoring or Green Chemistry Programs.

May Revision Changes to Trigger Cuts

New Local Water Safety Patrol Trigger Cuts. The Governor is now proposing to reduce funding by $10.6 million annually to local law enforcement for boating safety activities in order to redirect those funds to backfill a General Fund reduction to Game Wardens if the Governor's tax initiative is not approved in November.

Reduced Fire Fighting Trigger Cuts. The Administration proposes to reduce the amount of reductions to the department's firefighting capabilities from the amount proposed in the January Budget of $15 million to $10 million in 2012-13 and from $60 million to $30 million ongoing, if the Governor's tax initiative is not approved by the voters in November. This reduction would still require cuts to fire protection services, including the closure of fire stations and reduced emergency air response times.

Lifeguard and Park Ranger Trigger Cuts. The May Revise proposes increased cuts to park lifeguards and rangers from the January Budget amount if the Governor's tax initiative is not approved in November. The reductions increased from $8.7 million to $10.4 million annually and would result in reduced water safety and a reduction in park citations, arrests, and resource protection. The actual number of lifeguards and park ranger's positions that would be eliminated is unknown at this time.

Employee Compensation

State Workforce

Employee Compensation Reduction. The Governor's May Revision proposes to reduce state employee compensation by five percent through collective bargaining, for savings of $839.1 million ($401.7 million GF). The Governor's intent to collectively bargain compensation reductions without the use of furloughs or layoffs is unlikely to materialize. The budget includes a control section that allows the Administration to reduce compensation without specific detail as to how those savings will be achieved. A straight five percent salary reduction could be done statutorily and provides the best policy solution as well. The Administration states that it intends to avoid furloughs and layoffs and will negotiate with labor organizations to pursue the implementation of a four-day, 38-hour workweek for the majority of state employees.

The Payoff. It is unlikely the unions will feel any pressure to bargain if there appears to be no threat of statutory salary reductions or administrative furloughs and layoffs. When the state and labor organizations enter into negotiations for contract changes the process usually involves much "give and take." The last time this Governor negotiated concessions for additional retirement contributions from employees, the state ended up having to fund ongoing salary increases that offset savings achieved as a result of the retirement contributions. It has been suggested that the payoff for public employee labor unions this time is protection from any privatization under the federal Obamacare Health Benefits Exchange and statewide collective bargaining for In-Home Supportive Services under the Medi-Cal Coordinated Care Initiative (see Health section for discussion on Coordinated Care Initiative).

New Barriers to Competition in Government Services. The May Revision reduces the use of external contracts by decreasing vendor support for information technology oversight and transitions those duties to the state workforce. In addition, the Department of General Services will review all personal services consultants, including janitorial and security services, and transition that work to state employees where appropriate. This proposal is a giveaway to public employee unions, and seems contrary to the Governor's proposal to "Permanently Reduce the State Workforce" while creating another obstacle for competition. **The state should be encouraging more private sector competition to reduce costs and create efficiencies, not discourage it.**

Retired Annuitants. The May Revision eliminates the "non-essential" hiring of retired annuitants. The Administration proposes each department review their use of retired annuitants, allowing only those deemed "critical" to remain. The proposal does not specify, however, what criteria will be used to define critical and non-essential. It is possible that every department will find all retired annuitants "critical" to their mission and basically do nothing. It is unclear if this proposal is supposed to achieve savings or another unknown goal. Utilizing retired annuitants in the workforce is a way for the state to reduce long-term compensation costs while retaining institutional program knowledge.

Giving Up on a Core Health Plan. The May Revision proposes to eliminate Control Section 4.21 (Health Care Premium Savings), resulting in additional costs of $67.8 million ($45.4 million General Fund) in 2012-13. The 2011 Budget included a proposal to reduce health care premium expenditures by $115 million ($80 million General Fund), with the intent that CalPERS would achieve an equivalent amount of ongoing savings in the Health Benefits program based on the core health plan option or other cost saving measures. The savings were included as a compromise to the Administration's proposal to move responsibility for the state's health care program to the Department of Human Resources. The Administration has been unclear about their reasons for giving up on a proposal that could reduce health care costs for employees and the state by tens of millions of dollars.

Various Issues

Redevelopment Agencies

Chapter 5, Statutes of 2011 (ABx1 26), eliminated redevelopment agencies (RDAs) and designated local organized successor agencies tasked with retiring the former RDAs' outstanding debts and other legal obligations. After debt service and pass-through payments are made, the revenues remaining property tax revenues and assets are to be distributed as property taxes to cities, counties, school and community college districts, and special districts under existing law.

May Revision. The May Revision estimates that approximately $818 million in additional property tax revenue will be received by K-14 schools in 2011-12 as a result of ABx1 26 (down from $1.05 billion estimated in the Governor's Budget). The May Revision also estimates $991 million in additional property tax revenue will be received by K-14 schools in 2012-13 (down from $1.08 billion estimated in the Governor's Budget).

Beginning in 2012-13, the May Revision proposes that K-14 schools be allowed to retain one percent of the property tax annually received pursuant to ABx1 26 above the Proposition 98 guarantee. This equates to approximately $10 million in 2012-13.

In addition to the revised residual property taxes noted above, the May Revision proposes legislation to require successor agencies to transfer cash assets not obligated or reserved for legally authorized purposes to cities, counties, special districts, and K-14 schools in 2012-13. The May Revision estimates that $2 billion will flow to K-14 schools and offset the state's Proposition 98 General Fund obligation ($1.4 billion in 2012-13 and $600 million in 2013-14). In addition, the May Revision proposes that K-14 schools be authorized to retain an additional 5 percent of the amount received (or $105 million) above the Proposition 98 guarantee for discretionary purposes.

It is difficult to assess the positive or negative aspects of the RDA proposal since we have not yet seen the details. The concept appears consistent with the Republican budget plan, but since the funds are not being used to protect education from trigger cuts, it must be viewed in a different context.

Reductions in Special Fund Programs

The May Revision proposes the following reductions to departments funded by special funds:

- Department of General Services. A decrease of $108.4 million special funds to reflect savings in the following areas:
  - $75 million reduction to the Natural Gas Program.
  - $15.4 million reduction to the Office of State Publishing related to increased usage of automation and technology, restructuring procurement processes, and consolidating space needs.
  - $6.7 million reduction to the Real Estate Services Division related to streamlining submittal processes, renegotiating leases, and reducing travel.
  - $6.3 million reduction to the Building Regulation Services related to increasing the use of technology and eliminating duplicative meetings.
  - $5 million reduction to administration and statewide support related to centralizing purchasing, consolidating shared services with other divisions, reducing office equipment costs, and reducing travel costs.

- California Technology Agency Rate Reductions. A decrease in rates for data center services of $13 million ($1.9 million General Fund) in 2012-13 based on reduced costs in the mainframe and mid-range service areas. In 2011-12, data center rates were reduced by $21.4 million ($3.1 million General Fund) on a one-time basis, due primarily to a temporary spike in mainframe utilization and other limited-term savings.

At this point, we have not raised any concerns with these changes, which we would expect to see from good government reforms being implemented in the Department of General Services, as well as rate reductions that should occur on the natural as a result of implementing the Governor's Reorganization Plan #1 (approved in 2009). ***All this does is allow the Governor to claim a win for doing something that would otherwise occur on the natural.***

National Mortgage Settlement Rip-off.

In February 2012, 49 state attorneys general and the federal government reached agreement on a joint state-federal settlement with the country's five largest loan servicers (Ally/GMAC, Bank of America, Citi, JPMorgan Chase, and Wells Fargo) that will provide as much as $25 billion in relief to distressed borrowers and direct payments to states and the federal government. The agreement settled state and federal investigations finding that the country's five largest loan servicers routinely signed foreclosure related documents outside the presence of a notary public and without really knowing whether the facts they contained were correct. Both of these practices violate the law. Key Provisions of the settlement include:

- **Financial Relief for Homeowners: Services are required to dedicate $20 billion to various forms of relief to borrowers, including:**
    - *Principal reduction.* At least $10 billion will be dedicated to reducing principal for borrowers who, as of the date of the settlement, owe more on their mortgages than their homes are worth and are either delinquent or at imminent risk of default.
    - *Refinancing.* At least $3 billion will be dedicated to a refinancing program for borrowers who are current on their mortgages but who owe more on their mortgages than their homes are worth.
    - *Other forms of relief.* Servicers will be required to dedicate up to $7 billion to other forms of relief, including forbearance of principal for unemployed borrowers, anti-blight programs, short sales and transitional assistance, benefits for service members who are forced to sell their homes at a loss as a result of a Permanent Change in Station, and other programs.

- Payments to State and Federal Governments: Servicers are required to make $5 billion in cash payments to the states and federal government, including:
    - *Payments to Foreclosed Borrowers.* Through the settlement, a $1.5 billion Borrower Payment Fund will be established to provide cash payments to borrowers whose homes were sold or taken in foreclosure between and including Jan. 1, 2008 and Dec. 31, 2011, and who meet other criteria.
    - *State and federal payments.* The remaining funds will go to state and federal governments to be used to repay public funds lost as a result of servicer misconduct, fund housing counselors, legal aid, and other similar purposes determined by state attorneys general.

Of the $25 billion total, approximately $18 billion will come to California and California homeowners. The State of California's share of the $5 billion identified above is $410.7 million. The May Revision proposes to use $410.7 million from the National Mortgage Settlement to backfill various General Fund programs and pay housing bond debt (allocation detail below).

Proposed Allocation of Settlement	**2011-12**	**2012-13**	**2013-14**	**Total Settlement**
Department of Justice				
Administration Costs (10% of total)	$41,060	$0	$0	
Program 20.30: Public Rights	$12,400	$18,805	$18,805	
Program 50.15: Office of the Director	$7,723	$0	$0	
Program 50.23: Bureau of State Investigations	$0	$5,995	$5,995	
Department of Fair Employment and Housing				
Program 50: Administration of Civil Rights Law	$4,000	$4,200	$4,200	
Housing Bond Debt Service Offset				
Propositions 1C and 46	$106,000	$92,000	$89,477	
Total All Programs	**$171,183**	**$121,000**	**$118,477**	**$410,660**

Source: Back-up Data provided by the Department of Finance

Most of the money coming to California will go directly to reducing principal amounts, refinancing loans, allowing forbearances, and providing cash payments to borrowers who have been foreclosed upon. The $410.7 million provided to the state is proposed to be used, not to fund new programs to help homeowners stay in their homes, but to offset General Fund costs for programs that already exist and generally align with the intent of the settlement. Attorney General Kamala Harris has already raised concerns with the May Revision, stating **"While the state is undeniably facing a difficult budget gap, these funds should be used to help Californians stay in their homes," but "The Governor's May Revision, however, proposes to redirect $410 million from the state's homeowners to other budget purposes."**

Given the apparently tenuous nexus between the settlement documents and the proposed use of funds, it would be appropriate to institute a little bit of transparency for this issue. However, the Department of Finance has proposed not to reduce the departmental budgets for DOJ and DFEH to account for these offsets, but to instead facilitate the offset using "off-budget" accounting mechanisms, similar to the mechanisms proposed to account for the $500 million of offsets proposed under the new Cap and Trade Program.

The bottom line is that (1) the May Revision doesn't really reduce General Fund programmatic spending, (2) the Administration is proposing to use these funds for purposes other than to help Californians stay in their homes, and (3) the Administration is playing "behind the scenes budgeting" that doesn't allow for transparent expenditure tracking.

Employment Development Department (EDD)

The EDD administers the Unemployment Insurance (UI), Disability Insurance, and Paid Family Leave programs and collects payroll taxes from employers, including the Personal Income Tax. To support the EDD, the Budget includes $18.4 billion ($334.3 million General Fund).

Unemployment Interest (UI) Payment. In January, the Governor's Budget proposed a $417 million loan from the Unemployment Compensation Disability Fund (DI Fund) to the General Fund to pay for the UI interest to the federal government. Payment of interest to the federal government is a General Fund obligation. Now that the federal government has lowered the interest rate on funds borrowed, the May Revision proposes to decrease that loan amount by $104.4 million in 2012-13 (from $417 million to $312.6) to reflect a reduction to the loan from the DI Fund to the General Fund. This is also counted as a reduced General Fund obligation by $104.4 million in "natural" savings. Senate Republicans generally do not support this as it is just another opportunity for the Democrats to kick the can down the road with no plans to pay back the loan.

Debt Service

Budget Year Debt Service. General Fund debt service expenditures will decrease by $162.5 million, to a total of $5.2 billion, including a decrease of $158 million for General Obligation debt service ($4.5 billion total) and a decrease of $4.5 million for lease revenue bonds ($741.1 million total).

Current Year Debt Service. General Fund debt service expenditures will decrease by $172.8 million, for a total of $5.2 billion, including a decrease of $159.2 million for General Obligation debt service ($4.5 billion total) and a decrease of $13.6 million for lease revenue bonds ($670.9 million total).

General Fund cost savings for debt service reflect (1) using the recent mortgage settlement to offset targeted housing debt service costs ($105.9 million in 2011-12 and $92.1 million in 2012-13), and (2) savings related to workload adjustments. The primary driver of adjustments to workload costs is a more focused approach by the Department of Finance to use bond cash more efficiently, working with departments to better manage bond cash and ensure additional bonds are issued only when necessary. As a result of actions taken by Finance, the spring 2012 bond sale was $1.468 billion lower than projected, and the fall 2012 bond sale will also be slightly lower than the projected estimate. According to the Administration, progress has already been made, as the balance of unspent bond proceeds available from previous bond sales has been reduced to approximately $7.3 billion, as of April 30, 2012, as compared to $9.5 billion, as of December 2011.

Governor's Reorganization Plan. The Governor plans to reduce the number of state agencies from 12 to 10.

- The Legislature is expecting a report on this proposal from the Little Hoover Commission around May 22, 2012.
- This proposal could provide real efficiencies and savings if implemented properly. The Administration has not yet provided details regarding the level of budget savings or reduction in state employees.

Elimination and Consolidation of Boards and Commissions. The Governor identified some forty boards and commissions in his January budget for elimination or consolidation into other entities.

- Thus far, legislative Democrats have not acted on many of the Governor's proposals from his January budget. In his May Revision, the Governor has proposed to eliminate an additional 22 Boards and Commissions.

Improving Budget Process. The Governor signed Executive Order B-13-11 directing departments to supply information in regards to program performance in their annual budget process.

- The modified budget process incorporating zero-based budgeting, strategic planning, audits, performance measures and cost-benefit analysis is a noteworthy starting point with many good government ideas republicans have advocated for years. Republicans encourage the Governor to continue to improve the departmental budget process realizing the key to success in implementation is to require legislative Democrats to utilize the same measures when enacting the state budget.

Reducing State Real Estate and Lease Costs. The Governor signed Executive Order B-17-12 attempting to show an effort at reducing state real estate and lease costs by renegotiating state leases keeping rental costs low.

- Although this executive order was signed a little more than two weeks ago, Republicans are encouraged that the Governors has signaled a commitment to lower state facility costs through a series of directives.

- Republicans have identified state agency leases which are wastefully using taxpayer dollars for office space with questionable locations and costs per square foot such as the Department of Insurance's office in San Francisco. A recent review by the LAO of this lease identified over 8,000 square feet of excess space at a cost of $336,000 to taxpayers. Additionally, by moving this office to Sacramento, $1.3 Million in savings from annual lease costs could be realized.

Realignment

The May Revision continues the 2011 public safety realignment, which began with the enactment of AB 109, and establishes a permanent funding structure for the various affected local entities. Since the release of the Governor's Budget, realignment revenue projections are up by approximately $23 million in 2011-12, $74 million in 2012-13, $64 million in 2013-14, and $91 million in 2014-15. Total realignment spending is projected to be $5.9 billion in 2012-13, growing to $6.8 billion by 2014-15. (*See funding table on next page.)*

Tinkering on the Margin. Relative to the Governor's Budget, the May Revision proposes to adjust realignment spending by marginally increasing funding for Early and Periodic Screening, Diagnosis and Treatment (EPSDT), Mental Health Managed Care, substance abuse treatment, foster care and child welfare services, and adult protective services, and by decreasing funding for juvenile justice and community mental health programs. **Overall, these adjustments reflect the Governor's continued prioritization of social services over traditional public safety programs.**

Failure to Acknowledge Public Safety Threat. Other than proposing $50 million in additional lease-revenue bond (LRB) funding for counties to build facilities to manage realigned offender populations, the May Revision does not address the multitude of issues and mounting criticism that the Governor's realignment plan jeopardizes public safety. Local law enforcement officials describe with increasing frequency the lack of resources and manpower to protect their communities. News stories abound of AB 109 offenders, now under local supervision, committing serious and violent crimes. Though disappointing, the May Revision contains few surprises with respect to realignment. **It poses an ongoing threat to public safety and the Administration and legislative Democrats continue to pretend that the difficulties imposed on local law enforcement by realignment are not serious.**

Realignment Costs Continue to Grow. As mentioned above, the May Revision proposes $500 million in LRB funding for counties to construct facilities to manage realigned offender populations. The May Revision also includes General Fund increases of $750,000 for the Board of State and Community Corrections to provide support to local agencies to implement realignment and $20 million for a grant program to help mitigate the impact of realignment on city police departments. These examples are in addition to proposals included in the Governor's Budget, including $8.9 million for realignment support for local agencies, $2 million for CDCR to implement realignment-related layoffs, and $2.8 million to replace trial court funding that was "inadvertently transferred to the counties" as part of realignment. The May Revision reflects total cost growth for realignment of more than $365 million from 2011-12 to 2012-13, reaching $1.3 billion by 2014-15. It appears realignment will cost the state money rather than saving the state money.

2011 Realignment Funding

(Dollars in Millions)

Program	2011-12	2012-13	2013-14	2014-15
Court Security	$496.4	$496.4	$496.4	$496.4
Local Public Safety Programs	489.9	489.9	489.9	489.9
Local Jurisdiction of Lower-level Offenders and Parole Violators				
Local Costs	239.9	581.1	759.0	762.2
Reimbursement of State Costs	989.9	-	-	-
Realign Adult Parole				
Local Costs	127.1	276.4	257.0	187.7
Reimbursement of State Costs	262.6	-	-	-
Mental Health Services				
EPSDT	-	584.2	584.2	584.2
Mental Health Managed Care	-	196.7	196.7	196.7
Existing Community Mental Health Programs	1,083.6	1,120.6	1,120.6	1,120.6
Substance Abuse Treatment	183.6	183.6	183.6	183.6
Foster Care and Child Welfare Services	1,567.2	1,585.4	1,605.8	1,621.1
Adult Protective Services	55.0	55.0	55.0	55.0
Existing Juvenile Justice Realignment	97.1	98.8	98.8	98.8
Program Cost Growth	-	221.7	456.6	1,014.7
Total	**$5,592.3**	**$5,889.8**	**$6,303.6**	**$6,810.9**
Vehicle License Fee Funds	$439.4	$455.1	$463.3	$471.1
1.0625% Sales Tax	$5,152.9	$5,434.7	$5,840.3	$6,339.8
Total Revenues	**$5,592.3**	**$5,889.8**	**$6,303.6**	**$6,810.9**

Source: Department of Finance

Trigger Reductions

The May Revision continues to propose major budget reductions that would "trigger" on in the event that the Governor's tax increase fails to obtain voter approval in November. The table below lists the programs targeted for reduction. The overall trigger total has grown by $687 million since January. **The proposal continues to disproportionately target education, with 99 percent of the reductions aimed at Proposition 98 and Higher Education.** Unfortunately, the May Revision trigger proposal continues the Governor's cynical approach of holding education funding hostage to force voter approval of his tax plan.

Trigger Reductions *(Dollars in Millions)*			
	January 2012	**May 2012**	**Difference**
Proposition 98	$ 4,836.9	$ 5,493.6	$ 656.7
University of California	200.0	250.0	50.0
California State University	200.0	250.0	50.0
Courts	125.0	--	-125.0
Department of Developmental Services	--	50.0	50.0
Local Water Safety Patrol	--	10.6	10.6
Department of Forestry and Fire Protection	15.0	10.0	-5.0
Flood Control	6.6	6.6	--
Fish and Game: Non-Warden Programs	2.5	2.5	--
Park Lifeguards	1.0	1.4	0.4
Fish and Game: Wardens	1.0	1.0	--
Department of Justice	1.0	1.0	--
Park Rangers	1.0	0.1	-0.9
Total	**$ 5,390.0**	**$ 6,076.8**	**$ 686.8**

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