Highlights and Analysis of the Governor's 2013-14 May Revision

May 19, 2013
SENATE REPUBLICAN FISCAL OFFICE

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Executive Summary

Economic Slowdown. The May Revision reflects a downward change to the economic forecast that is largely driven by the federal payroll tax increase. It is unclear what the effects have been from the $45 billion sales and income tax increase voters approved in Proposition 30, and the lack of any measures to improve California's hostile business climate or create new jobs, but certainly those factors have not helped the economy.

The Revenue Windfall That Wasn't. On May 1, 2013, state revenues were about $4.6 billion above the January budget forecast, but the Governor projects that they will end up only $2.8 billion higher for the 2012-13 fiscal year ($95.4 billion grows to $98.2 billion), and will drop by $1.3 billion (from $98.5 billion to $97.2 billion) in 2013-14 compared to the Governor's January budget projections. With other accounting and accrual adjustments for prior years **the net effect is that state revenues are only about $1.2 billion higher** than expected per the January 2013-14 Governor's Budget. Absent a *$500 million loan from Cap-and-Trade fee revenue*, state revenues would be just $750 million higher.

Legislative Analyst Calls Governor Pessimistic. The Legislative Analyst's Office (LAO) has released a new state revenue forecast that differs significantly from the Governor's Department of Finance estimates. **The LAO projections are $3.2 billion higher than the Governor's** May Revision total (noted above). The disagreement is largely over the amount of capital gains revenue the state will collect, and the LAO specifically points to recent increases in stock prices and higher housing prices. The Analyst does agree with the Governor that the Legislature should be cautious about increasing spending and seems to believe that any new revenues provide an opportunity to build a budget reserve and pay off past debts as a priority.

State Spending Hits New Record. Notwithstanding his pleas for fiscal restraint, the 2013-14 Governor's May Revision actually proposes a net increase in General Fund spending relative to the January budget plan. State spending in 2012-13 grows by $2.7 billion (from $93 billion to $95.7 billion), and it drops by $1.3 billion in 2013-14 (from $97.7 billion to $96.4 billion) resulting in **a net spending increase of $1.4 billion General Fund** compared to the January 2013-14 Governor's Budget proposal. In fact, total state spending from all fund sources is $232.9 billion in 2013-14, **$8.3 billion higher** compared to the January budget plan - **a new historic state spending record.**

The Scorpion and the Frog. Unfortunately, it is clear that the Governor's May Revision represents the state spending floor from which legislative Democrats will only increase the costs – just as in the parable of *The Scorpion and the Frog*, it is their nature. **Legislative Democrats have already exhibited their disappointment with the Governor's "fiscal prudence" as they call for potentially billions of new government spending** on everything from welfare programs to low-income housing and government subsidized child care. The lesson of the “boom and bust cycle” that occurred twice in the past decade clearly has not been absorbed.

Tax Frenzy--From Bags to Bullets. Despite the current base revenue increases and the $50 billion of new tax increases approved by voters in November 2012, **legislative Democrats have about twenty new tax and fee measures** pending at the moment that would affect everything from plastic bags to bullets; they even propose taxes on soda and strippers.

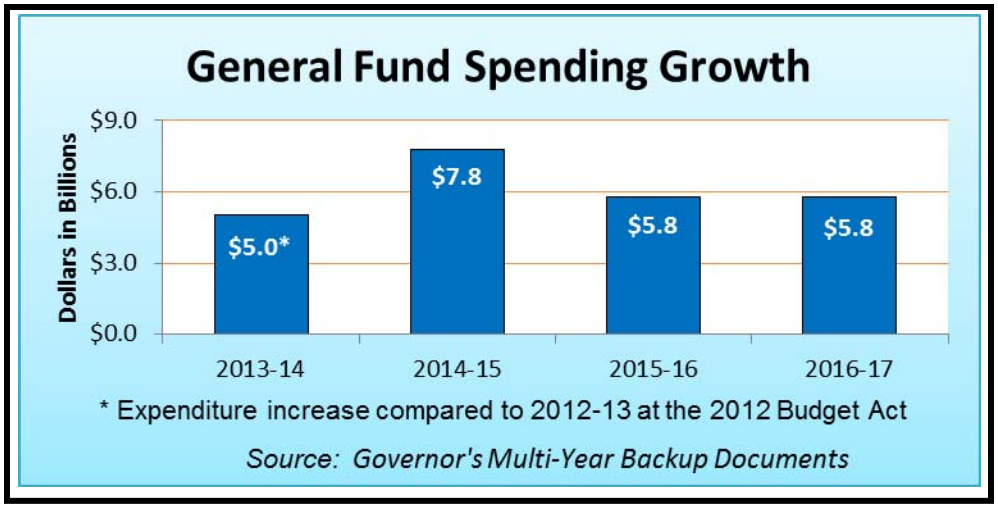
Budget Risks Everywhere. The Governor has acknowledged that the budget is only precariously balanced at best. The following is the short list of large-ticket items that could swing the state budget back into deficit mode:

- Despite a widely-held expectation that the Governor will be granting grant pay raises and benefit increases to the public employee unions there is no funding in budget for upcoming collective bargaining. Each one percent pay increase equals about $100 million General Fund and one of the largest public employee unions (SEIU) has already requested a $2,500 bonus for each employee in 2013, and seven and nine percent salary increases in 2014 and 2015 respectively.
- There is no funding included to address the recent federal court order to reduce the prison population, which could easily cost hundreds of millions of dollars for receivers and reduction programs, community supervision and additional secure facilities.
- There are pending federal regulations that could increase In-Home Support Services (IHSS) overtime costs by at least $200 million to $300 million, according to the Administration.
- The budget assumes $1.5 billion from the dissolution of Redevelopment Agencies, despite at least 70 lawsuits pending on this issue.
- Both the Governor and LAO have expressed concern over volatility in the capital gains revenue forecast, which could swing revenues by billions of dollars.
- Rising health care costs could strain the budget since Medi-Cal will cover nearly 25 percent of the state’s population, and state employee/retiree health care already costs billions of dollars. A change in the inflation rate could cost hundreds of millions more.
- **The greatest risk** to the budget is pent-up spending demand among legislative Democrats, the advocates that influence their decisions, and public employee union demands.

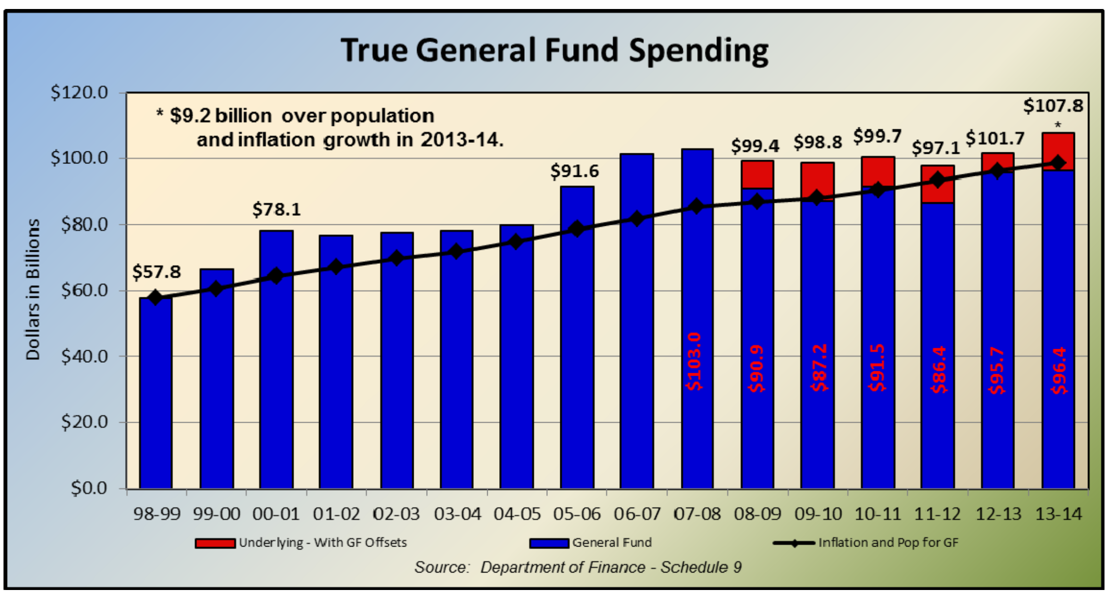
California Needs A Common Sense Rainy Day Reserve Fund. To his credit, Governor Brown has said “It’s not time to break out the champagne” and he is trying to prevent his fellow Democrats who rule the Legislature from taking California back into a new budget crisis. However, he fails to set an example by following the State Constitutional requirement to put money into a budget reserve fund. In addition, **the Governor should support the Republican effort to allow a vote of the people** on a true rainy day reserve pursuant to the bipartisan plan enacted in ACA 4 (2010) that would help ensure budget stability and avoid future budget crises.

Essential Charts:

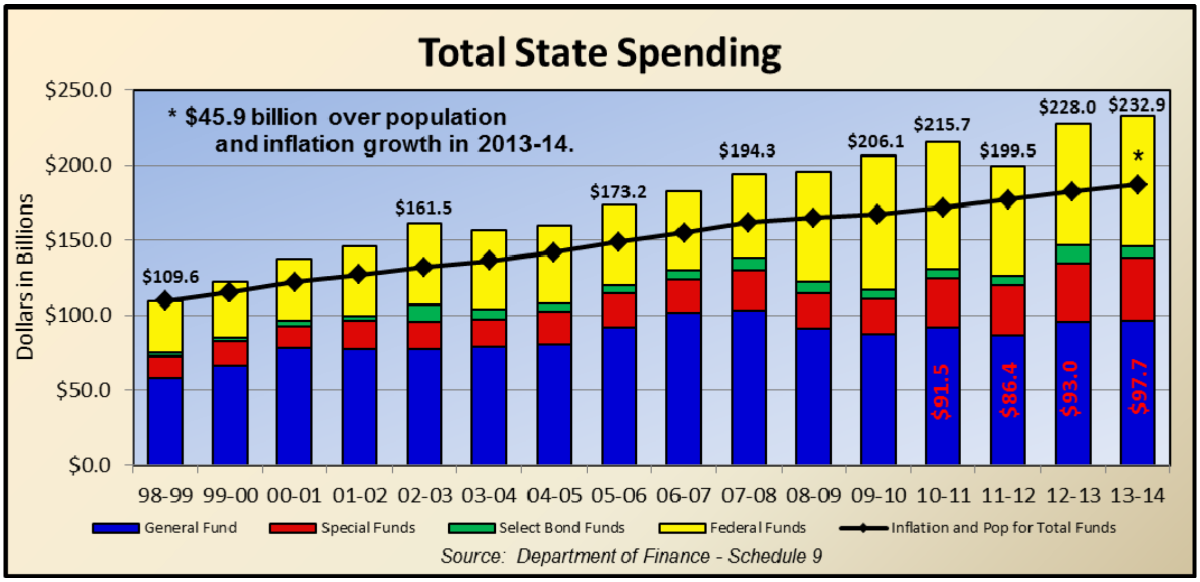
State Spending Grows Rapidly. Under the Governor’s May Revision, state General Fund spending in 2013-14 grows by $5.0 billion (5.5 percent) over the 2012 Budget Act level and by nearly $25 billion (27 percent) over the next four fiscal years (*see chart on next page*). With regard to state spending, Governor Brown has said his budget “is a call for prudence, not exuberance." The Governor is preaching fiscal restraint, but **if a $25 billion spending increase is fiscal restraint, then one can only imagine to what “exuberance” would lead.**



True General Fund Program Spending. Legislative Democrats frequently claim that state spending has been slashed by $40 billion or more, and the Governor claims General Fund spending is down since its peak of $103 billion in 2007-08. In fact, true General Fund program spending, which includes fund shifts, transfers, and various General Fund offsets was never significantly reduced. As noted in the chart below, fiscal year 2013-14 General Fund program spending **totals $107.8 billion, which is $4.8 billion higher than the previous peak General Fund spending level.**



Total State Spending. General Fund spending is only a part of total state spending. Special funds, bond funds, and federal funds bring total state spending for 2013-14 to about $233 billion (*see chart below*). Despite the Great Recession and Democrats' claims of "cutting to the bone," total state spending has hit record high levels, and is nearly $46 billion above population and inflation growth trends since the last stable budget in 1998-99 (i.e., stable being defined as normal spending growth with no state spending reductions or significant new taxes).



Proposition 30 Promises to Students Not Kept. California voters signaled their willingness to prioritize education when they agreed via Proposition 30 to pay higher taxes to benefit education. K-14 Proposition 98 funding in 2013-14 will include only about $2.2 billion (36 percent) of the $6.1 billion in new tax revenue generated by Proposition 30 - *education will not get the full benefit of those tax hikes, as voters were led to believe.* As noted in the chart below, if Proposition 30 revenues were dedicated solely to K-14 education, funding for the state's schools and community colleges would be about $2.1 billion higher in 2012-13 and $3.9 billion higher in 2013-14 than proposed by the Governor.

Proposition 98 funding - 3 scenarios

$ in billions

	2012-13	2013-14
Minimum guarantee with no Prop 30 revenue	$53.2	$53.0
Minimum guarantee plus all Prop 30 revenue	$58.6	$59.1
Prop 98 funding proposed by Governor	$56.5	$55.3
Shortfall	$2.1	$3.9

Source: Legislative Analyst's Office

Instead of targeting all of the Proposition 30 revenue toward education, the Governor's budget plan uses some of it for his own priorities (e.g., over $1.5 billion for health and welfare programs, $400 million to end state worker furloughs, $250 million to fund increased state worker salaries and benefit costs, etc.). *The promise of Proposition 30 has already been broken.*

Expenditures

The 2013-14 May Revision proposes total General Fund expenditures of $95.7 billion in 2012-13 and $96.4 billion in 2013-14. As reflected in the table below, since the 2012-13 Budget Act was signed, total General Fund spending will increase by $4.4 billion in 2012-13 and an additional $666 million in the budget year 2013-14, bringing the total year-over-year spending increase to $5 billion (a 5.5 percent increase year-over-year). Expenditure levels in both years include new revenues provided with the passage of Proposition 30 this past November, as discussed in the *Revenue* section on Page 9.

General Fund Expenditures by Agency

(Dollars in Millions)

Agency	Budget Act 2012-13	Revised 2012-13	Projected 2013-14	Change Since Budget Act
Legislative, Judicial, Executive	$2,056	$2,002	$2,559	$503
Business, Consumer Services, Housing	$219	$217	$646	$427
Transportation	$183	-$53	$206	$23
Natural Resources	$1,900	$2,030	$2,118	$218
Environmental Protection	$46	$47	$46	$0
Health and Human Services	$26,695	$27,001	$28,473	$1,778
Corrections and Rehabilitation	$8,887	$8,763	$8,929	$42
K-12 Education	$37,848	$41,085	$39,863	$2,015
Higher Education	$9,432	$9,909	$10,564	$1,132
Labor and Workforce Development	$342	$345	$299	-$43
Government Operations	$668	$661	$743	$75
General Government/Other	$3,062	$3,681	$1,908	-$1,154
Total, General Fund Expenditures	**$91,338**	**$95,688**	**$96,354**	**$5,016**
Difference since the Budget Act		$4,350	$666	
- As a Percentage		4.8%	0.7%	5.5%

Source: Department of Finance Schedule 9

The "General Government/Other" category includes a variety of statewide proposals that have not yet been allocated to specific departments or programs, including employee compensation changes, health and dental benefits for annuitants, the PERS deferral, and assumptions for federal fund offsets related to education and health and human services programs.

As reflected in the table above, most major programs grew from the 2012-13 to 2013-14, with the exception of "General Government/Other." A variety of factors contribute to the $1.2 billion decrease for that category, but the primary reason is that 2012-13 included about $2 billion (one-time) to repay local governments for property taxes borrowed in 2009-10 under Proposition 1A.

In January, the Governor proposed a budget that would increase spending by $1.7 billion in 2012-13 and $4.7 billion in 2013-14. Now, the May Revision reflects a $4.4 billion increase in 2012-13 above the 2012 Budget Act, followed by an increase of $666 million in 2013-14 compared to the 2012 Budget Act. The table on the following page provides a simple comparison of how 2012-13 and 2013-14 spending has changed since the Governor's Budget.

Total General Fund Expenditures (Dollars in Millions)				
	Budget Act 2012-13	Revised 2012-13	Projected 2013-14	Change Since Budget Act
Governor's Budget Projections	**$91,338**	**$92,994**	**$97,650**	
Difference since Budget Act		$1,656	$4,656	**$6,312**
May Revision Projections	**$91,338**	**$95,688**	**$96,354**	
Difference since Budget Act		$4,350	$666	**$5,016**
Change in Projections Since Governor's Budget		**$2,694**	**-$1,296**	

Source: Department of Finance Schedule 9

General Fund spending represents only 41.4 percent of total state spending in 2013-14. As shown on Page 3 of the *Executive Summary*, adding special funds, bond funds, and federal funds brings total state spending for 2013-14 to about $232.9 billion (including an additional $4.2 billion of federal funds related to the mandatory and optional health care reform expansions and increased managed care tax revenues). This level of total state expenditures is $4.9 billion higher than total expenditures in 2012-13 ($228.0 billion), and continues to exceed population and inflation growth since 1998-99 by nearly $46.9 billion.

True state General Fund program spending, which accounts for fund shifts, transfers, and General Fund offsets that allow General Fund programs to continue growing, now totals $107.8 billion in 2013-14, this is 4.6 percent higher than peak General Fund program spending in 2007-08 (prior to the "Great Recession"). See the chart below.

Underlying General Fund Program Spending (dollars in billions)							
	'07-08	**'08-09**	**'09-10**	**'10-11**	**'11-12**	**'12-13**	**'13-14**
General Fund Expenditures	$103.0	$90.9	$87.2	$91.5	$86.4	$95.7	96.4
"Offsets" to Maintain General Fund Program Levels	--	$8.5	$11.6	$8.9	$11.3	$6.0	$11.4
Total, General Fund Program Expenditures	**$103.0**	**$99.4**	**$98.8**	**$100.4**	**$97.7**	**$101.7**	**$107.8**
Percentage Change from Peak 2007-08 General Fund Spending		-3.5%	-4.0%	-2.6%	-5.2%	-1.3%	4.6%

Department of Finance – Schedule 9

Though direct General Fund spending is down (compared to 2007-08), true General Fund program spending nears $102 billion in 2012-13 and reaches $107.8 billion in 2013-14. In addition to $96.4 billion General Fund, the 2013-14 May Revision relies on an assortment of "offsets" that boost funding for General Fund programs including: (1) nearly $1.5 billion of property taxes from redevelopment agencies to fund education, (2) realigning $6.3 billion of public safety programs to the local level, (3) $200 million of trial court reserves to fund court costs, (4) $969 million of weight fees to pay general obligation bond debt, and (5) a variety of smaller transactions to offset General Fund reductions and maintain General Fund programs. In prior years, the Legislature has relied on additional federal funds, redevelopment agencies, inter-year Proposition 98 deferrals, employee compensation deferrals, and local property tax borrowing to maintain General Fund programs in the absence of General Fund revenues.

Revenues

The 2013-14 Governor's Budget projects total General Fund revenues of $98.2 billion in 2012-13 and $97.2 billion in 2013-14. The table below reflects point-in-time changes in the Administration's revenue estimates, including a $1.2 billion increase over Governor's Budget projections over the three-year fiscal window. This increase is in addition to the $2.1 billion increase over the 2012 Budget Act forecast in the Governor's January budget.

Compared to the January budget, the May Revision reflects two significant changes to the revenue forecasts.

First there is a change related to the state's economic outlook as a whole. The May Revision indicates that while California and national economies are expected to continue modest-paced growth, they will be weaker than anticipated in the Governor's Budget. With unemployment falling, the housing sector slowly recovering, and monetary conditions offsetting fiscal tightening at the federal level, growth is becoming more sustainable. However, the expiration of the two percent payroll tax holiday at the beginning of 2013 has notably reduced disposable income, and with consumers now preferring a higher saving rate, we are seeing decreased sales and use tax revenues. Corporation tax revenues are expected to decrease for a variety of reasons, including outflows in the current and budget years from the resolution of disputes between taxpayers and the state and recent tax law changes that are increasing the usage of credits to offset profits.

General Fund Revenue Projections

(dollars in millions)

2011-12 Revenue Source	**Governor's Budget**	**May Revision**	**Forecast Change**	**%△**
Personal Income Tax	$53,836	$54,261	$425	0.8%
Sales & Use Tax	$18,652	$18,658	$6	0.0%
Corporation Tax	$7,949	$7,233	-$716	-9.0%
Other Revenues	$5,125	$5,125	$0	0.0%
Transfers	$1,509	$1,509	$0	0.0%
Total Revenue	**$87,071**	**$86,786**	**-$285**	**-0.3%**
2012-13 Revenue Source	**Governor's Budget**	**May Revision**	**Forecast Change**	**%△**
Personal Income Tax	$60,647	$63,901	$3,254	5.4%
Sales & Use Tax	$20,714	$20,240	-$474	-2.3%
Corporation Tax	$7,580	$7,509	-$71	-0.9%
Other Revenues	$4,653	$4,797	$144	3.1%
Transfers	$1,800	$1,748	-$52	-2.9%
Total Revenue	**$95,394**	**$98,195**	**$2,801**	**2.9%**
2013-14 Revenue Source	**Governor's Budget**	**May Revision**	**Forecast Change**	**%△**
Personal Income Tax	$61,747	$60,827	-$920	-1.5%
Sales & Use Tax	$23,264	$22,983	-$281	-1.2%
Corporation Tax	$9,130	$8,508	-$622	-6.8%
Other Revenues	$4,383	$4,449	$66	1.5%
Transfers	-$23	$468	$491	-2134.8%
Total Revenue	**$98,501**	**$97,235**	**-$1,266**	**-1.3%**
Three-Year Total			**$1,250**	

Source: Department of Finance Schedule 9

Second is the unanticipated windfall of Personal Income Tax (PIT) revenues received by the state. In February 2013 the State Controller's Office reported that the state General Fund in January had collected $4.3 billion more revenue than projected in the Governor's Budget, driven by $4.8 billion of unanticipated PIT revenues. Through February, March, and April, revenue collections generally tracked with projections. The May Revision now reflects higher PIT revenues in both 2011-12 (about $425 million accrued back to that fiscal year) and 2012-13. In conjunction with other economic factors, the windfall revenues contribute to increasing the 2012-13 PIT revenue projections by nearly $3.3 billion.

Updated Revenue Estimate from November Ballot Initiatives
As we noted in January, voters approved two major tax -related initiatives that contribute significant revenues to the state (Propositions 30 and 39). With the May Revision, the Governor has revised the revenue estimates related to these initiatives.

Proposition 30 was originally estimated to generate $47 billion of new tax revenue spread over eight fiscal years. With the Governor's Budget, the Administration revised its estimates downward to about $45 billion over that same eight years. The following table reflects the most recent Department of Finance estimate of revenues related to Proposition 30 (totaling $44.5 billion).

Proposition 30 Revenue Estimates
Dollars in Millions

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Personal Income	$3,356	$4,780	$4,766	$5,355	$5,709	$6,017	$6,326	$2,582
Sales Tax		$598	$1,321	$1,427	$1,484	$812	$0	$0
Total	**$3,356**	**$5,378**	**$6,087**	**$6,782**	**$7,193**	**$6,829**	**$6,326**	**$2,582**

Source: Department of Finance Multi-year Backup Documents

Proposition 39 was projected to generate annual General Fund revenues of $1.1 billion, and required at least half ($550 million) to be used to fund projects that create energy efficiency and clean energy jobs in California. The May Revision reflects minor increases to the Governor's Budget estimates, increasing the 2012-13 projection by $13 million (from $440 million to $453 million) and the 2013-14 projection by $28 million (from $900 million to $928 million). See the table above.

LAO Revenue Projection Less Conservative

On May 17, 2013 the Legislative Analyst’s Office (LAO) released its *Overview of the May Revision*, which indicated that the Administration’s view of the economy and revenues seems too pessimistic.

> “We do not agree with the Administration’s view that there has been a significant dimming of the state’s near-term economic prospects. In addition, we observe that the Administration’s new revenue forecast does not seem to reflect some recent economic improvements—most notably, a sharp increase in stock prices. As a result, **our forecast now is $3.2 billion higher than the Administration’s May Revision** total for 2011-12, 2012-13, and 2013-14 combined.”

As a result of an improved fiscal forecast, the LAO cautions against expanding, or creating new government programs, and advises the Legislature to begin addressing its huge budgetary and retirement liabilities, including building a rainy day reserve fund to protect against budgetary volatility, paying down the “Wall of Debt,” and funding problems of the California State Teachers’ Retirement System.

Statewide Debt

Wall of Debt. The "Wall of Debt" reflects the fiscal impact of actions taken over the past 11 years by the Legislature and Governors Davis, Schwarzenegger, and Brown to solve annual budget deficits, including borrowing from special funds, deferring repayment of local and education mandate obligations, Economic Recovery Bonds, Proposition 1A borrowing from local governments, deferral of Medi-Cal costs and state payroll costs, etc. The Administration estimates that as of June 30, 2012, the state's "budgetary borrowing" totaled approximately $34.2 billion.

With the 2012 Budget Act, Governor Brown adopted a schedule for paying down the "Wall of Debt," however, that schedule continues to be revised to balance the budget. The following table compares the Governor's repayment schedule when the 2012 budget was enacted to his repayment schedule proposed with the 2013-14 May Revision.

	Outstanding	'12-13	'13-14	'14-15	'15-16	Remaining
2012-13 Budget Act	$34,165	$5,933	$5,244	$7,356	$6,708	$8,924
2013-14 May Revision	$34,165	$7,304	$3,099	$5,860	$8,142	$9,760
Difference		**+$1,371**	**($2,145)**	**($1,496)**	**+$1,434**	**+$836**

In January, the most notable change to the pay-down schedule was a $1 billion delay of repayments for special fund loans, requiring fee payers to continue supporting General Fund programs instead of the special fund programs (funded by the fee), for which they paid the fee in the first place.

The May Revision proposes two additional notable changes to the pay-down schedule:

- $500 million loan of cap-and-trade auction revenues to the General Fund **increases** the Wall of Debt in 2012-13. At a time when the state is collecting more General Fund revenues than anticipated in January ($2.8 billion), it is not clear why this $500 million loan is necessary, especially since the cap-and-trade program has only realized $139 million to-date. Additional detail regarding the cap-and-trade loan can be found on Page 24.

- The May Revision proposes to dedicate an additional $1.8 billion to reduce education deferrals in 2012-13, but reduces the amount of money dedicated to paying down education deferrals in 2013-14 by $1 billion. This results in a net decrease of about $800 million in outstanding education deferrals over the two year period.

Statewide Debt. The "Wall of Debt" is but one small portion of total California debt obligations. Additional information regarding the big picture of statewide debt can be on found Page 30 of our *January 2013 Highlights and Analysis* document (*http://cssrc.us/pubs/130114_Budget_HighlightsAnalysis.pdf*), but for reference purposes, the state is also responsible for the following obligations:

- $181.2 billion of *Unfunded Retirement Liabilities*.
- $74.1 billion of outstanding *General Obligation Bond* debt.
- In excess of $11 billion of outstanding *Lease Revenue Bonds*.
- $10.2 billion will be owed to the federal government to cover the *Unemployment Insurance (UI) Fund deficit* by the end of 2013.

Debt Service Costs. The May Revision reflects $484 million of decreased borrowing costs for both short-term cash and long-term infrastructure investments. The Administration indicates that much of the savings identified below are the result of the state's improved budget outlook and a more focused approach to managing bond cash.

Long-term Infrastructure Investments. With $85+ billion of outstanding General Obligation (GO) and Lease Revenue (LR) debt, the state Treasurer operates the General Obligation Bond and Commercial Paper program, which includes budgeting for interest and redemption costs. The May Revision budgets $4.7 billion ($4 billion General Fund for GO Debt) in 2012-13 and $5.7 billion ($4.9 billion General Fund for GO debt) in 2013-14. Over the two fiscal years, these amounts are about $434 million lower than was estimated in the 2013-14 Governor's Budget. The net decrease in GO debt service is primarily attributable to:

- Increased projected premiums generated from spring 2013 and future bond sales,
- Savings related to bond re-financings,
- A smaller than anticipated spring 2013 bond sale, and
- Increased costs related to reduced Build America Bond subsidies related to the federal sequestration.

Short-term Cash Borrowing. Each year the state borrows internally (from special funds within the state treasury) and externally (Revenue Anticipation Notes from financial markets) to fund the cash flow purposes when monthly and daily expenditures exceed General Fund revenue collections. The May Revision reflects decreased General Fund costs to fund interest on these two borrowing mechanisms, as follows:

- $10 million decrease, from $50 million to $40 million, due to lower projections for internal borrowing costs.
- $40 million decrease, from $100 million to $60 million, due to the expectation of lower interest rates and the reduced size of borrowing from the financial markets.

Economic Development Plan

The May Revision proposes significant changes to how the state provides tax incentives to businesses, including the elimination of state tax incentives currently provided under the Enterprise Zone program and 2009 New Hire tax credit and redirection of those funds to broader incentives provided on a statewide basis (discussed below). As proposed, this measure is intended to be revenue neutral. Eliminating the two existing programs would require two-thirds vote of the Legislature as a tax increase under Proposition 26.

Existing Programs

- Enterprise Zone (EZ) Program. Proposal would close out the EZ program, while allowing businesses to retain incentives already earned over the next five years. Estimated to "generate" $700 million of revenues annually. The Administration's claims that EZs fail to encourage the creation of new jobs are questionable, since proponents provide evidence that EZs created or retained more than 130,000 new jobs in 2012. With the elimination of RDAs, EZs continue to be the only economic development tool remaining for local governments to prevent businesses from leaving the state.

- 2009 New Hire Tax Credit. Proposal would eliminate this credit, which provides up to $3,000 for each additional full-time employee hired by small businesses with 20 employees (capped at $400 million). To date, only $160 million has been claimed (leaving $260 million). Estimated to "generate" $30-$40 million of revenues annually for five to six years.

New Programs

- New Hiring Credit. Proposed new credit would be targeted to areas of high unemployment and poverty rates, based on census tract data, and focused on the long-term unemployed, unemployed veterans, and people on state subsistence. Estimated to decrease General Fund revenues by $100 million to $150 million annually. ***Republicans have supported revamping the existing hiring credit (above).*** However, it's not clear this proposal goes in the right direction. California should be focusing on creating jobs and getting people back to work, not creating a barrier to job creation by limiting this credit only to jobs that pay two times the minimum wage.

- Sales Tax Exemption for Purchasing Manufacturing and Bio-tech Equipment. Proposal would exempt the first $200 million of equipment purchases from the state share of the sales tax (4.25 percent). Estimated to decrease General Fund revenues by $400 million. ***On its own, Republicans should be supportive of this proposal,*** which could be even more appealing if the $200 million limit were removed. With the highest economic multiplier of all options this proposal would bring California on par with 47 other states that do not tax the purchase of manufacturing equipment.

- GO-Biz Investment Incentives. Proposal would allow Governor's Office of Business and Economic Development to negotiate with businesses to locate and/or expand in California, and provide income tax credits for meeting negotiated performance (capital investment, hiring, multipliers, etc.). Estimated to decrease revenues by $50-75 million in first year, growing to $200 million annually. ***Given the potential for abuse, this "slush fund" should raise red flags.*** Even with the "safe guards" proposed by the Administration, this proposal would allow the Governor and legislative Democrats to use these funds as a political opportunity to help favored friends and supporters to the detriment of all Californians.

Judiciary

No Additional Help for Trial Courts. The Governor's January budget proposed the restoration of $400 million General Fund in 2013-14 that was eliminated in 2012-13 to force trial courts to spend down their reserves. It also included a one-time transfer of $200 million from the Immediate and Critical Needs Account to the General Fund to offset the impact of the restoration on the General Fund. The May Revision does not provide any additional new funding to the trial courts.

Judicial Council Revamps Trial Court Funding Methodology. Among its other responsibilities, the Judicial Council is charged with allocating the annual funding for trial courts. Although not technically part of the May Revision, the Judicial Council recently adopted a new trial court funding allocation methodology that will result in significant changes in the level of funding provided to each trial court.

Since 1997, when the state assumed sole responsibility for funding trial court operations, each trial court's budget has been based in large part on the historical level of funding provided by the county before the state took over. The result has been that pre-1997 funding disparities between courts in different counties have been largely perpetuated. The Judicial Council's new methodology will instead allocate funding based on each court's workload, which will be estimated based on the number of filings by case type for each court.

While the new methodology will ensure that available funding is distributed equitably amongst the trial courts over the long term, in the short term, some courts will experience significant budget increases, while others will see significant decreases. For example, San Diego and Orange County courts will likely see reductions of about $18 million (15 percent) and $21 million (17 percent), respectively, while Riverside and San Bernardino County courts, which have been chronically and severely underfunded, will likely see increases of about $19 million (33 percent) and $26 million (43 percent), respectively. This new approach is intended to resolve decades-old disparities in trial court funding.

Education

K-14 funding grows, but less than promised. The chart below displays proposed Proposition 98 funding for K-14 education:

Proposition 98 Funding at 2013-14 May Revision

Source: Legislative Analyst's Office

($ in millions)

	2011-12	2012-13	2013-14	change 12-13 to 13-14
K-12 education				
General Fund	**$29,685**	**$36,196**	**$35,028**	**-$1,168**
Local property tax revenue	**$12,125**	**$13,773**	**$13,668**	**-$105**
K-12 subtotal [1/]	**$41,810**	**$49,968**	**$48,696**	**-$1,272**
California Community Colleges				
General Fund	**$3,279**	**$3,699**	**$3,761**	**62**
Local property tax revenue	**$1,977**	**$2,253**	**$2,242**	**-11**
CCC subtotal	**$5,256**	**$5,953**	**$6,003**	**50**
Other Agencies	**$83**	**$78**	**$78**	**-**
Total Proposition 98	**$47,149**	**$56,480**	**$55,259**	**-$1,221**
General Fund	**$33,047**	**$40,454**	**$39,349**	**-$1,105**
Local property tax revenue	**$14,102**	**$16,026**	**$15,910**	**-$116**
Prop 98 per-pupil funding (K-12)	**$7,007**	**$8,450**	**$8,221**	**-$229**

As this chart shows, the 2012-13 Proposition 98 minimum guarantee of funding for education is $56.48 billion (up from $53.54 billion in January, an increase of over $2.9 billion), and the 2013-14 guarantee is $55.26 billion (down from $56.20 billion projected in January, a decrease of about $940 million since January and a year-over year decrease of about $1.2 billion from the 2012-13 level).[1] As the next chart shows, proposed funding for Proposition 98 is almost $4 billion less than it would be if all of the new tax revenue generated by Proposition 30 was used for K-14 education.

Proposition 98 funding - 3 scenarios

$ in billions

	2012-13	2013-14
Minimum guarantee with no Prop 30 revenue	**$53.2**	**$53.0**
Minimum guarantee plus all Prop 30 revenue	**$58.6**	**$59.1**
Prop 98 funding proposed by Governor	**$56.5**	**$55.3**

Source: Legislative Analyst's Office

Proposition 30 was sold to the voters as a benefit to education, but rather than spend all of the resulting revenue in support of education, the Governor continues to direct some of it toward his other priorities (e.g., over $1.5 billion for health and welfare programs, $400 million to end furloughs for state workers, $250 million to increase state worker salaries and benefits, etc). California voters signaled their willingness to prioritize education when they agreed via Proposition 30 to pay higher taxes for the benefit of education. The Governor and Legislature should honor that bargain by using *all* of the

[1] The Governor proposes to use most of the one-time 2012-13 increase to pay down K-14 education funding deferrals ($1.8 billion) and provide one-time funding for implementation of the new K-12 "common core" state standards ($1 billion). He reduces 2013-14 spending to match the guarantee mostly by reducing the proposed deferral paydown by $920 million from the January level (the paydown would be $1.02 billion rather than $1.94 billion). However, across the two years, deferral paydowns would *rise* by more than $750 million.

Proposition 30 tax revenues to improve California's schools, colleges, and universities, instead of redirecting them to other uses.

In addition, should the Legislature ultimately adopt a higher revenue estimate, consistent with the Legislative Analyst's projections, any additional spending should be restricted to increasing funding for education, building a rainy-day reserve, and reducing the state's "wall of debt."

New K-12 funding formula. The Governor continues his January proposal for a "local control funding formula" (LCFF). Most of the formula's features are unchanged since January: it would still phase in from 2013-14 through 2019-20, and would provide average base funding of $6,816 per student, with an additional layer of funding for every student who is poor[2], an English learner, or in the foster care system, and a second layer of "concentration" funding for school districts where more than 50 percent of students fall into these categories. The May Revision does make a few modifications, however. Most notably:

- increases first-year (2013-14) LCFF funding by $240 million, to $1.87 billion
- extends from the number of years for which the state will pay extra for an English learner five to seven
- extends funding for direct-funded Regional Occupational Centers and Programs (ROCP) joint powers authorities by two years, after which they would have to operate through agreements with school districts
- requires additional funding provided for poor, English learner, and foster students to be spent for their benefit, and requires additional reporting and service coordination for foster youth
- authorizes county superintendents, the Fiscal Crisis and Management Assistance Team, and the Superintendent of Public Instruction to intervene when districts fail to meet the state's academic standards.

While many in the school community have welcomed the formula's expansion of local control, some have expressed concern about a few of the specifics. For example, the formula:

- creates "winners and losers," with suburban districts the relative losers, compared with the current system
- ignores concentrated pockets of poor and English learner students in districts with lower total percentages of those students
- imposes significant risk on the state, should local school boards opt to use its enhanced local control to increase employee salaries and benefits rather than increase service to students. In that case, education advocates will almost certainly litigate to force the state to step in and fulfill its constitutional responsibility to ensure that students are appropriately served, and the courts could require the state to come up with billions of dollars more to fund services that local districts failed to provide.[3]

On the up side, the proposal's shift of power over schools away from the ruling party in Sacramento and toward local school boards and its recognition that needy students are not evenly distributed across the state make it attractive, despite its potential flaws. Senate Democrats have their own version of the LCFF, which offers a higher base grant to all schools (because it eliminates the second layer of supplemental 'concentration grant' funding). However, it contains a potential "poison pill" in that

[2] Defined as eligible for free or reduced-priced school meals.

[3] Butt v. State of California, 1992. The California Supreme Court ruled that the state Constitution makes public education "a fundamental concern of the State and prohibits maintenance and operation of the common public school system in a way which denies basic educational equality to the students of particular districts. The State itself bears the ultimate authority and responsibility to ensure that its district-based system of common schools provides basic equality of educational opportunity."

it retains the statutory authority for existing categorical programs, such that those programs could easily be resurrected in the future, thereby unwinding the local control at the heart of the proposal.

New energy efficiency program (Proposition 39). In January, the Governor proposed to spend $450 million in funds resulting from voter approval of Proposition 39 for energy efficiency projects at schools and community colleges. The May Revision retains this approach, adds another $14 million in grant funding, and authorizes minimum grants of $15,000 and $50,000 for small local educational agencies.[4] With these changes, the proposal would provide about $65 per K-12 student and about $46 per full-time-equivalent community college student.

Adult education. The May Revision rescinds the Governor's proposal to add $300 million for adult education and shift the program to the community colleges. He now proposes $30 million for regional planning grants, in anticipation of a $500 million program expansion in 2015-16.

UC and CSU. Funding proposed for UC and CSU at the May Revision is almost identical to that proposed in January – virtually the only funding changes proposed in the May Revision are decreases to estimated general obligation bond debt service of $1.4 million for UC and $1.3 million for CSU.

UC & CSU Funding at 2013-14 May Revision
(Core funds, in millions)

		2011-12	2012-13	2013-14	change 12-13 to 13-14
UC	General Fund [1/]	$2,504	$2,567	$2,844	$278
	Tuition and Fees [2/]	3,427	3,408	3,460	52
	Other UC Core Funds [3/]	388	441	385	-55
	Lottery	30	37	37	0
	Total UC	$6,349	$6,453	$6,727	$274
CSU [4/]	General Fund [1/]	$2,228	$2,492	$2,808	$316
	Tuition and Fees [2/]	2,568	2,514	2,544	30
	Lottery	42	56	56	0
	Total CSU	$4,838	$5,062	$5,408	$346
	Total	$11,186	$11,515	$12,135	$620

1/ Beginning in 2011-12, includes GO bond debt service (segment-specific amounts not available before 2011-12).
2/ Includes systemwide fees before discounts and waivers, and nonresident tuition.
3/ Includes application fees, interest, and a portion of grant overhead and patent royalty income.
4/ Beginning in 2012-13, includes funding for CSU retired annuitant health care costs from a new budget item. Segment-amounts not available prior to 2012-13.

Source: Legislative Analyst's Office

As the chart above shows, year-over-year General Fund support rises by $278 million for UC and $316 million for CSU. Most of each augmentation ($250 million each) is comprised of the $125 million per segment appropriated in a 2012 budget trailer bill, AB 1502, plus another $125 million per segment included in the Governor's January budget.

While it continues to fund UC and CSU at the January levels, the May Revision withdraws the Governor's January proposal to cap the number of state-subsidized units that students can take, and postpones the development of the specific "performance measures" upon which future UC and CSU funding increases would depend (e.g., decrease time-to-degree, increase graduation rates, freeze current tuition levels, etc.). *Assembly and Senate Republicans strongly believe that a hard tuition freeze should apply for as long as the Proposition 30 tax hikes are in effect,* and have proposed via AB 67 (Gorell)[5] and SB 58 (Cannella)[6] to implement such a freeze.

[4] Several pending bills, including AB 29 (Williams), AB 39 (Skinner), SB 39 (De Leon), and SB 64 (Corbett), would spend Proposition 39 funds differently from the Governor.
[5] http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0051-0100/ab_67_bill_20130107_introduced.pdf
[6] http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0051-0100/sb_58_bill_20130107_introduced.pdf

Health & Human Services

Health

The May Revision updates or revises January proposals in the following key areas: (1) implementation of the Medi-Cal eligibility expansion resulting from the federal Affordable Care Act (ACA), (2) extension of a tax on Medi-Cal managed care plans, and (3) Medi-Cal provider reimbursements. The May Revision also confirms a substantial Medi-Cal deficiency in 2012-13. These changes are discussed in more detail below. The following table summarizes changes in proposed General Fund spending levels and significant changes since January 2013 for the largest health departments.

Summary of Department General Fund Spending						
Dollars in Millions				**2013-14 Proposal Change from January to May**		
	Revised	**January Proposal**	**May Proposal**			
Department	**2012-13**	**2013-14**	**2013-14**	**$**	**%**	**Key Changes Since January**
Health Care Services, Medi-Cal	$ 14,929	$ 15,601	$ 16,072	$ 471	3%	Delayed implementation of rate reductions; delay in Coordinated Care Initiative for "dual eligibles"
Public Health	131	114	114	0	0%	None
MRMIB	166	22	22	0	0%	None
Developmental Services	2,677	2,759	2,812	52	2%	Loss of federal funds due to Sonoma Developmental Center safety violations and due to federal Sequester reductions
State Hospitals	1,351	1,459	1,468	8	1%	More staff proposed
MRMIB - Managed Risk Medical Insurance Board (administers Healthy Families)						

Medi-Cal Health Reform Implementation

The ACA mandated a multifaceted expansion of Medi-Cal eligibility, set to begin January 1, 2014. However, the U.S. Supreme Court ruling in June 2012 effectively made a portion of that expansion optional for states. The May Revision updates cost estimates and proposals for the mandatory and the optional portions of the expansion.

Optional Expansion. The May Revision proposes that the optional ACA expansion for non-disabled, childless adults younger than 65 years of age would be made using a state-based approach. The Governor's Budget had laid out a county-based alternative as well, but the May Revision abandons that option. The Governor previously proposed to exclude long-term care from the benefit package, but the amended proposal would make long-term care available if the federal government agrees to allow Medi-Cal to maintain an asset test for that benefit only. The ACA provides that the federal government will pay 100 percent of Medi-Cal coverage costs for these newly eligible adult enrollees for the first three years, after which the federal share would ratchet gradually down to 90 percent of costs by 2020. The Administration estimates that 635,000 enrollees in this category will join Medi-Cal in 2013-14 at a federal cost of $1.4 billion. According to estimates by the Legislative Analyst's Office, the state's cost could range from $60 million to $257 million General Fund beginning in 2016-17, when the federal share begins to decline, and could exceed $1 billion by 2019-20.

Mandatory Expansion Cost Updated. The mandatory portion of the ACA expansion refers to various eligibility standardization requirements and the mandate that most citizens obtain health coverage. Many individuals who could have enrolled under the old rules are expected to sign up, and the state must pay its usual 50 percent share of their costs. The Administration estimates that 606,000 new enrollees will join Medi-Cal in 2013-14 as part of this expansion. The May Revision updates the estimated state cost for these enrollees to $194 million General Fund, compared to a placeholder amount of $350 million in the January budget. Combined with the optional expansion, the ACA is expected to bring 1.2 million more enrollees to Medi-Cal in 2013-14 alone, contributing substantially to the program's growth. **With a total of 9.1 million average monthly enrollees now projected for 2013-14, Medi-Cal would cover an astounding 24 percent of California's population.**

State Savings from County Health Funds. Counties are currently responsible for providing coverage to indigent adults, and are estimated to spend around $1.5 billion annually from 1991 realignment revenue on health programs. In theory, counties stand to save substantially as indigent adults shift from their programs to the new ACA Medi-Cal coverage. As a result, the May Revision proposes to capture a portion of these county savings for the state. Because of complications associated with directly taking local funds, however, the Administration would achieve savings through a realignment mechanism. The state would shift a portion of its current costs for CalWORKs to counties, who would then pay those costs with newly freed-up local health funds. The May Revision proposes to ramp up the savings over three years: $300 million in 2013-14, $900 million in 2014-15, and $1.3 billion in 2015-16, all of which would be realized in the state's CalWORKs budget. This realignment proposal is discussed in more detail below under the Human Services section (see Page 20).

The Administration states that the specific savings amounts are only placeholder figures and that actual savings would be determined over time, based on how much county health costs decline each year. In concept, this graduated approach recognizes the uncertainty regarding how fast uninsured individuals will sign up for Medi-Cal, but the Administration has yet to release any details of the actual method for determining savings in each county. Thus, there is no way to determine whether counties would be treated fairly.

County Administration Savings Giveaway. Medi-Cal currently reimburses county welfare departments to conduct Medi-Cal eligibility determinations. While the ACA increases the volume of cases that counties process, the new, streamlined Medicaid rules should substantially reduce the costs *per application* for most enrollees. However, the May Revision only recognizes this new, lower cost per application for the 1.2 million new enrollees; it fails to make any adjustment in 2013-14 to the costs for the existing enrollees, whose applications and redeterminations will also be streamlined. The Administration indicates an intent to base future county administration appropriations on a time study of resources, but this would only be implemented in 2015-16, and the May Revision offers no details. Instead, base costs per case are budgeted at 2.3 times the cost of the new enrollees. **Waiting to recognize the lower county administration costs until 2015-16 would result in Medi-Cal squandering hundreds of millions of General Fund dollars over the next two years.**

Managed Care Tax Revision

The May Revision updates the proposed tax on Medi-Cal managed care organizations (MCOs). The previous MCO tax, implemented as a gross premiums tax of 2.35 percent, expired June 30, 2012. The May Revision proposes to extend that tax for one year retroactively for 2012-13 and then replace it in 2013-14 with a new, permanent sales tax on Medi-Cal managed care plans. The 2012-13 gross premiums tax would provide $128 million in General Fund savings to offset the current year Healthy Families Program deficiency (the rest of the funds would be returned to managed care plans in the form of higher Medi-Cal rates). The new sales tax, which effectively would apply a state sales tax rate of 3.94 percent to Medi-Cal managed care plans, would provide General Fund savings of $305 million (with the remaining funds returned again to managed care plans through higher Medi-Cal rates).

Regardless of the change in the form of the tax from a gross premiums tax to a sales tax, the original impetus for the tax in 2009 was a temporary means to sustain the Healthy Families Program. The May Revision makes no changes to the current process of eliminating Healthy Families and shifting its kids to Medi-Cal, despite continuing concerns about the lack of access to physicians and to behavioral services. Furthermore, the sales tax would be permanent, and could potentially open the door to additional increases in the future. Unlike the gross premiums tax, which is constitutionally fixed at 2.35 percent, the sales tax can change. Health plans that participate are walking a very slippery slope, and Republicans should continue to oppose this tax based on these concerns.

Medi-Cal Provider Rates

The May Revision updates and revises various Medi-Cal provider reimbursement issues, including:

- *Hospital Quality Assurance Fee (QAF).* The May Revision continues to assume new savings of $310 million General Fund in 2013-14 from revising the QAF and extending it for three years starting January 1, 2014. This amount would be in addition to $310 million in savings already assumed for the first six months of the budget year, bringing the total savings for 2013-14 to $620 million. Although the savings would be recognized in the budget, a policy vehicle currently in the legislative process (SB 239, Hernandez) would actually implement this extension. **Some hospitals have expressed concerns that the Administration would retain too large a share of the proceeds under the Governor's proposal.**
- *10 Percent Rate Reductions.* The May Revision recognizes the continuing legal delay in implementing the 10 percent rate reductions that were originally authorized as part of the 2011-12 budget. This delay increased costs by over $500 million General Fund in 2012-13. The Administration now assumes it will prevail in court in August 2013 and begin implementing the reductions in September 2013. However, the Administration has decided to exclude free-standing pediatric subacute care providers and certain audiology services from the reductions, based on concerns about access to care for those services. Two policy bills currently in the legislative process would reverse these reductions, either in whole (SB 640, Lara) or only for distinct-part nursing facilities (SB 646, Nielsen).
- *District Hospital Reimbursement.* The 2012-13 budget authorized the state to shift "non-designated public hospitals" (primarily district hospitals) to a "certified public expenditure" reimbursement mechanism that was expected to generate $94 million in General Fund savings annually, while making additional federal funds available to district hospitals at the same time. The May Revision indicates that the federal government has not yet approved or denied this method, but abandons this policy anyway, resulting in a loss of the savings. The budget would instead leave these hospitals on their current payment methodology until January 1, 2014, when they would shift to the new Diagnosis-Related Group (DRG) system that Medi-Cal is also adopting for private hospitals. Some district hospitals have raised the concern that this approach foregoes needed federal funds and would shift them too quickly to the DRG approach.

Medi-Cal Deficiency

The January Governor's budget indicated that a current year deficiency was possible, and the May Revision confirms **a shortfall of $483 million General Fund** for Medi-Cal. While numerous factors helped produce this shortfall, the single largest contributor is the delayed implementation of provider rate reductions due to court injunctions, as discussed above. The Administration indicates it will seek a supplemental appropriations bill to fund this deficiency.

Human Services

The movement from welfare checks to paychecks continues its decline as the Governor's May Revision continues to encourage a reliance on government entitlements within the state's human services programs, increasing net expenditures nearly $600 million General Fund above the Budget Act of 2012 (from $6.9 billion General Fund in the Budget Act of 2012 to $7.5 billion General Fund proposed for 2013-14). The May Revision budget continues to include a number of program restorations and new spending as proposed in the Governor's January Budget, and goes even further, increasing General Fund costs with new spending in CalWORKs and the In-Home Supportive Services (IHSS) program.

Continued Restorations and New Spending from Governor's 2013-14 Budget

- **Fully Restored County Administration Funding.** $359 million increase in CalWORKs employment services and child care funding, increasing county funding for administration of the program, effectively restoring the $375 million reduction included in the Budget Act of 2012.

- **Generous New Money for Services.** $143 million increase to support CalWORKs refocusing efforts through employment services and expanded job development activities, as well as intensifying case management for non-participating recipients. In addition, the January Budget included $98 million to reengage previously exempt CalWORKs adults, providing job search and child care support.

- **State Assumes Cost of Fastest Growing Program.** $47.1 million in new General Fund spending in 2013-14 as a result of creating a new county maintenance of effort (MOE) spending level within the IHSS program that exempts counties from sharing cost increases.

Additional Spending Proposed in 2013-14 May Revision

- **More Money for CalWORKs Services.** The May Revision includes $48.3 million General Fund for implementation of a new appraisal protocol intended to identify barrier removal activities such as domestic violence, substance abuse, and mental health services, investment in family stabilization such as housing stability, and an enhanced subsidized employment program (net funding of $28.1 million for 8,250 slots per month by June 2014). The funding proposed is **partial year funding** and the Governor proposes to determine the appropriate level of ongoing resources needed in the 2014-15 Budget. This new policy could easily increase costs in the **hundreds of millions of dollars** upon full implementation. Yet another example of the state's expanding entitlement programs without regard to cost.

- **Even More IHSS Maintenance of Effort Costs.** The May Revision includes $30 million General Fund in 2012-13 and $29.4 million in 2013-14 for even higher costs as a result of the IHSS county MOE, which shifts program costs exceeding the county MOE requirement to the state General Fund. Counties now have even less incentive to maintain program integrity as they will not share in any future cost increases.

- **Program Integrity Efforts Fail - Health Care Certificate Savings Erode.** The May Revision includes an increase of $95 million General Fund in 2013-14 to reflect significantly eroded savings related to the IHSS health care certification requirement. The 2011-12 Budget included savings of $67.4 million General Fund as a result of a requirement that all IHSS applicants and recipients have a certification of need from a licensed health care professional prior to receipt of services. The Governor's January Budget increased the savings projection to $97 million, but now the May Revision includes savings of only $2 million annually. Clearly the effort to ensure recipients are truly in need has failed due to use of "licensed health care professional" in lieu of “physician” in statute, a the loose definition that **allows acupuncturists, psychiatrists, and dental assistants to authorize an IHSS recipient’s need** for home health care services.

IHSS Settlement Unwinds Reductions, $260 million in Lost Savings. In March 2013, the Administration reached a settlement agreement resolving outstanding lawsuits over cost saving measures, an agreement which **results in $260 million in higher costs within the state IHSS program.** The agreement repeals provisions related to three budget reductions, a 20 percent reduction in hours, reduced participation in wages, and more restrictive eligibility criteria (which had projected savings of $436 million if all three reductions were implemented), and replaces them with an eight percent reduction in hours, effective July 1, 2013 thru June 30, 2014 (projected savings of $176 million). Additionally, beginning July 1, 2014, a seven percent reduction in hours would be implemented (savings of $159 million General Fund) and could be triggered off, in whole or in part, by an “assessment” on home care services, including IHSS, which results in enhanced federal funding for IHSS. Should the state actually get federal approval for a provider tax or “assessment”, the program would return to the status quo, no reductions, increasing costs and caseload, continuing its trend as one of the state’s fastest growing programs.

Federal Overtime Regulations Result in Major General Fund Cost Pressure. In addition to the lost savings from the settlement agreement noted above, proposed federal regulations would now require the state to pay overtime rates in the IHSS program, resulting in significant cost pressure on the state General Fund. In a recent Senate Full Budget and Fiscal Review Committee, when asked what the Administration’s plan was for dealing with the federal regulations and what the potential cost would be to the state, the Governor’s Department of Finance responded that there was no plan to address the issue and state costs could increase by at least $200 million to $300 million. The Administration now indicates trailer bill language will be forthcoming that would minimize the state’s fiscal risk as well as minimize future IHSS program impacts associated with a change in federal overtime regulations, but details of the proposed policy changes are unknown at this time.

Health Care Reform and the CalWORKs Program. As a way to minimize state costs for health care reform and share the risk with counties, the May Revision proposes that counties take on more financial responsibility for certain human services programs. The May Revision proposed to withhold $300 million in 2013-14, $900 million in 2014-15, and $1.3 billion in 2015-16 from county realignment health funds, as a way to allow the state to offset increased health care costs. The shift would be fiscal in nature for the first year, but would progress to a programmatic realigning of duties and oversight to counties in the CalWORKs program and CalWORKs-related child care over time. Counties would play an expanded role in directing the provision of services in these programs, though eligibility, grant levels and rates would continue to be set by the state. Counties would be able to reinvest caseload savings and revenue growth in the programs.

CalFresh administration could also be part of the shift, but on a fiscal basis only since no additional administrative duties are proposed to be shifted. The proposal would also give counties protection from “above average costs” resulting from economic downturns or policy changes outside the counties’ control. It is unknown exactly what would constitute an “economic downturn” however, leaving the state vulnerable and financially on the hook for additional program cost increases in subsequent years.

Additionally, the May Revision mentions the possibility that the state would take full fiscal responsibility for IHSS over time, with additional programmatic or fiscal realignment shifts likely to offset the IHSS cost reduction to counties. There is no detail provided, but currently, the state is responsible for all costs incurred by counties above the MOE negotiated last year as part of the budget agreement to shift collective bargaining to the state.

Public Safety

Community Corrections Performance Incentive Grants. The May Revision includes an increase of $72.1 million General Fund for grants to county probation departments pursuant to the California Community Corrections Performance Incentives Act of 2009 (SB 678). Grants are awarded to county probation departments that successfully reduce the number of adult felony probationers they send to state prison for violating probation or committing new crimes. Republicans have generally supported this performance-based concept to improve the success of the probation system. The May Revision adjusts the funding formula, which shares state savings from reduced incarceration with counties, to account for the effects of realignment on the felony probation population.

Restoration of Fire Camp Funding. The Governor's January budget reflected a reduction of $15.4 million General Fund to the Department of Corrections and Rehabilitation's (CDCR) fire camp program based on a projected average daily population (ADP) decrease of about 1,300 fire camp-eligible inmates – the result of realignment shifting many low-level offenders to counties. CDCR's updated projections now suggest no decrease in the ADP of fire camp-eligible inmates. Thus, the May Revision proposes the restoration of $15.4 million to CDCR's fire camp budget.

According to the Administration, the change in the fire camp ADP projection is attributable to two developments. In 2011-12, CDCR revised its Inmate Classification Score System (ICSS). As a result, some inmates who were near the margins between housing security levels were moved down a level or more, making some former Level III and Level IV inmates who were not fire camp-eligible into Level I or Level II inmates who are eligible. In addition, CDCR indicates that new felony prison admissions have been higher than expected, which has also expanded the fire camp-eligible ADP.

Budget Benefits. Having fire camp inmates available for work crews generally results in savings from three sources. First, the Department of Forestry and Fire Protection (CAL FIRE) can save about $9,900 per day, per 15-person fire crew, by using inmate labor instead of hiring a non-inmate crew. Second, CDCR saves the costs of housing those inmates in a prison facility, which are about $28 per inmate, per day. Third, because fire camp inmates earn two-for-one credits, CDCR also has savings associated with reduced prison terms. A rough estimate suggests that having 1,300 additional inmates in fire camps each year should result in General Fund savings of about $14.3 million to $34.2 million annually, depending on the extent to which CAL FIRE is able to use inmate crews to avoid hiring non-inmate crews. To the extent that CAL FIRE makes even minimal use of the additional inmate fire crews, the savings should more than offset the $15.4 million cost to restore fire camp capacity. Moreover, if camps were shut down as proposed in January, approximately 1,300 inmates would return to prison facilities, further hampering the Administration's ability to comply with the federal court's prison population cap.

Public Safety Risks. While the benefits in terms of costs and prison capacity seem clear, this proposal could also put the safety of CDCR and CAL FIRE employees, as well as the public, in jeopardy. The effects of the recent revisions to the ICSS are not yet fully known for traditional prison facilities, let alone for camps that lack secure perimeters. The bottom line is that some former Level III and Level IV inmates who were never eligible for fire camp assignments will now be housed in camps. Before the ICSS modifications, these inmates were considered dangerous. Nothing has changed except some arbitrary shifts in classification score cutoff points. Rather than letting the proven classification system determine the security risk of the inmate and thus, where he or she should be housed, it appears CDCR may have adjusted its classification system to artificially align its offender population with the types of housing and work assignments available. Whether housing these types of offenders in camps will result in assaults on CDCR or CAL FIRE employees, or even increased escapes, remains to be seen.

Transportation

Zero-Based Budgeting = Zero Savings. In December 2011 Governor Brown issued Executive Order B-13-11 directing the Department of Finance to incorporate common sense program-evaluation methods, including zero-based budgeting, into the budget process in order to fund programs based on their necessity and effectiveness. The goal is to cut costs and increase efficiency by looking at programs from top to bottom, rather than only considering incremental changes.

The May Revision includes two zero-based budgeting proposals for the California Department of Transportation (Caltrans). While the zero-based budgeting process is intended to cut state spending and increase operational efficiency, the proposals submitted by Caltrans redirect savings, grow programs, and increase overall state spending. In fact, the chart below shows that Caltrans turned $19.3 million in efficiency reductions into net additional expenditures of $4.4 million.

Caltrans Zero-Based Budget Proposals
(Dollars in Millions)

Caltrans Program	Efficiency Savings	Position Changes	Redirected Funding	New Funding	Net Fiscal Impact
Equipment Program	$12.8	-41	$10.3	-	-$2.5
Stormwater Program	$2.1	25	$2.1	-	-
Planning Program[1/]	$2.9	10	$2.1	$9.2	$8.4
Local Assistance Program[1/]	$1.5	-23 but converted 26 LT to Permanent	-	-	-$1.5

[1] 2013-14 Governor's Budget Proposal

Where does the money go?

- $10 million to purchase new vehicles and mobile construction equipment to replace vehicles and equipment in the fleet considered to be "old" or "aging."
- $250,000 for a cost analysis study of vehicle and mobile construction equipment, conducted while the $10 million is being spent to purchase new vehicles and equipment. This analysis is supposed to help determine if Caltrans should purchase ready to use equipment or continue to manufacture equipment by adding components to purchased cab and chassis. This study would also evaluate replacement vs. repair standards.
- $6.3 million to fund existing positions in the Project Initiation Documents (PIDs) Program, which conducts preliminary studies on cost, scope, and schedule prior to a project being programmed and funded. It is unclear how the program developed this funding shortfall for existing positions.
- $5.0 million to support new workload in the PIDs Program; however, Caltrans is unable to provide data to support the workload assumptions.
- $2.1 million to implement new stormwater pollution discharge standards effective July 1, 2013.

While the goal of zero-based budgeting is to reduce state spending through efficiencies, Caltrans and the Administration have used the process to redirect potential savings, grow programs, and increase overall state spending. The Administration must have an alternative definition of "fiscally prudent" when it comes to Caltrans proposals.

Resources, Environmental Protection & Energy

Adding to the Wall of Debt, Cap-and-Trade Fees. The Governor's May Revise proposes to loan $500 million in Cap-and-Trade fee revenues to the General Fund with no repayment date identified. Initially, the Governor's January Budget proposed $400 million (2013-14) and $200 million (2012-13) in expenditure authority to backfill existing General Fund programs ($500 million) and create new AB 32 programs ($100 million) from anticipated Cap-and-Trade revenues. So far, two Cap-and-Trade auctions have generated $139.2 million for state programs and $373.3 million for investor owned and publically owned utilities to be used as credits/benefits to ratepayers. A third auction took place on May 16, 2013 however, the revenue results are unknown at this time. Although the Governor has provided an investment plan to the Legislature pursuant to AB 1532 (John A. Perez) of 2012 that identifies broad state priorities, there are no details on future program expenditures. The Governor's proposal also deletes Budget Control Section 15.11 that would have required the Department of Finance to notify the Joint Legislative Budget Committee no fewer than 60 days prior to the expenditure of revenues to backfill existing General Fund programs. ***The Governor's proposal suggests that existing programs meeting greenhouse gas mitigation requirements don't exist.***

The Legislative Analyst's Office (LAO) had indicated in its document entitled, *2012-13 Budget: Cap-and-Trade Auction Revenues*, only about $100 million in existing programs could potentially meet the legal requirements of these fee revenues. The LAO has received a Legislative Counsel opinion indicating that the revenues generated from the Cap-and-Trade auctions would constitute "mitigation fee" revenues and be subjected to the so-called "Sinclair nexus test." This test requires that a clear nexus must exist between an activity for which a mitigation fee is used and the adverse effects related to the activity on which that fee is levied. The Administration may be biding its time while trying to find legal opinions to justify the use of these monies for its favorite programs, such as, High Speed Rail or it may just need to fill a budget hole this year. Either way, the Administration has been unable or unwilling to identify new or existing programs that would be funded with these revenues.

Once the third auction's revenue results are known, there will be greater insight into program revenues. Additional auctions are also planned for the 2013-14 fiscal year.

AB 32, Cost of Implementation (COI) Fee Increases. At the same time the Governor is proposing to borrow Cap-and-Trade revenues, he is also proposing to increase the AB 32 COI fee on businesses by $1.9 million to fund oversight of the Cap-and-Trade program and to identify disadvantaged communities eligible for the Cap-and-Trade program funding pursuant to SB 535 (De Leon) of 2012. These administrative activities could be funded from Cap-and-Trade proceeds but the Governor has chosen to transfer the entire $139.2 million in existing revenues and $360.8 million in future revenues to the General Fund. With these two proposals, the total annual AB 32 COI fee would increase to $41.5 million. In addition, there is a loan repayment of $8 million plus interest to the Beverage Container Recycling Fund in 2013-14 to be made from the COI fee. This will be the last remaining loan repayment. Given that all of the Cap-and-Trade fee revenues are just being loaned to the General Fund, it seems that this COI fee is little more than a General Fund tax.

Employee Compensation

Budget at Risk as Bargaining Agreements Expire. The May Revision continues to include $507 million ($250.5 million General Fund) for employee compensation and health benefit costs in 2013-14, costs generated as part of the current bargaining agreements. What the May Revision doesn't include, however, is additional funding for the soon-to-expire bargaining agreements, putting the "balanced budget" at risk by potentially hundreds of millions of dollars. Of the 21 bargaining units, 19 will be expired by July 2, 2013, with two expiring in future years (Bargaining Unit 5- California Highway Patrol expiring July 3, 2018 and Bargaining Unit 8- Firefighters expiring July 1, 2017).

It is difficult to imagine that the public employee unions, financially supportive of the Governor's Proposition 30 last fall, will be happy with anything less than a significant increase in salary and benefits over the next few years. News outlets have reported that Service Employees International Union Local 1000's (SEIU) initial request at the bargaining table is for a $2,500 bonus for each employee in 2013, and seven and nine percent salary increases in 2014 and 2015 respectively. Local 1000 gave $1.2 million to Brown's Proposition 30 last fall.

Additionally, health premiums continue to rise, with average increases of six percent a year for the past five years, and these costs are automatically adjusted every year for most of the bargaining units (of the $250 million General Fund increase proposed for 2013-14, about $28 million General Fund is for health premium increases). In addition to the ever-rising health care costs, a one percent increase in salary generally costs the state about $100 million General Fund, with this projection being an average of all bargaining units.

Republicans continue to be concerned that voters who supported Proposition 30 did not contemplate the new income and sales tax increase being used to reward public employee unions. However, it looks like that is exactly what will happen as new contracts are agreed to in the next month.

Still No Proposal to Deal with CalSTRS' Looming Fiscal Liability. One major liability still ignored in the May Revision and not included in the Governor's Wall of Debt is the unfunded pension liability of CalSTRS, recently estimated at $70 billion. In a recently released report, the Legislative Analyst's Office indicates that CalSTRS needs roughly $4.5 billion more in contributions annually to meet all of its pension obligations. Unlike CalPERS, CalSTRS does not set contribution levels, those levels are set in statute and would need a legislative change in order to increase the rates. This looming multi-billion debt will need to be addressed, sooner rather than later, and when that happens, the question will be, "What critical state services will suffer as a result of redirecting Proposition 30 revenues towards the unfunded pension obligations of CalSTRS?"

Realignment

Shrinking Revenues Hurt Local Law Enforcement. Due to the effects of the recent Proposition 30 income tax and federal payroll tax increases and the resulting anemic economic recovery, Sales and Use Tax (SUT) revenue projections are down significantly. This has a negative impact on the revenues provided to local government to implement the 2011 Public Safety Realignment (realignment). The May Revision reflects reduced funding available to local governments by about $122 million in 2012-13 and $111 million in 2013-14 relative to January projections. This translates into a reduction in the funding for local sheriffs and probation departments to manage realigned offender populations of about $32 million in 2012-13 and $7.3 million in 2013-14.

This unfortunate bit of economic news comes at a time when county sheriffs and probation departments across the state are feeling the full impact of realignment. Many local officials have raised concerns that the funding the state provides to local governments to implement realignment is grossly inadequate. For the past several months, individual sheriffs and chiefs of probation have been focused on maximizing their respective shares of $77 million in 2012-13 growth funding that was identified in the Governor's Budget. Due to the SUT revenue picture described above, that $77 million is now $45 million.

Funding Solution Identified. Meanwhile, SB 144 (Cannella), a common-sense measure that is supported by the entire Senate Republican Caucus, would have redirected about $900 million per year in savings that the state is currently pocketing as a direct result of realignment, making it available to local agencies to manage realigned offender populations by providing treatment, job training, and other rehabilitative programming, or by expanding front-line law enforcement services and jail capacity. SB 144 died in the Senate Committee on Budget and Fiscal Review, where legislative Democrats voted it down on a straight party-line vote.

Prisoner Swap Proposal Acknowledges Problems. Since 2011, when realignment was imposed on the people of California by the Governor and legislative Democrats, proponents have been reluctant to acknowledge any problems with the policy, and even more reluctant to take any corrective actions. To the Governor's credit, the May Revision finally acknowledges one major flaw in the realignment program – that jails are ill-equipped to handle the longer-term prisoners they are now receiving – and includes a proposal intended to help address that issue. The proposal would make statutory changes allowing counties to house offenders sentenced to long jail terms in state prison facilities if they agree to accept an equivalent average daily population of short-term offenders. Before a long-term offender could be exchanged for a shorter-term one, he or she would be required to serve the first three years of his or her sentence in a county jail. While it is not clear exactly what benefit counties would derive from a net-zero population exchange, or whether counties might end up with more dangerous and violent inmates, this proposal is a sign that the Governor realizes the current realignment has serious flaws and that there may be hope for addressing some of the more serious problems.

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