Highlights and Analysis of the Governor's 2014-15 Budget

January 17, 2014
SENATE REPUBLICAN FISCAL OFFICE

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CALIFORNIA Senate Republican Caucus

Budget Briefs

SENATE REPUBLICAN FISCAL OFFICE

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January 17, 2014

Executive Summary

State Spending Achieves New Record High. The 2014-15 Governor's Budget continues to hit new record spending levels with both total state spending ($240 billion) and General Fund spending ($106.8 billion). General Fund spending is $10.5 billion higher than the current budget act level, but despite the massive spending increase proposed by the Governor, legislative Democrats and their special interest allies have indicated a desire to spend several billion more than the Governor. **Those additional spending demands will impair our ability to pay off the state's immense debt and unfunded liabilities, and will put the burden on future generations of Californians. Our children deserve better.**

Governor Embraces Republican Values – Let's Hope He Means It. The good news is that the Governor has generally adopted many of the same core values that Republicans have been advocating for years - *spending restraint, paying off state debts, and building a prudent budget reserve*. It is also important to note that local schools will benefit from the state's new revenues since the budget provides an increase of more than $6 billion to K-14 education for 2014-15, assuming legislative Democrats keep the promises made to the voters when they campaigned for Proposition 30 and do not divert these taxes from schools to other purposes.

Budgets Are About Priorities. Republicans were early and strong supporters of the Governor's new local control funding formula based on its focus on increased local control and flexibility. Maintaining this flexibility and keeping the promise to fully fund education programs continue to be top priorities, along with providing adequate funding to local governments to manage more than 100,000 criminals that the state made their responsibility under the 2011 state-local realignment. Republicans remain concerned that the Governor hasn't done enough to protect our neighborhoods from increasing crime.

State Debts and Liabilities Keep Growing. The Governor should be commended for focusing on the massive $355 billion wall of state debt and liabilities. This budget proposes to pay off $11 billion, which is a very good start. However, we must fund pension and health care commitments for teachers and other retirees. Money also must be set aside to repair and rebuild California's aging roads, schools, parks, court buildings, and local jails. **There is no "budget surplus" for new state spending while these unfunded liabilities exist.**

No Such Thing as Temporary Taxes. Both the Legislative Analyst's Office and the Department of Finance have indicated that there will likely be large "operating surpluses" for the foreseeable future. However, both fiscal agencies have also warned that there are many budgetary threats and that another economic recession is a serious concern. Nonetheless, it has become clear that the Proposition 30 (2012) tax increases were not necessary to protect K-14 education programs, so the

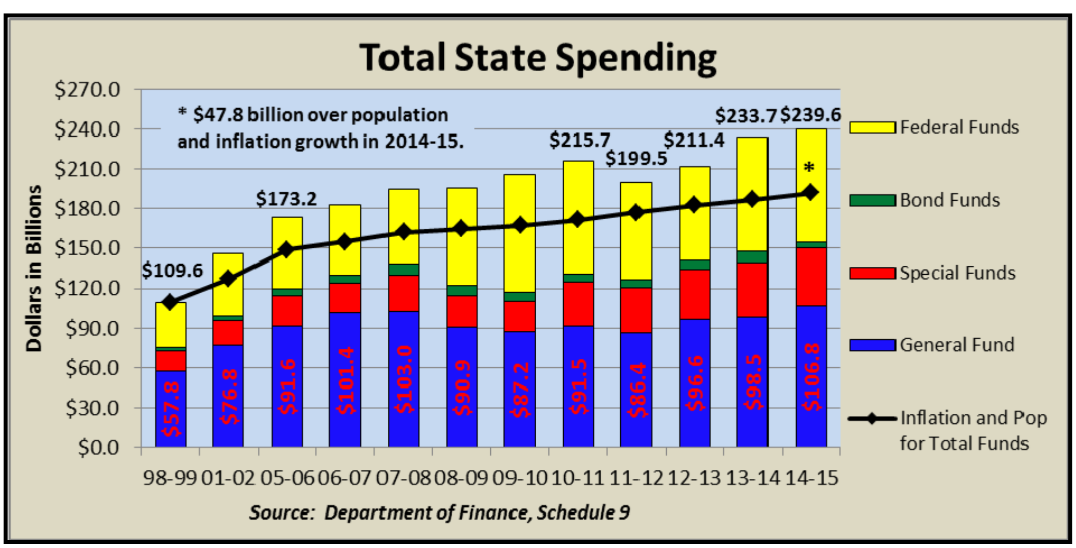
Governor has shifted his stance by focusing on long term debt as a continuing justification for the taxes. At the same time, some leading Democrats, such as the Superintendent of Public Instruction, are already calling for those tax increases to continue beyond their expiration in 2018 to sustain new state program spending, support public employee salary and benefit increases, and fund state retiree pension liabilities. **It is important that the Governor keep his promise that the Proposition 30 tax increases truly will be temporary.**

Will The Real Rainy Day Fund Please Stand Up. In yet another acknowledgment of Republican influence, the Governor has outlined his concept for a new constitutional "rainy day fund" to put away money to alleviate the inevitable future economic downturn (*see Governor's Rainy Day Reserve on Page 7*). However a better and stronger rainy day fund already exists: ACA 4 was approved by both parties in 2010 and scheduled for the 2012 ballot, but legislative Democrats moved it to the 2014 ballot to delay a vote of the people. Now, Democrats want to change it because they fear it will work. This new reserve proposal is less effective than the original. **The Governor and legislative Democrats should honor the agreement to let the people of California vote on ACA 4 – it's simply the right thing to do.**

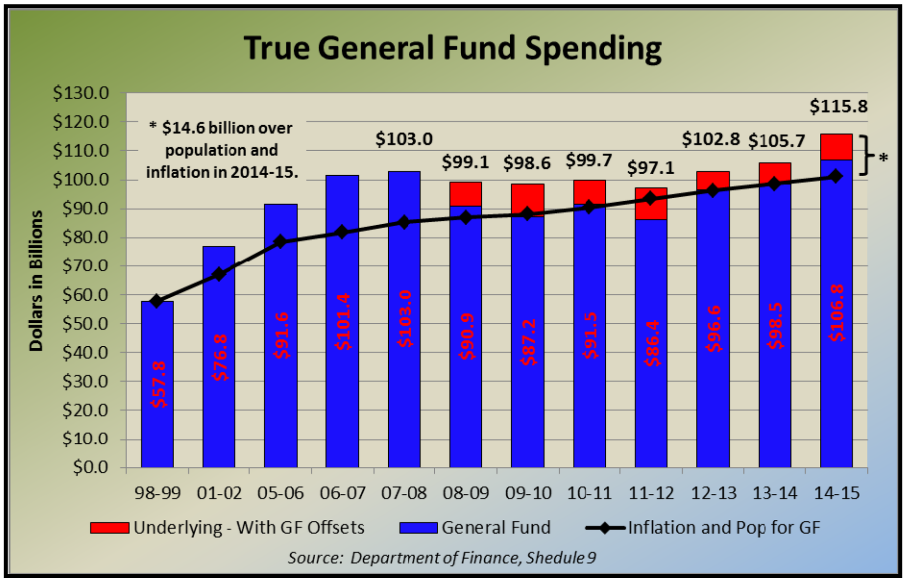
The Real Challenge. The Governor's greatest challenge will be managing the spending desires of his fellow Democrats in the Capitol. Since the Democrats are clearly the ruling party, controlling every statewide elected office and both legislative houses with a supermajority, Republicans cannot stop them from repeating the mistakes of the past. However, Republicans will continue to hold them publicly accountable for their actions and maintain a focus on protecting Californians from future budget crises. We will ensure that state programs are operated with integrity and efficiency, and we will maintain pressure to improve California's economy so that all Californians have the job opportunities they want as opposed to the ruling party's plan to simply channel them into a government program that doesn't truly help.

Key Charts

Total State Spending Hits New Record Level. General Fund spending is only a part of total state spending. Special funds, bond funds, and federal funds bring total state spending for 2014-15 to about $239.6 billion. Despite the great recession and Democrats' claims of "cutting to the bone" in recent years, **total state spending reaches new record highs in 2014-15**. Also, total expenditures per $100 of personal income in 2014-15 ($8.17) are now *higher* than historic averages ($8.12 over 20 years/$8.07 over 30 years).

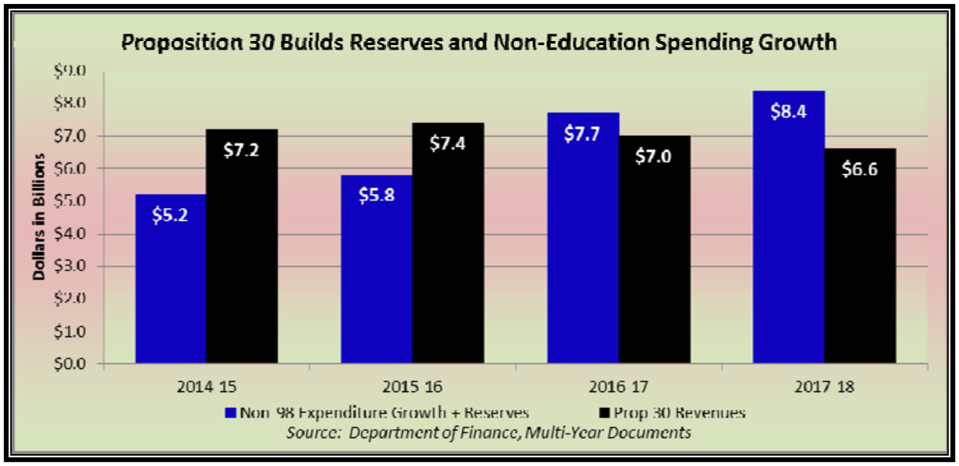


True General Fund Program Spending. Over the past seven years, legislative Democrats frequently claimed that state spending had been slashed by $40 billion or more, and General Fund spending was consistently below its peak of $103 billion in 2007-08. In fact, *true General Fund program spending*, which includes fund shifts, transfers, and various General Fund offsets remained within five percent of 2007-08 spending. Also, now that General Fund revenues have rebounded, **General Fund spending has increased to $106.8 billion in 2014-15 ($3.8 billion more than 2007-08), and true General Fund program spending has increased to $115.8 billion in 2014-15, which is $12.8 billion higher than the previous peak General Fund spending level.**



The 2014-15 Governor's Budget includes $9.0 billion in spending from other sources for General Fund programs, with the $6.8 billion "Realignment," $2.1 billion of Medi-Cal and health care related cost shifts, and $1.1 billion from transportation weight fees to fund debt service accounting for most of General Fund program backfill.

Proposition 30 Revenues Used to Build Reserves and Non-Education Spending Growth. The chart below demonstrates that the Proposition 30 (2012) tax increases are not necessary to protect education spending. Cumulatively, Proposition 30 taxes are expected to provide $28.2 billion of additional revenue over the next four years, but $27.1 billion (96 percent) will be spent on state programs unrelated to Proposition 98 (K-14) education and to build the general budget reserve. Also, it is a little known fact that **state law provides for a ¼ cent reduction in the sales and use tax rate** when specified General Fund reserves reach four percent of General Fund revenues, but this budget plan avoids executing this tax reduction.



Proposition 30 Promises to Students Not Kept. In 2012, California voters signaled their willingness to prioritize education when they agreed via Proposition 30 to pay higher taxes to benefit education. However, actual K-14 Proposition 98 funding in 2014-15 will include only about 40 percent ($2.9 billion) of the almost $7.2 billion in tax revenue generated by Proposition 30 - *education will not get the full benefit of those tax hikes, as voters were led to believe.* As shown 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 over $4 billion higher in 2014-15 than provided in the Governor's proposed budget.

Budget Uses Proposition 30 Revenue for Non-Education Programs

	2014-15
Minimum Prop 98 guarantee with no Prop 30 revenue	**$58.681**
Proposition 30 revenue	**$7.167**
Minimum Prop 98 guarantee plus all Prop 30 revenue	**$65.848**
Prop 98 funding included in final budget	**$61.559**
Prop 30 revenue used for non-education programs	**$4.289**

Instead of targeting all of the Proposition 30 revenue toward education, the Governor's Budget uses most of it for other priorities: increased pension contributions and salary and benefit increases for state employees ($457 million), increased debt service ($416 million), new health and human services program spending ($460 million), corrections spending ($200 million), and supplemental debt repayment and rainy day reserves ($3.2 billion). *The promise of Proposition 30 continues to be broken (see Proposition 30 Promises Not Kept on Page 13).*

Governor's Rainy Day Reserve

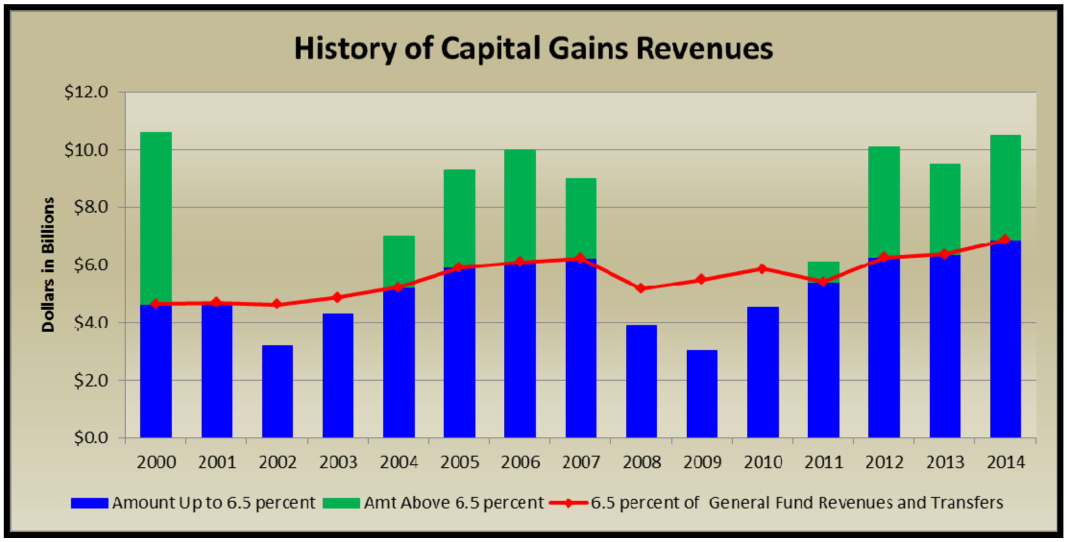
California state revenues and spending have typically followed boom-or-bust cycles. Sharp increases in state spending during good years create the need for substantial budget cuts and/or tax increases during the inevitable down years. Proposition 30, approved by the voters in 2012, exacerbated the state's revenue volatility by relying even more heavily on contributions from a small pool of high-income taxpayers, whose earnings tend to fluctuate more from year to year. Enacting sensible spending management tools are all the more critical as legislative Democrats push to spend the most recent revenue boom.

Constitutional Amendment Currently Set for Ballot. As part of the 2010-11 budget negotiations, Democrats agreed to place a spending limit before the voters on the 2012 primary ballot in the form of Assembly Constitutional Amendment 4 (ACA 4; Chapter 174, Statutes of 2010). However, the next year Democrats unilaterally passed legislation (SB 202, Hancock) to delay a ballot vote on ACA 4 until November 2014. Now, legislative Democrat leaders and the Governor are seeking to further undermine the agreement made in 2010 by replacing ACA 4 and the current reserve (Proposition 58) with a Rainy Day Fund (RDF) proposal that lacks a spending limit and may not effectively address the boom-and-bust cycle.

ACA 4 vs. Governor's Proposal. The Governor's Budget lays out several high-level points for the RDF proposal, but does not provide details for how it would work. The table below summarizes these high-level points as available to date and compares them to ACA 4.

	Governor's Rainy Day Proposal	**ACA 4 (Ch. 174/2010)**
Spending Limit	None	Limits GF spending to a twenty-year revenue trend
Reserve Requirement	General reserve up to a maximum of 10 percent of GF revenue; Separate Proposition 98 reserve up to 10 percent of Prop 98 obligation	General reserve up to 10 percent of GF revenue, plus a supplemental reserve for paying down bond debt or funding one-time infrastructure projects
Deposits to Reserve	Capital gains revenue that exceed 6.5 percent of total GF revenues	3 percent of GF revenues, plus GF revenues that exceed a moving twenty-year trend.
Debt Retirement	In lieu of a year's deposit, allows supplemental payments to Wall of Debt or other long-term liabilities	Maintains existing requirement to limit half of reserve to recovery bonds, up to $5 billion. Creates new supplemental reserve for bonds or infrastructure projects. Limits some excess revenue to paying down other obligations.
Proposition 98 Education Budget	May reduce programmatic spending for schools, compared with current law, by shifting funds to Prop 98 reserve	Fully funds Prop 98 without programmatic reductions

Capital Gains Highly Volatile. Over the past 14 years, capital gains revenues have contributed between $3.0 billion and $10.6 billion to total General Fund revenues. The following chart demonstrates the volatility of capital gains revenues over that time compared to the 6.5 percent threshold proposed by the Governor and legislative Democrats.



Source: Governor's Budget Summary

As shown in the chart, the sum of the green bar plus the blue bar equals the total amount of capital gains tax revenues generated that year. The red line reflects the point at which capital gains taxes would equal 6.5 percent of total General Fund revenues and transfers. The green bar thus indicates the amount of revenues that would be redirected to the Governor's proposed new RDF in any year, prior to considering whether the RDF had already reached its maximum level. However, since the details of the Governor's proposal are not available at this time, the actual amounts that would have been deposited to the RDF cannot be determined. Nonetheless, the chart shows that deposits would not have been made to the RDF in six of the 15 years shown, even if there had been room under the reserve cap.

Governor's Proposal Falls Short. ACA 4 includes an actual spending limit that would apply to all General Fund expenditures. The RDF proposal, however, would fall short in several ways, including:

- Allow unlimited spending of any General Fund apart from capital gains. **Thus, any tax increase legislative Democrats enact for personal income, sales, corporate, or other taxes could be spent without restraint.**
- May provide an "escape hatch" to use capital gains revenue for regularly scheduled debt payments, such as lease-revenue or general obligation bonds, which in turn would free up General Fund resources for new spending. This could eviscerate the reserve while maintaining the appearance of restraint.
- Reduce programmatic spending for schools, compared with current law, by shifting funds to a Proposition 98 reserve.

Democrats appear intent on removing the opportunity for the people of California to vote on an actual spending limit because they are worried that it will pass and that it will work. The Governor's RDF proposal leaves legislative Democrats with the ability to continue spending the vast majority of General Fund revenues on their interests with only limited restrictions. Republicans should hold the Governor and legislative Democrat leadership to the 2010 agreement on ACA 4, and let the people vote on a true spending limit.

Expenditures

The 2014-15 Governor's Budget includes revised General Fund expenditures of $98.5 billion in 2013-14 and projected General Fund expenditures of $106.8 billion in 2014-15. As shown in the table below, since the 2013-14 Budget Act was signed, spending in the current year has increased by nearly $2.2 billion, and the Governor has proposed to spend an additional $10.5 billion in 2014-15 (above the 2013-14 Budget Act spending level). As a result, while the following table reflects a year-over-year spending increase of $8.3 billion, the true spending increase is $12.7 billion over the 2013-14 Budget Act.

General Fund Expenditures by Agency

(Dollars in Millions)

Agency	Budget Act 2013-14	Governor's Budget Revised 2013-14	Governor's Budget Proposed 2014-15	Year over Year Change
Legislative, Judicial, Executive	$2,778	$2,694	$2,844	$150
Business, Consumer Services, Housing	$646	$646	$745	$99
Transportation	$206	$151	$212	$61
Natural Resources	$2,124	$2,127	$2,175	$48
Environmental Protection	$46	$47	$54	$7
Health and Human Services	$28,084	$28,330	$28,793	$463
Corrections and Rehabilitation	$8,911	$9,361	$9,560	$199
K-12 Education	$39,661	$41,333	$45,251	$3,918
Higher Education	$10,923	$11,173	$12,377	$1,204
Labor and Workforce Development	$299	$298	$268	-$30
Government Operations	$742	$753	$685	-$68
General Government/Other	$1,861	$1,550	$2,238	$688
Supplemental ERB Payment			$1,591	$1,591
Total, General Fund Expenditures	**$96,281**	**$98,463**	**$106,793**	**$8,330**
Difference since the Budget Act		$2,182	$10,512	$12,694
- As a Percentage		2.3%	10.9%	

Source: Department of Finance, Schedule 9

The "General Government/Other" category includes a variety of small departments, tax relief, and statewide proposals that have not yet been allocated to specific departments or programs, including employee compensation adjustments, health and dental benefits for annuitants, and the PERS deferral.

The largest General Fund expenditure growth would occur in K-12 Education and Higher Education, primarily related to the Governor's commitment to paying down Proposition 98 deferrals. Also, as noted above in the previous section, re-activating Proposition 58 in 2014-15 would result in $1.6 billion of increased expenditures to provide a supplemental Economic Recovery Bond payment in 2014-15.

General Fund spending is only a part of total state spending. ***As shown on Page 4 of the Executive Summary***, special funds, bond funds, and federal funds bring total state spending for 2014-15 to about $239.6 billion. This level of total state expenditures is $5.9 billion higher than total expenditures in 2013-14 ($233.7 billion), and exceeds population and inflation growth by more than $47.8 billion. Despite the Great Recession and Democrats' claims of "cutting to the bone," **total state spending remains at record high levels.** Total expenditures per $100 of personal income ($8.17) are slightly higher than historic averages ($8.12 over 20 years/$8.07 over 30 years).

True state General Fund program spending, which accounts for fund shifts, transfers, and General Fund offsets – allowing General Fund programs to continue growing – now totals $115.8 billion in 2014-15, which is 15.9 percent higher than peak General Fund spending in 2007-08.

Underlying General Fund Program Spending (dollars in billions)	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Schedule 9 Expenditures	**$103.0**	**$90.9**	**$87.2**	**$91.5**	**$86.4**	**$96.6**	**98.5**	**106.8**
"Offsets" to Maintain General Fund Program Levels*	--	$8.5	$11.6	$8.9	$11.3	$6.2	$7.2	$9.0
Total, General Fund Program Expenditures	**$103.0**	**$99.4**	**$98.8**	**$100.4**	**$97.7**	**$102.8**	**$105.7**	**$115.8**
Percentage Change from Peak 2007-08 General Fund Spending		-3.5%	-4.0%	-2.6%	-5.1%	-0.2%	2.6%	15.9%

Department of Finance – Schedule 9

In addition to $106.8 billion General Fund, the 2014-15 Governor's Budget relies on (1) $785 million of property taxes from redevelopment agencies to fund education, (2) realigning $6.8 billion of public safety and human services programs to the local level, (3) $1.1 billion of weight fees to pay general obligation bond debt, (4) $960 million of Medi-Cal related offsets, and (5) nearly $1.2 billion of revenues from the Medi-Cal hospital fee and Managed Care Fee/Sales Tax. In prior years, the Legislature 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.

Over the past five years, we have included this table to demonstrate that even though actual General Fund spending had decreased below 2007-08 spending levels, actions taken by the Legislature over those years to solve chronic budget deficits had the effect of retaining General Fund program spending near or above the 2007-08 pre-recession peak.

Now that General Fund revenues have rebounded and actual General Fund expenditures are proposed to exceed 2007-08 spending levels by $3.8 billion (approximately 3.7 percent higher), “Offsets to Maintain General Fund Program Levels” that were established to “save” General Fund programs remain intact. As a result, underlying General Fund program spending has been driven far beyond previous peak General Fund spending levels.

Revenues

The 2014-15 Governor's Budget estimates total General Fund revenues and transfers of $100.1 billion in 2013-14 increasing to $106.1 billion in 2014-15, and is a little more conservative than revenue estimates provided by the Legislative Analyst's Office (LAO) in its November *Fiscal Outlook*. The following table compares the Governor's Budget estimates to the LAO estimates over 2013-14 and the next four years, and reflects that the LAO estimate is $8.2 billion higher over that period.

	Dollars in Billions					
	2013-14	**2014-15**	**2015-16**	**2016-17**	**2017-18**	
LAO	$101.8	$107.6	$113.8	$119.0	$124.2	
Governor's Budget	$100.1	$106.1	$111.4	$117.4	$123.2	**Total**
Difference	**$1.7**	**$1.5**	**$2.4**	**$1.6**	**$1.0**	**$8.2**

The difference between the two estimates can be attributed to (1) additional information available from the state's taxing agencies used to develop the Administration's estimates, and (2) slightly different and more conservative economic factors used by the Administration to develop its estimate. One thing that is certain: General Fund revenues are much stronger in 2013-14 and 2014-15 than they have been in the recent past. The following table reflects that the Proposition 30 tax increases, a strengthening economy, and a rapidly increasing stock market have had a significantly positive impact on General Fund revenue collections, generating nearly $20 billion more in 2014-15 than was collected in 2011-12.

General Fund Revenue Projections			
	Dollars in millions	**Growth over Prior Year**	**Percentage Growth**
2011-12 Actual	$86,786		
2012-13 Actual	$99,915	$13,129	15.1%
2013-14 Estimate	$100,147	$232	0.2%
2014-15 Estimate	$106,094	$5,947	5.9%

Proposition 30. One of the main drivers of this massive influx of revenue continues to be the passage of Proposition 30 by voters in November 2012. The tax increases included in Proposition 30 are temporary and completely expire by 2018-19. In May 2013, the Governor estimated that the total impact of Proposition 30 would generate about $44.5 billion of new revenue over the eight-year life of the tax increase. The following table reflects the most recent Department of Finance estimate of revenues related to Proposition 30 (totaling $47.2 billion).

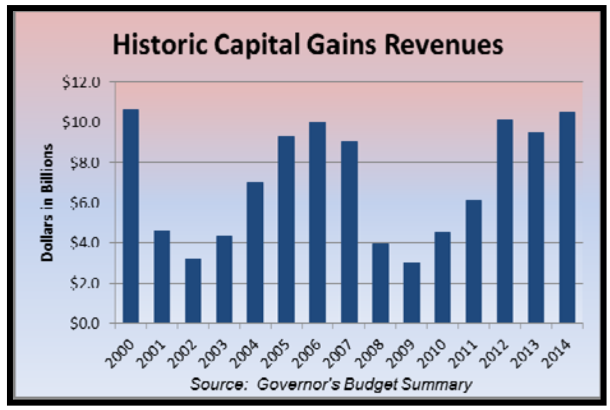
Proposition 30 Revenue Estimates Dollars in Millions								
	2011-12	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**
PIT	$3,356	$5,417	$5,590	$5,715	$5,835	$6,213	$6,563	$2,679
SUT		$640	$1,379	$1,452	$1,556	$826	$0	$0
Total	**$3,356**	**$6,058**	**$6,969**	**$7,167**	**$7,390**	**$7,039**	**$6,563**	**$2,679**

Source: Department of Finance

As discussed on Page 13 (Proposition 30 Promises Not Kept), California voters were promised that Proposition 30 tax increases were necessary to mitigate and avoid spending cuts to the state's education programs. Now that revenues are much stronger than anticipated in 2011-12 and the increased taxes are not necessary to protect education spending, the Governor has pivoted to suggest that Proposition 30 continues to be necessary to pay down costs associated with the state's unfunded retirement and health care costs, despite the fact that this would be a different use than voters were promised. In fact, the Superintendent of Public Instruction is already calling for these temporary tax increases to be made permanent, four years before they expire. Pursuant to Proposition 26 (2010), extending Proposition 30 tax increases beyond their current expiration dates or making them permanent would require a 2/3 vote of the Legislature.

Volatility. One positive aspect of the Governor's Budget is that it recognizes the volatility of capital gains, which appears to be another significant driver of General Fund revenue collections as of late. The Governor's Budget goes into great detail discussing the strength of the stock markets, the impact of market growth on capital gains revenues (and resulting tax revenues), the historical impact of capital gains tax revenues on state General Fund revenues, and the risk associated with relying on capital gains revenues during boom years to fund ongoing programmatic spending.

The adjacent chart demonstrates the large swings in capital gains tax revenues over the past 14 years.



In light of the risks associated with volatile capital gains tax revenue, the Governor has also proposed a new rainy day fund. The details of this new proposal are limited, but a discussion regarding the Governor's new proposal, as well as the rainy day reserve contained in ACA 4 that is pending for the 2014 ballot, can be found in the ***Governor's Rainy Day Reserve section on Page 7***.

Proposition 58. Another positive aspect of the Governor's Budget is that it respects rainy day reserve and Economic Recovery Bond supplemental payment obligations established by Proposition 58, which was passed by the voters in 2004. Proposition 58 required the Controller to make annual transfers to the Budget Stabilization Account to pay down Economic Recovery Bonds (50 percent) and build a "rainy day reserve" (50 percent), as follows:

- One percent of General Fund revenues for 2006-07,
- Two percent of General Fund revenues for 2007-08, and
- Three percent of General Fund for 2008-09 and annually thereafter.

After the first two transfers, Governors Schwarzenegger and Brown suspended the transfers for each of the next six fiscal years. The 2014-15 Governor's Budget proposes to transfer about $1.6 billion to the Budget Stabilization Account ("rainy day reserve") and spend another $1.6 billion as a supplemental payment on the Economic Recovery Bonds, thereby restoring the Proposition 58 transfers authorized by the Constitution. In light of the significant revenue increases projected for 2014-15 and the risk associated with capital gains tax revenues, this proposal is a good first step toward reducing the state's debt and saving for the future.

Proposition 30 Promises Not Kept

Proposition 30 Spending on Education. According to the Proposition 30 ballot summary, its tax hikes were expected to generate additional state revenues of about $6 billion annually from 2012–13 through 2016–17, and smaller amounts in 2017–18 and 2018–19. The summary also stated that these additional revenues would be "available to fund programs in the state budget." Perhaps more significantly, the Governor and others who campaigned for the initiative led voters to believe that *all* of the Proposition 30 tax increase revenue would be used for education. However, after voters agreed to the new taxes, the Governor and legislative Democrats negotiated a 2013-14 budget that used only about a third of the new money (roughly $2 billion of the $6 billion generated) for K-14 education, with the lion's share of the revenue going for other priorities, e.g., to eliminate state employee work furlough days and fund salary and benefit increases ($600 million), and to grow health and human services spending (about $2 billion for Medi-Cal, CalWORKs, IHSS, state-funded child care, mental health, etc.).

As the chart below shows, the 2014-15 Governor's Budget continues to divert about $4 billion of Proposition 30 revenue to other programs:

Budget uses Prop 30 revenue for non-education programs
$ in billions

	2014-15
Minimum Prop 98 guarantee with no Prop 30 revenue	$58.681
Proposition 30 revenue	$7.167
Minimum Prop 98 guarantee plus all Prop 30 revenue	$65.848
Prop 98 funding included in final budget	$61.559
Prop 30 revenue used for non-education programs	$4.289

Specifically:

- According to the Legislative Analyst, in the absence of Proposition 30 revenue, the Proposition 98 minimum guarantee of funding for K-14 education would be about $58.7 billion.
- Estimated revenue from Proposition 30 in 2014-15 is about $7.2 billion.
- Thus, despite multi-billion dollar growth in Proposition 98 funding, it is still almost $4.3 billion below what it would be if all Proposition 30 revenue was spent on K-14 education, as promoted by its supporters. Even taking into account the $284 million aggregate augmentation proposed for the University of California and California State University, education will get less than half of the Proposition 30 revenue.
- The Administration says that all Proposition 30 revenue goes into a special account used entirely to fund education, which is true. However, what it fails to say is that these special funds offset state General Fund that would have to be spent to meet the Proposition 98 guarantee *even if Proposition 30 revenue did not exist,* thereby freeing up that same amount of General Fund for non-education uses.

Education

Proposition 98 Funding. Recent General Fund tax revenue growth has increased the Proposition 98 guarantee of funding for education by almost $10 billion across three years. The chart below displays proposed Proposition 98 funding:

Proposition 98 Funding at 2014-15 Governor's Budget
Source: Legislative Analyst's Office
($ in millions)

	2012-13 at 13-14 FBA[2]	2012-13 at 14-15 GB[3] (revised)	change from FBA to GB	2013-14 at 13-14 FBA	2013-14 GB at 14-15 GB (revised)	change from FBA to GB	2014-15 GB	change from revised 13-14
K-12 education [1/]								
General Fund	$36,676	$38,220	$1,544	$35,235	$36,868	$1,633	$40,588	$3,720
Local property tax revenue	$13,760	$13,895	$135	$13,936	$13,633	-$303	$14,171	$538
K-12 subtotal	$50,436	$52,115	$1,679	$49,170	$50,502	$1,332	$54,759	$4,257
California Community Colleges								
General Fund	$3,701	$3,908	$207	$3,742	$4,001	$259	4,396	395
Local property tax revenue	$2,251	$2,241	-$10	$2,291	$2,232	-$59	2,326	94
CCC subtotal	$5,952	$6,149	$197	$6,033	$6,233	$200	$6,722	$489
Other Agencies	$78	$78	$0	$78	$78	$0	$77	-$1
Total Proposition 98	$56,466	$58,342	$1,876	$55,281	$56,813	$1,532	$61,559	$4,746
General Fund	$44,207	$42,207	-$2,000	$39,055	$40,947	$1,892	$45,062	$4,115
Local property tax revenue	$16,135	$16,135	$0	$16,226	$15,865	-$361	$16,497	$632
Prop 98 per-pupil funding (K-12)	$8,448	$8,741	$293	$8,219	$8,469	$250	$9,194	$725

[1/] K-12 education includes preschool funded with Prop 98 ($481m in 12-13, $507m in 13-14, and $409m in 14-15).
[2/] FBA = final budget act
[3/] GB = Governor's budget

As the chart shows, the Proposition 98 minimum guarantee of funding for K-14 education for the past and current years has grown since enactment of the 2013 budget by roughly $1.9 billion in 2012-13 and $1.5 billion in 2013-14. Consistent with this trend, the 2014-15 guarantee is currently projected to be $61.6 billion, over $4.7 billion higher than the revised current-year guarantee, and almost $6.3 billion higher than the 2013 Budget Act level of $55.3 billion. New Proposition 98 funding available for 2014-15 thus totals about $9.7 billion.[1]

The Governor uses most of this growth in the guarantee to eliminate past inter-year funding deferrals and increase flexible school funding, as discussed further below. In an effort to minimize future volatility of school funding, he also proposes to create a constitutional “Proposition 98 reserve” to smooth allocations to schools and community colleges over time and thus minimize the need for future funding reductions during economic downturns (see “Governor’s Rainy Day Reserve” discussion on Page 7). The reserve would have no effect on the calculation of the minimum guarantee.

Deferrals Fully Extinguished. Consistent with his efforts to reduce the state’s “Wall of Debt,” the Governor proposes to retire the remaining $6.2 billion in year-to-year deferrals of Proposition 98 funding, which peaked in 2011-12 at over $10.4 billion. School districts would receive full funding for a year’s operational costs in the same year incurred, and would no longer need to take out short-term loans while waiting for deferred state payments to be made in the following fiscal year.

[1] $1.9 billion + $1.5 billion + $6.3 billion = $9.7 billion. The Administration’s budget summary refers to this as $10 billion.

Local Control Funding Formula. The 2013-14 budget launched a new "local control funding formula" (LCFF) for K-12 education, which was supported by Republicans for its focus on local control and flexibility.[2] The LCFF established district-specific funding targets that vary based on grade span and student demographics. Full funding of the targets is expected to require roughly $25 billion and will be phased in over time as the Proposition 98 guarantee of funding grows. The Governor's Budget increases this locally-flexible funding by $4.5 billion in 2014-15. In addition, he proposes to establish a continuous appropriation of these funds, similar to the existing continuous appropriation of K-12 school apportionments, after which annual legislative approval would no longer be required.

Categorical Programs. All K-12 categorical program funding was folded into the LCFF effective in 2013-14, except for the following programs:

- Special education
- Child nutrition
- K-12 mandates block grant
- Before- and after-school programs
- State preschool
- Quality Education Investment Act (QEIA)
- Assessments (testing)
- American Indian education centers
- Partnership academies
- Foster youth programs
- Adults in correctional facilities (jail education)
- Agricultural vocational education
- Specialized secondary programs

The Governor's 2014-15 budget proposal would shift funding for the last two programs on the list: agricultural vocational education[3], a program traditionally supported by Republican members ($4.1 million), and specialized secondary programs[4] ($4.9 million), into the LCFF. Local educational agencies would then be free to continue operating these programs with no changes or to shift the funds to other local educational priorities. In addition, he proposes a $46.5 million augmentation for implementation of a new student assessment (testing) system outlined in Chapter 489, Statutes of 2013 (AB 484)[5] and $7.6 million for development of a new English language proficiency exam. The Governor also proposes to streamline and expand non-classroom based independent study for grades 9-12, and restates his intention to expand adult education funding in 2015-16.

School Facilities. The Governor's Budget does NOT propose a new education facilities bond. Department of Finance staff indicate that the Administration wants a wide-ranging discussion of the state's existing debt, various demands for new debt, the General Fund's capacity to service new debt, and what new debt should take priority. Pending the results of that discussion, the Governor proposes to transfer $211 million in existing bond authority for specialized school facility bond programs to new

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[2] LAO's overview of the LCFF is available here: http://www.lao.ca.gov/reports/2013/edu/lcff/lcff-072913.aspx
[3] http://www.cde.ca.gov/ci/ct/ae/
[4] http://www.cde.ca.gov/ci/gs/hs/sspgen.asp
[5] http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0451-0500/ab_484_bill_20131002_chaptered.pdf . Republicans opposed that bill because it weakened the state's formerly-robust measures of academic progress.

construction and modernization ($105.5 million to each), and to provide $188.1 million in one-time funding for the Emergency Repair Program[6], which settled the Williams "dirty bathrooms" lawsuit.

Local Libraries. The Governor's Budget includes a General Fund augmentation of $3.25 million to enable California's public libraries to access the same statewide high-speed internet network currently used by K-12 schools and universities.

Proposition 39 Energy Efficiency Projects. The 2013-14 budget allocated $428 million in new tax revenue resulting from voter approval of Proposition 39 for energy efficiency projects at K-12 schools ($381 million) and community colleges ($47 million).[7] The 2014-15 Governor's Budget anticipates available funding of $363 million in 2014-15, most of which would go to K-12 schools ($316 million) and community colleges ($39 million).

Child Care/Preschool. The Governor's proposed budget makes only minor and technical adjustments to child care funding. It does not fund universal preschool (transitional kindergarten) as proposed by Senator Steinberg and several other legislators in SB 837.[8] At full implementation, that proposal would require an additional $1 billion annually in Proposition 98 General Fund, thus diverting that same amount of funding away from the LCFF and other K-14 education priorities, despite a number of studies that raise doubts as to whether preschool programs produce any lasting benefit.[9]

California Community College (CCC) Funding Grows. As discussed previously, higher-than-projected revenues have increased the 2013-14 Proposition 98 guarantee since enactment of the 2013 budget last June, and the Governor's budget proposal would therefore increase 2013-14 CCC funding by about $85 million, to over $6.2 billion. In 2014-15, CCC funding would grow to over $6.7 billion, with the following augmentations:

- $236 million to extinguish remaining inter-year funding deferrals
- $203 million to expand the Student Success and Support program (matriculation)
- $175 million in one-time funding, split evenly between deferred maintenance and instructional equipment
- $155 million for three percent enrollment growth
- $48 million for a 0.86 percent COLA

State funding rates per full-time-equivalent student would rise to $2,788, $3,283, and $4,636 for non-credit, enhanced non-credit, and for-credit coursework, respectively. CCC fees remain the lowest in the nation, at $46 per credit-unit, and well over half of community college students receive fee waivers.

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[6] http://www.dgs.ca.gov/opsc/Programs/emergencyrepairprogram.aspx
[7] SB 73 (Ch 29/2013) set forth an allocation methodology for these funds: http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0051-0100/sb_73_bill_20130627_chaptered.pdf
[8] http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0801-0850/sb_837_bill_20140106_introduced.pdf
[9] http://www.acf.hhs.gov/sites/default/files/opre/head_start_report.pdf

UC, CSU, and Student Financial Aid. Proposed funding for UC and CSU is displayed in the chart below.

UC & CSU Funding at 2014-15 Governor's Budget
(Core funds, in millions)

		2012-13	2013-14	2014-15	change
UC	General Fund [1/]	2,566	2,844	2,987	142
	Tuition and Fees [2/]	3,516	3,611	3,657	46
	Other UC Core Funds [3/]	351	344	331	-13
	Lottery	30	38	38	0
	Total UC	$6,463	$6,837	$7,012	$175
CSU	General Fund [1,4/]	$2,473	$2,789	$2,966	$177
	Tuition and Fees [2/]	2,643	2,669	2,720	51
	Lottery	40	56	57	1
	Total CSU	$5,157	$5,514	$5,743	$229
	Total	$11,619	$12,351	$12,755	$404

[1/] Includes general obligation bond debt service.
[2/] Includes systemwide fees before discounts/waivers, and nonresident tuition.
[3/] Includes application fees, interest, and a portion of grant overhead and patent royalty income. Excludes carry-forward of prior year balance in 2013-14 under the assumption that most of this balance will continue to be carried forward.
[4/] Includes funding for CSU retired annuitant health care costs and other minor adjustments.

Source: Legislative Analyst's Office

UC/CSU Funding. Consistent with his previously-announced plan to provide annual funding increases of five percent, five percent, four percent, and four percent respectively over four years beginning in 2013-14, the 2014-15 Governor's Budget would increase General Fund support of UC and CSU by over $284 million ($142.2 million to each segment) in 2014-15[10]. The proposal would make these augmentations contingent on the segments' agreement not to increase tuition during this four-year period[11]. *Senate Republicans have strongly advocated for* ***a strict tuition freeze to apply for as long as the Proposition 30 tax hikes are in effect,*** and have proposed via SB 58 (Cannella)[12] to statutorily require such a freeze.

In addition to five-percent augmentations of General Fund support for both UC and CSU, the Governor's Budget provides $50 million in one-time incentive grant funding for awards to UC, CSU, community colleges, and/or inter-segmental consortia in support of innovative education models that would expand the use of technology and reduce costs.

While it provides substantial additional funding for both UC and CSU, the Governor's Budget imposes no new "performance measures" as a condition of its funding augmentations, nor does it specify enrollment targets.[13] This lack of accountability continues to be a concern for Republicans.

New CSU Capital Outlay Process. The Governor proposes to shift CSU's general obligation bond debt into its support budget and suspend future adjustments of state funding for debt service, similar to the change made to UC's budget in 2013-14. This approach is intended to incentivize the prioritization of capital outlay expenditures within the context of all of CSU's other competing priorities. CSU would

[10] Formula-driven adjustments to health benefits for retired annuitants and other minor adjustments increase CSU's total General Fund augmentation to $177 million.
[11] UC's mandatory systemwide tuition fees are $11,220 and CSU's are $5,472.
[12] http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0051-0100/sb_58_bill_20130107_introduced.pdf
[13] It assumes that enrollment will remain flat at UC and grow by 2 percent at CSU.

be required to submit future project proposals to the Department of Finance for approval (with notification to the Joint Legislative Budget Committee), would issue its own bonds to pay for future capital projects, and would service future debt using funds from its base support budget.

Student Financial Aid. The Governor's Budget includes over $1.9 billion in support of various student financial aid programs, including the following augmentations:

- $107 million for first-year funding of the Middle Class Scholarship program authorized by Chapter 50, Statutes of 2013 (AB 94).[14] Total General Fund support for this program is expected to grow to $305 million by 2017-18.
- $103 million to support an expected increase in CalGrant financial aid awards
- $15 million to restore CalGrant eligibility for students whose incomes temporarily rise beyond the eligibility limits, then fall again to below those limits.

[14] http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0051-0100/ab_94_bill_20130701_chaptered.pdf

Employee Compensation

Several Bargaining Units Have No Contract. Of the 21 bargaining units (BU), 18 bargaining units currently have contracts in place, with most expiring July 1, 2015 or July 1, 2016 (with the exception of BU 5-California Highway Patrol which expires July 3, 2018 and BU 8- Firefighters which expires July 1, 2017). Three BU's (about 6,650 employees out of 200,000 included in the 21 bargaining units) are currently working under an expired contract. These include BU 2- Attorneys and Hearing Officers, BU 10- Professional Scientific, and BU 13- Stationary Engineer, whose contracts all expired on July 1, 2013. There has been no indication from the Administration whether or not these bargaining units will have new agreements to be considered by the Legislature in the upcoming year.

AB 1377 (Committee on Public Employees, Statutes of 2013) ratified the memoranda of understanding (MOU) for BU's 1, 3, 4, 11, 14, 15, 17, 20, and 21, represented by the State Employees International Union (SEIU) and AB 478 (Gomez, Statutes of 2013) ratified the MOU's for BU 6 (Correctional Peace Officers), BU 7 (Statewide Law Enforcement), BU 9 (Professional Engineers), BU 12 (Craft and Maintenance), BU 16 (Physicians and Dentists), BU 18 (Psychiatrists), and BU 19 (Health and Social Professionals).

Salary Increases Ramp Up. Thirteen of the bargaining unit contract agreements referenced above included salary increases tied to a revenue-based "trigger" and the Governor's proposed budget assumes revenues will be sufficient to pull the "trigger" and provide the first of two salary adjustments, a two percent salary increase effective July 1, 2014 for these state employees. The 2015-16 Budget will include funding for the balance of the salary increases (an additional 2.5 percent effective July 1, 2015). The 2014-15 budget includes $173.1 million ($82.4 million General Fund) for these salary increases. The full cost of the 4.5 percent salary increases will be $763.9 million ($507.3 million General Fund) in 2015-16. This is in addition to the furloughs that expired last year, costing $800 million ($400 million General Fund), and five percent pay raises that will cost $502.1 million ($247 million General Fund) in 2013-14.

Salary Increases Extended to Managers and Supervisors. The Governor's Budget includes $98.6 million ($40.3 million General Fund) to extend salary increases to unrepresented state managers and supervisors to avoid salary compaction issues. All managers and supervisors will receive these increases even if the bargaining unit they are associated with does not have an agreement in place, which is not consistent with historic practice since the rank and file didn't get their raises yet.

Major Salary Increases for State Scientists and Engineers. The Governor's Budget includes $51.2 million ($5.6 million General Fund) to provide significant salary increases for managers and supervisors within many scientist and engineer classifications. Beginning in 2006, the California Association of Professional Scientists argued their members were performing similar work as certain engineering supervisors and should receive "like pay for like work." The Administration's Department of Personnel Administration recommended the salary increases to address compaction issues but the adjustments were never included in a Governor's budget. The Administration has not provided information on the range of salary increases but similar adjustments included in recent legislation for other classifications (working within the Department of Water Resources) increased some classifications by almost 40 percent.

Unspoken Automatic Pay Increases. The new state spending increases for state employees are in addition to merit salary adjustments (MSA's) that have quietly increased baseline spending on employee wages by nearly $800 million since 2005-06, cumulatively costing the state $3.4 billion. Merit salary adjustments are <u>automatic</u> salary increases, and are not affected by furloughs or personal leave programs. Auto-pilot pay raises should not occur while core government services to California's families are reduced and taxes raised. Annual pay increases should not be considered an entitlement for public employees, but should be tied to performance, which is the intent of “merit” pay after all.

State Employee Numbers Begin to Grow Again. The Governor’s Budget includes 355,453 state personnel years, including the UC and Community Colleges, a slight increase over 2013-14. It looks like the Governor is done with his years of restricting bureaucracy.

Personnel Years by Agency				
Agency	**2013-14**	**2014-15**	**Change in Positions 14-15 to 13-14**	**Percentage Change 14-15 to 13-14**
Government Operations	14865.6	14,990.60	125	1%
Business, Consumer Services , and Housing	5409.4	5,555.50	146.1	3%
Transportation	39014.5	39,824.50	810	2%
Resources	19215.8	19,434.30	218.5	1%
Environmental Protection	4939.5	5,421.20	481.7	10%
Health and Human Services	32617.5	32,626.60	9.1	0%
Corrections and Rehabilitations	60870.9	60,683.00	-187.9	0%
K-12	2,845.30	2,852.30	7	0%
Community College/Other	330.9	338.9	8	2%
Higher Education	133,068.10	133,068.10	0	0%
Labor and Workforce Development	11725.2	11,403.30	-321.9	-3%
Other (Gen Govt, Legislative, Judicial, Executive)	28,992.10	29,254.30	262.2	1%
Total	**353,894.80**	**355,452.60**	**1,557.80**	**0.01%**
Higher Education	-133,068	-133,068.00		
Legislative, Judicial	-2,736.00	-2,736.00		
Total Executive Branch	**218,090.70**	**219,648.60**	**1,557.90**	**0.01%**

[1/] Government Operations Agency created with 2013-14 budget. Includes PERS, STRS, FTB and other oversight depts such as DGS, DHR, CTA, SPB.

[2/] Various Org 9901was carrying a lump sum unallocated cut of -16,000.0 positions.

*** Department of Finance Schedule 4**

Employee Retirement

CalSTRS

No Substantive Action Plan for CalSTRS' Pension Liabilities. The Governor's Budget does not include a plan to address CalSTRS' $80.4 billion unfunded pension obligation, even though the state is expected to have billions of dollars in surplus to spend in 2014-15. According to CalSTRS, the fund will run out of money in 2043 (under the most optimistic scenario of investment return assumptions), at which point school districts would have to make the benefit payments now being made by CalSTRS, requiring school districts to divert most of their operating funds to fund the pension promises. The result will be massive teacher layoffs and little money for the education of millions of K-14 students.

CalSTRS' liabilities compound at a very high rate, currently **causing the deficit to grow $22 million per day.** The longer it takes for the additional contributions to begin, the greater the contribution increase will need to be. CalSTRS currently estimates that $4.5 billion a year for the next 30 years is necessary to stabilize the plan. It should be noted that several years ago Senate Republicans raised concerns about the CalSTRS funding shortfall and submitted a proposal that required the legislature and Governor to set actuarially sound rates for CalSTRS.

But Begin to Think About a Plan. The Governor does propose to begin working with the Legislature, school districts, teachers, and the pension system on a plan of shared responsibility to achieve a fully funded and sustainable system within 30 years and expects the plan to be adopted as part of the 2015-16 Budget. The Governor also indicates that school districts and community colleges should anticipate absorbing much of any new CalSTRS funding requirement, but that would likely impact teachers and students. Thus, it seems more likely taxpayers will be on the hook for the money.

The Governor's Budget also includes a statement that the long-term role of the state as a direct contributor to the plan should be evaluated. This discussion is long overdue and the idea worthy of merit. For 2014-15, the state will contribute $1.4 billion, growing nearly 20 percent by 2017-18 to $1.64 billion. As the contribution continues to grow annually, more of the state's limited General Fund resources will be diverted from education, public safety and other important programs.

CalPERS

Pension Reform Savings Modestly Reduce Unfunded Liability. The Governor's Budget includes savings as a result of the passage of AB 340- Public Employees' Pension Reform Act of 2013 (PEPRA). PEPRA provided lower pension benefits, required higher retirement ages, and also required higher contributions from state employees. These contributions must go towards the state's unfunded liability, which was $45.5 billion as of June 30, 2012. As a result, the state will contribute an additional $67.1 million in 2013-14 and $108.4 million in 2014-15 towards the state's unfunded liability.

CalPERS Costs Will Continue to Rise. The Governor's 2014-15 proposed budget includes $4.0 billion ($2.3 billion General Fund) for contributions to CalPERS for retirement costs of state employees. This is a slight increase (about two percent) over 2013-14, but contributions are expected to increase four times as fast in 2015-16 (about eight percent) and will continue to grow by double digits in 2016-17 (about 25 percent) and 2017-18 (about 38 percent). Contributions are projected to reach $5.5 billion ($3.1 billion General Fund) in 2017-18.

In March 2012, the CalPERS Board took action to lower the assumed rate of return from 7.75 percent to 7.5 percent, reflecting CalPERS' expectations of what the financial markets will deliver over time, resulting in additional contributions from the state and local governments. In April 2013, CalPERS

adopted new actuarial policies aimed at returning the pension fund to fully-funded status in 30 years, phasing in additional contributions beginning in 2015-16, with a five year ramp up period.
In October 2013, CalPERS began a review of mortality rate projections, which lead to preliminary recommendations to the Board for changes to economic (discount rate, price inflation, and wage inflation) and demographic assumptions (retirement rates, employment trends, disability rates, salary rate projections and mortality rate projections), with action expected by the Board in February 2014. What this translates into is continued annual increases in retirement costs, beginning as soon as 2016-17.

For example, the impact of the proposed assumption changes on rates for state employees could be as follows:

Employee Group	**2013-14 Contribution Rate**	**2020-21 Contribution Rate**
State Miscellaneous	21.3%	32%
Schools	11.5%	20.5%
State Industrial	16.4%	21.5%
State Safety	17.9%	20.5%
State PO/FF	31.3%	45%
CHP	35.9%	56%

These actions are driving the double digit increases by 2016-17, as projected by the Department of Finance.

If Californians Only Knew….

- **The total liability for the state's unfunded retirement liability equals $10,386 per taxpayer or $5,650 for every man, woman and child in California.**

Local Government

Redevelopment Agencies. Despite significant Republican opposition, the Governor succeeded in eliminating Redevelopment Agencies, and winding down the state's former RDAs continues to be a priority for the Administration. With the elimination of RDAs the state established "successor agencies" to ensure the timely retirement of outstanding RDA debts and other legal obligations, and the move resulted in billions of property tax dollars being redirected back to cities, counties, special districts, and K−14 schools. According to the Department of Finance, while billions of dollars are being retained by successor agencies to retire debts and other legal obligations, billions of dollars are also flowing back to local governments and schools, as reflected in the following table:

Dollars in Millions	Total to be Allocated	Schools	Cities	Counties	Special Districts
2011-12 & 2012-13	$4,057.3	$2,252.6	$619.8	$875.1	$309.9
2013-14	$1,849.2	$1,073.6	$295.4	$356.3	$123.8
2014-15 Estimate	$1,346.3	$784.7	$229.8	$249.0	$82.8
2015-16 Estimate	$2,113.6	$1,228.2	$339.6	$400.6	$145.2
2016-17 Estimate	$1,779.3	$1,039.7	$310.3	$327.4	$102.0

Source: Department of Finance

On an ongoing basis, Proposition 98 General Fund savings are estimated to be $1 billion annually, and it is estimated that additional ongoing property tax revenues of more than $700 million annually will be distributed to cities, counties, and special districts.

In 2011 many Republicans opposed the elimination of RDAs because despite the many horror stories, there were many success stories and many cities statewide were using this tool to improve transportation infrastructure, provide affordable housing, and revitalize town centers. Over the past two years, there have been numerous attempts by local entities to pass legislation that would provide for exemptions or solutions to fix "problems" resulting from the "one-size-fits-all" elimination of RDAs, and the Governor has consistently vetoed all of the attempts that made it to his desk.

Revise and Expand Infrastructure Finance Districts (IFD). Apparently, the Governor is cognizant of the concern that there are few tools remaining for local governments to use when engaging in economic development activities. The following tools are currently available to local entities:

- <u>Issuance of General Obligation Bonds.</u> Can be issued by cities and counties, but doing so requires a two−thirds vote of the electorate (except for K-14 schools, which require 55−percent voter approval).
- <u>Issuance of Lease Revenue Bonds.</u> Can be used by cities and counties without voter approval, but must be repaid using revenues generated by the newly constructed facility (e.g., a parking garage that is paid for with parking fees). While lease revenue bonds can be effective tools for adding and upgrading public infrastructure, their value to other aspects of urban renewal is limited.
- <u>Increase in Local Tax Rates.</u> A two−thirds vote of the impacted electorate is required to raise local taxes for a specific purpose, and a majority vote is required to raise those taxes for general purposes. Since most economic development is specific in nature, a two−thirds vote would generally be required to fund these activities.
- <u>Infrastructure Financing Districts.</u> Cities and counties may establish IFDs with the approval of all affected taxing authorities and a two-thirds vote of approval by the electorate. IFDs may use tax increment financing to finance tax allocation bonds, the proceeds from which are used for local

development. Similar to the RDAs, the IFDs also have a cap on their existence and may exercise eminent domain powers during their existence. However, IFDs are limited in the types of projects they may fund. Generally IFDs can only fund 1) highways and transit projects, 2) water, flood control, sewer, and solid waste projects, 3) child care facilities, and 4) libraries and parks. Unlike the RDAs, schools cannot participate in IFDs, which means IFDs have no Proposition 98 General Fund impact.

The 2014-15 Governor's Budget proposes expanding the tax increment financing tool utilized by IFDs for a broader array of uses than that which is currently authorized under law, including the following changes:

- Expand the types of projects that IFDs can fund to include military base reuse, urban infill, transit priority projects, affordable housing, and associated necessary consumer services.
- Allow cities or counties that meet specified benchmarks to create these new IFDs, and to issue related debt, **subject to receiving 55‑percent voter approval**.
- Allow new IFD project areas to overlap with the project areas of the former RDAs, so long as tax increment financing does not impede repayment of former RDA obligations.
- Maintain the current IFD prohibition on the diversion of property tax revenues from K‑14 schools.

This is the extent of information provided regarding the expansion of IFDs, and the Department of Finance has indicated that specific trailer bill language should be available by the beginning of February. In the meantime, some issues should be considered:

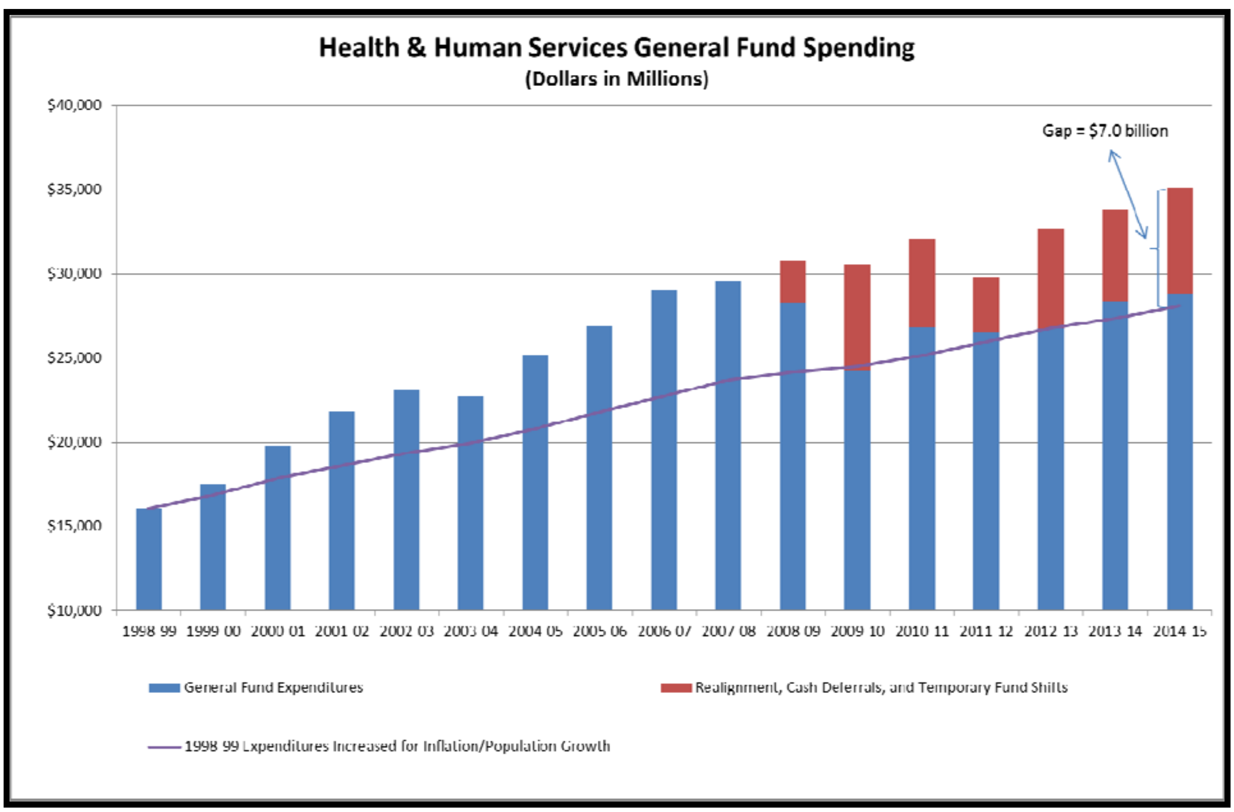
- Cities and counties throughout the state are clamoring for additional tools to engage in economic development. The League of California Cities (League) indicates that while IFDs make available the same debt financing mechanism as RDAs, IFDs are seldom used as a result of the vote threshold.
- Taxpayer advocates have raised concerns and opposition to reducing the vote threshold from 2/3 to 55 percent because they believe that super-majority approval should be required when the government wants to establish long-term debt.
- In 2013, cities and counties supported SB 33 (Wolk/2013), which would have eliminated the vote requirement for the creation, adoption, and financing of an IFD (allowing a legislative body to create the district, adopt the plan, and issue the bonds only by resolution). SB 33 also would have expanded the life of an IFD from 30 years to 40 years, expanded the uses for IFDs to include sustainable communities strategies (“smart growth”), flood management, levees, bypasses, open space, habitat restoration, environmental mitigation and more, and ensured that projects financed by IFDs pay prevailing wages. SB 33 has not received a single Republican vote.

Health & Human Services

The proposed 2014-15 Governor's Budget includes total expenditures of $118 billion from all fund sources for all Health and Human Services (HHS) Agency budgets. General Fund expenditures for HHS are projected to be $28.8 billion, which represents an increase of $463 million (1.6 percent) from the revised 2013-14 budget. Significant factors included in this net General Fund cost increase include:

- $461 million to expand Medi-Cal eligibility under federal health care reform.
- $10 million in 2014-15 and $115 million total over three years to implement a pilot program intended to connect the most vulnerable low-income families with stable licensed child care, even if they are in sanction status.
- $177.3 million to provide for a five percent grant increase in CalWORKs.
- $209 million for compliance with federal overtime regulations and to establish an In-Home Supportive Services (IHSS) provider backup system to assist recipients in finding additional providers on short notice.

As the chart below demonstrates, General Fund expenditures had increased far faster than inflation and population until 2009-10, when temporary fund shifts (primarily federal stimulus funds) reduced General Fund spending below the trend line. Absent federal funds or other funding shifts such as the 2011 Realignment, which do not reduce actual program activities, underlying program spending for HHS in 2014-15 would remain $7.0 billion above the trend line. General Fund spending is still $678 million above the trend line even after accounting for those fund shifts. However, spending trends differ substantially by department. Spending for numerous health programs such as Medi-Cal and IHSS has grown rapidly, offset somewhat by flat overall spending for human services programs such as CalWORKs.



Health

The 2014-15 Governor's Budget for Health programs is dominated by the implementation of federal health care reform and other previously authorized initiatives. Key changes are discussed in more detail below. The following table summarizes proposed General Fund spending levels and significant cost factors for the largest health departments.

Summary of Department General Fund Spending

(Dollars in Millions)

				Change from 13-14 to 14-15		
Department	**2012-13**	**2013-14**	**2014-15**	**$**	**%**	**Key Changes**
Health Care Services--Medi-Cal	$14,862	$16,230	$16,899	$669	4.1%	Expansion of Medi-Cal eligibility due to ACA. Increase is net of reduced costs from implementing provider payment reductions.
Public Health	129	115	111	-4	-3.5%	Proposed shift of water programs to the State Water Resources Control Board
MRMIB	178	23	-	-23	-100.0%	Completion of Healthy Families Program elimination and proposed elimination of MRMIB
Developmental Services	2,674	2,803	2,935	132	4.7%	Implementation of state's minimum wage increase; caseload growth.
State Hospitals	1,275	1,476	1,498	22	1.5%	Proposed increase in hospital beds for Incompetent to Stand Trial patients and certain court-ordered inmates
ACA - Affordable Care Act (federal health reform)						
MRMIB - Managed Risk Medical Insurance Board (administers Healthy Families)						

Medi-Cal

Health Reform Eligibility Expansion. The expansion of Medi-Cal eligibility mandated by the federal Affordable Care Act (ACA) became effective January 1, 2014. The Governor's Budget does not propose significant changes to the method of implementation, but instead provides updated cost and enrollment information. Key effects of the ACA on Medi-Cal include an enrollment increase of 16 percent in 2013-14 and 10 percent in 2014-15, reaching a caseload of 10.1 million, or 26 percent of the California population. Most costs in the early years of implementation will be federally funded. Enrollment expansion groups and their related costs are summarized in the table below and described in the paragraphs that follow.

Medi-Cal Health Reform Enrollment and Benefit Costs

(Dollars in Millions)

	Enrollees		Total Costs		General Fund Costs	
Enrollment Group	**2013-14**	**2014-15**	**2013-14**	**2014-15**	**2013-14**	**2014-15**
Mandatory Expansion: Children and parents	130,046	508,540	$223	$867	$104	$419
Optional Expansion: Adults without children	326,592	769,069	$2,609	$6,586	-	-
Newly qualified immigrants	2,982	9,665	$14	$12	$5	$4
Hospital presumptive eligibility	25,160	31,574	$19	$79	$9	$38
Total	**484,780**	**1,318,848**	**$2,865**	**$7,545**	**$118**	**$461**

- *Mandatory Expansion to Children and Parents.* The ACA standardizes the maximum income level at which children and adults can be eligible for Medi-Cal at 138 percent of the federal poverty level (FPL), which would equal about $32,500 for a family of four. The previous maximum income level was set at 133 percent of FPL for children and 100 percent for parents, although some income was excluded from the calculation.
- *Optional Expansion to Adults.* Previously, non-elderly adults needed to either be parents or have a qualifying disability to enroll in Medi-Cal, but the ACA expands Medi-Cal coverage to non-disabled, childless adults younger than 65 years of age. The ACA provides that the federal government will pay 100 percent of Medi-Cal coverage costs for these adult enrollees for the first three years, after which the state share of cost would gradually increase to 10 percent of costs by 2020. Even under modest assumptions for enrollment and health inflation, the state's share of costs for this group could reach $1 billion General Fund by 2020.
- *Newly Qualified Immigrants.* California already provides the full range of Medi-Cal benefits to legal immigrants during their first 5 years in the country. Because of federal restrictions, the state paid for the majority of these benefits without federal funding. Chapter 4, Statutes of 2013 (SB x1 1, Hernandez) includes these immigrants in the optional Medi-Cal expansion. For the group with incomes above 100 percent FPL, the Governor's budget proposes to pay the out-of-pocket costs to place these enrollees in Covered California, rather than Medi-Cal, beginning January 1, 2015.
- *Hospital Presumptive Eligibility.* The ACA requires states to give hospitals the option to enroll patients in Medi-Cal based on "presumptive eligibility" for two months. Under presumptive eligibility, the applicant does not need to provide documentation for income or other eligibility factors. California enacted its version of this program as Chapter 442, Statutes of 2013 (SB 28, Hernandez). Republicans have raised concerns about presumptive eligibility programs because they potentially

result in many people who are not eligible receiving benefits at significant cost to taxpayers, leaving less funding for those who are truly eligible.

Provider Rate Reductions. The 2013 Budget Act implemented Medi-Cal provider rate reductions of up to 10 percent for most provider types, despite bipartisan legislative efforts to reverse that action. The Governor's Budget for 2014-15 provides partial relief to some Medi-Cal providers, including physicians, clinics, dental, and medical transportation, among others, by foregoing the retroactive recovery of the rate reductions. This proposal would result in $36 million in additional General Fund costs. While this relief is a step in the right direction, the budget will still implement the retroactive reduction for clinical laboratories, most nursing facilities, durable medical equipment, medical supplies, and pharmacy, which were not included in the proposed exemption. Also, the Governor's Budget does not reverse the prospective 10 percent reduction itself, which is now estimated to reduce costs by $283 million General Fund in 2014-15. Continuing down the path of reducing provider payments at the same time that the state dramatically expands Medi-Cal enrollment threatens to diminish access for all Medi-Cal enrollees by discouraging providers from continuing to serve Medi-Cal patients.

Some Non-Medi-Cal Programs Could Transition to ACA Coverage. California has long provided various targeted health programs for populations with specialized needs, such as HIV/AIDS patients. Due to the ACA's individual mandate and the advent of coverage available through Covered California and the expanded Medi-Cal Program, some of these other state health programs potentially could phase out as their enrollees shift to the newly available options. Such programs include the Managed Risk Medical Insurance Program and the AIDS Drug Assistance Program, where the Governor has encouraged, but not required, enrollees to shift to ACA coverage. **The Governor's budget should do more to transition enrollees in other programs to new ACA options. Given the various costs imposed by the ACA, California should seek efficiencies and program consolidation where possible.**

<u>Department of Developmental Services (DDS)</u>

The Department of Developmental Services (DDS) estimates it will serve nearly 275,000 developmentally disabled Californians in 2014-15 in community settings and institutional developmental centers (DCs). While the vast majority of these individuals receive community-based services, the DCs are budgeted to serve 1,333 residents in 2013-14 and 1,110 residents in 2014-15, a decline of 223 residents (17 percent). The Governor's Budget projects DC expenditures of $305 million General Fund for the current year and proposes a decline of $30.6 million (10 percent) to $275 million General Fund for the budget year. The average cost per DC resident would rise from $417,000 (total funds) in 2013-14 to $474,000 in 2014-15, an increase of nearly 14 percent.

DC Oversight Woes Grow. In early 2013, DDS lost federal certification for a portion of Sonoma DC due to numerous safety and other regulatory violations. This decertification led to the loss of federal funding as well, leading to a General Fund cost of $10 million in the 2013 Budget Act and a deficiency notification submitted December 30, 2013, for an additional $3.6 million. Steps to correct the safety issues are also costing $5 million General Fund in 2014-15. While the Governor's Budget expects Sonoma DC to regain certification and federal funding in the budget year, the Administration revealed only on January 3, 2014, that **three other DCs are now potentially faced with decertification of certain facilities and the potential loss of federal funds as well.** While DDS is currently appealing and may retain its funding upon agreement with the federal government, mismanagement of three more DCs, even after the additional scrutiny brought on by the Sonoma decertification, is unacceptable. The apparent lack of institutional control suggests that the drawn-out closure of DCs and transition of residents to community care settings should be accelerated.

Lanterman DC Closure Process Nearing Conclusion. A budget action taken in 2010-11 began a gradual process of closing down Lanterman DC in Pomona, and the Governor's Budget now projects that all Lanterman residents will have transitioned to community living by December 31, 2014. While this timeline conforms to expectations set as part of the 2013-14 budget, the Governor's Budget also proposes dubious increases of $8.8 million General Fund and 68 positions for closure-related activities. **During the closure process for Lanterman, the Administration has demonstrated a reluctance to bring costs down commensurate with resident levels, and this proposal appears to continue that trend.**

Minimum Wage Increase Hits Home. The minimum wage increase enacted by Chapter 351, Statutes of 2013 (AB 10) is driving costs up for the state as well as for California businesses. The Governor's Budget proposes provider rate increases of $69 million General Fund in 2014-15 to accommodate the wage increase from $8.00 to $9.00. It remains to be seen whether this proposed level of funding will adequately compensate DDS community providers, most of whom have not received a provider reimbursement rate increase since 2003.

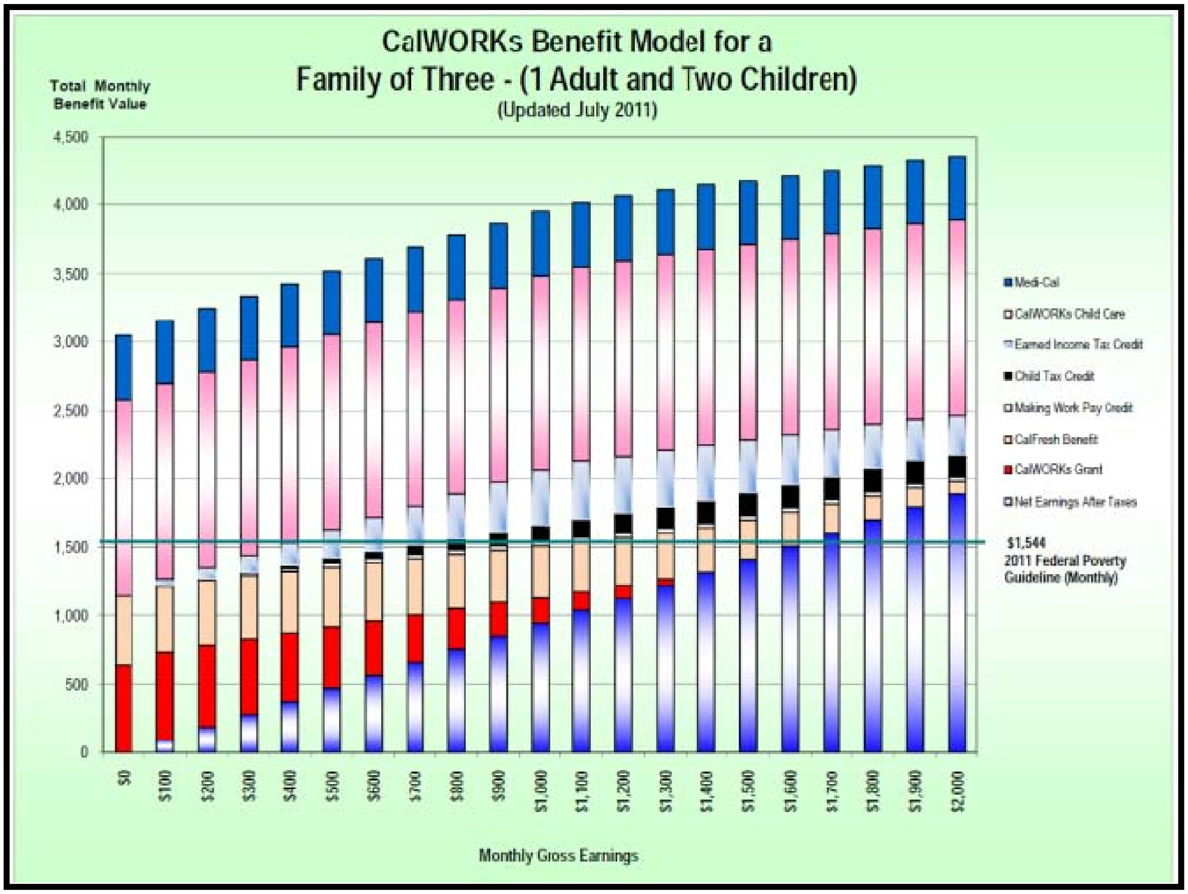
Human Services

<u>CalWORKs</u>

The CalWORKs program provides temporary cash assistance and welfare-to-work services to low-income families with children. The Governor's Budget proposes $5.5 billion ($1.7 billion General Fund) in 2014-15 for the program and estimates a caseload of 529,000 families (a decrease of four percent, or 16,280 families, from the revised 2013-14 caseload).

State Policies May Create Disincentives to Succeed. The state's entitlement programs could be creating disincentives for recipients to succeed and become self-sufficient because they fail to provide any incentive for people to become self-sustaining and risk losing the guarantee of cash assistance. It can be more financially lucrative, in the form of disposable income, to do nothing and collect various welfare entitlements rather than to work. The situation reflects a "moral hazard." In economic terms, this refers to the undue risks that people are apt to take if they don't have to bear the consequences. Moral hazard can explain why social safety nets like welfare, unemployment insurance and workers' compensation can provide perverse incentives if not carefully monitored and measured.

As the chart from the Department of Social Services on the next page shows, a family of three with $0 in annual earnings receives the equivalent of $36,000 annually in government-provided assistance and services from the state (additional county services not reflected on chart). A family earning $1,000 a month can receive nearly $3,000 a month in cash assistance and services from programs such as Medi-Cal, CalWORKs, Cal Fresh, child care and other programs.



The Governor recognizes that "compared to other states, California provides broader health care coverage to a greater percentage of the population, including in-home care and guarantees access to services for person with developmental disabilities. California makes available higher cash assistance to families, continues that assistance to children after their parents lose eligibility, and provides extensive child care to working families with children up to age 13. Finally, the state provides generous financial aid to those seeking higher education."

However, his proposed 2014-15 budget does not attempt to address the challenge posed by such generous entitlements, but instead includes funding for a welfare grant increase, proposes a new program for parental engagement, increases General Fund support to backfill county funds within In-Home Supportive Services (IHSS), and creates a new bureaucracy within IHSS that pays certain providers higher wages.

The 2014-15 budget includes the following increased General Fund expenditures within the CalWORKs program:

- **Grants on the Rise-** $61 million in 1991 Realignment funding for 2013-14 to fully fund the five percent CalWORKs grant increase included in the 2013 Budget Act, effective March 1, 2013. The 2014-15 budget includes $177.3 million for full-year costs of the five percent grant increase, of which $161.7 million is estimated to be 1991 Realignment funding and $15.5 million is General Fund. If 1991 Realignment funding is sufficient based on revenue and caseload estimates in the future, there could be an additional five percent grant increase (costing approximately $200 million) effective March 1, 2015.

- **New Pilot Program Focuses on Parenting-** The Governor's Budget proposes a new Parent-Child Demonstration Pilot, a three-year, six-county demonstration pilot intended to improve outcomes for 2,000 CalWORKs families, providing subsidized licensed child care, engaging parents with the child in the child care setting, enhancing parenting and life skills, and providing parents with work readiness activities. The first cohort of families would enroll into the pilot beginning March 2015, and is estimated to cost $9.9 million GF in 2014-15, with total costs of $115.4 million General Fund over three years. To the extent this pilot program changes parent behavior and improves the long term success of the children it may have merit.

In-Home Supportive Services

The In-Home Supportive Services (IHSS) program provides personal care and domestic services to approximately 450,000 low-income individuals who are aged, blind, or have disabilities. The budget includes $7.2 billion ($2.0 billion General Fund) in 2014-15, a six percent increase ($974.1 million total funds [$119.2 million General Fund]) above the 2013 Budget Act. Caseload is estimated to be 453,417, an increase of one percent (5,192 recipients) over the 2013 Budget Act.

County Giveaway Increases. The Governor's Budget includes $79 million General Fund in 2014-15, an increase of $13 million General Fund from 2013-14, as a result of a recent policy change that caps counties' share of IHSS expenditures at the 2011 level (a low point for expenditures in the program). This policy to backfill increasing IHSS costs with General Fund holds all counties harmless for most new program expenditures, increasing General Fund costs at an alarming rate. Additionally if the Legislative Democrats decide to allow overtime for IHSS providers those costs would be borne entirely by the General Fund.

Costly Federal Overtime Regulations. The Governor's Budget includes $208.9 million ($99 million General Fund) in 2014-15 (increasing to $327.9 million [$153.1 million General Fund] annually thereafter) in response to federal regulations effective January 1, 2015, that require the state to pay IHSS providers overtime under the Federal Labor and Standards Act (FLSA), and also require IHSS providers be compensated for training, travel time and for "wait time" during recipient's medical visits.

The Obama Administration adopted regulations that require overtime be provided for domestic workers, which now increases costs within the state's IHSS program. Advocates and stakeholders have raised concerns that to the extent states restrict overtime it may cause disruption in care, force recipients to use non-family members as providers and will reduce family income.

The Administration estimates that providing overtime to all IHSS providers could cost $400 million annually, but **the Governor is proposing to prohibit overtime within the program** and includes administrative costs to implement this restriction at the county level. Additionally, the costs include the establishment of a Provider Backup System intended to help recipients find additional providers on short notice. The Governor's proposal to address the federal overtime regulations will cost half as much as paying overtime and will pay backup providers higher wages than existing providers

These ill-conceived federal requirements will clearly benefit the ranks of SEIU membership.

Minimum Wage Increase Impacts State Costs. AB 10 (Chapter 351, Statutes of 2013) increases the minimum wage from $8 per hour to $9 per hour in July 2014, followed by an increase to $10 per hour in January 2016. In 2014-15, 17 smaller counties will be impacted by this increase, and the budget includes $5.7 million ($2.9 million General Fund) as a result. Due to implementation of the IHSS county MOE (see County Giveaway above), all non-federal IHSS provider wage costs will be General Fund.

Supplemental Security Income/State Supplementary Payment

The Supplemental Security Income/State Supplementary Payment (SSI/SSP) program provides monthly cash assistance to eligible individuals who are aged, blind, or who have disabilities. The

Governor's Budget includes $10.1 billion ($2.8 billion General Fund) for 2014-15, an increase of one percent ($358.4 million total funds [$29.4 million General Fund]) over the 2013 Budget Act. The estimated caseload for the SSI/SSP program is 1.3 million recipients in 2014-15, an increase of one percent (9,469 recipients) over the 2013 Budget Act.

Grants to Increase. The Governor's Budget includes $159.1 million federal funds to reflect an estimated cost-of-living increase of 1.5 percent in 2013-14 and 0.6 percent in 2014-15 (the increases are effective January 1 of each year) for the SSI portion of the grant. Effective January 2013, maximum SSI/SSP grant levels are $866 per month for individuals and $1,462 per month for couples. The maximum SSI/SSP monthly grant levels will increase by $11 and $16 for individuals and couples, respectively, effective January 2014.

The budget also includes an increase in state General Fund costs (included in the General Fund increase identified above) for benefits under the Cash Assistance for Immigrants (CAPI) program. The CAPI program provides benefits consistent with SSI/SSP for those legal immigrants not eligible for the federal program.

CalFresh

CalFresh is the state's version of the federal Supplemental Nutrition Assistance Program (SNAP) and provides food assistance to over 4.2 million low-income Californians, about 11 percent of the state's population. The average monthly benefit per household is roughly $333 per month and in 2013-14, approximately $7.6 billion in CalFresh benefits were distributed. Costs for administering the program are shared between the federal government, the counties and the state (50/15/35 percent share respectively). The Governor's Budget includes an additional $2 billion ($691.6 million General Fund) in administration costs for the CalFresh program.

Affordable Care Act Impact. The Governor's Budget includes $144.5 million ($56 million General Fund) for increased CalFresh and California Food Assistance Program (CFAP) administration costs as a result of implementing the Patient Protection and Affordable Care Act (ACA). The CFAP provides food benefits (fully funded with General Fund) to legal immigrants that are not eligible for the federal program.

The ACA implemented January 1, 2014 and will increase CalFresh and CFAP enrollment among those currently eligible for Medi-Cal but not enrolled and those newly eligible under the ACA. Caseload is projected to grow by 5.9 percent (145,000 recipients) in 2014-15.

Transportation

Rip-Off Cap and Trade Revenues for High-Speed Rail. The Governor proposes to rip-off $250 million of Cap and Trade tax revenues to fund high-speed rail and another $50 million for grants to existing rail operators to integrate rail systems and provide connectivity to the high-speed rail (HSR) system. In November, a Sacramento County Superior Court judge ordered the HSR Authority to rescind its funding plan because it is **financially unfeasible and in violation of Proposition 1A** bond language that voters approved. The rescission effectively halted the HSR Authority's ability to spend the bond funds. Although the HSR Authority was able to obtain approval from the federal government to spend the federal grant funds in advance of a state match, federal matching requirements continue, resulting in the Administration ripping-off Cap and Trade revenues to begin fulfilling this requirement.

So far, five Cap and Trade auctions have generated $532.6 million state revenues, of which, $500 million was loaned to the General Fund in the current fiscal year. An additional $836.3 million in auction proceeds have been distributed to investor owned utilities and public owned utilities. The Cap and Trade program was established as a "market-based mechanism" to fund programs that reduce greenhouse gas emissions (GHG) to 1990 levels by 2020. Cap and Trade tax money is supposed to be used for programs that would reduce greenhouse gas emissions in the short term, prior to 2020.

Since the first piece of operational high-speed rail track will not be completed until 2021 HSR **cannot possibly help reduce greenhouse gas emission levels by 2020**. This calls into question the legality of using Cap and Trade funds for HSR. Additionally, in a report entitled, "Funding Requests for High-Speed Rail," the Legislative Analyst's Office raised legal concerns surrounding the use of Cap and Trade revenues. The LAO references an independent study that determined the HSR project would initially be a net emitter of GHGs and it would take approximately **30 years before the project would reduce GHG emissions**. Taxing California businesses for producing GHGs then spending those tax proceeds on a state project expected to emit GHGs for the next 30 years rather than on mitigation programs is appalling. The Governor's plan to force California businesses to fund his broken HSR dream through the Cap and Trade tax should be denied.

Transportation Infrastructure Investment is Important but it Must Be Cost-Effective. The Governor proposes a $1.7 billion investment in transportation infrastructure. This includes the $300 million mentioned previously for the HSR project and rail integration and connectivity grants. Additionally, the Governor proposes allocating $1.7 billion of remaining Proposition 1B bond funds for the rehabilitation of transit systems and intercity rail projects. Finally, the Governor proposes an early repayment of $351 million in outstanding General Fund loans primarily from the Highway Users Tax Account (HUTA). The $337 million repaid to the HUTA will fund preservation and maintenance projects on state highways and local roads that would otherwise be funded in 2015-16 or later.

The early repayment of General Fund loans to invest in infrastructure is a step in the right direction but $337 million doesn't begin to scratch the surface. Last year, in light of a shortfall of $242.4 billion needed for infrastructure over a ten year period, the Governor called for a workgroup to prioritize transportation expenditures, explore long-term pay-as-you-go revenue options, and evaluate the most appropriate level of government to deliver high-priority investments. The Governor's Budget does not propose a long-term funding solution but states the workgroup will continue working toward this effort. However, there are concerns beyond how to raise funds. In a Reason Foundation Study, entitled "Examining U.S. Highway and Bridge Performance Trends from 1989 to 2008," **California ranked last in the country in "overall performance and spending efficiency."** California spent $5.84 per mile on state-administered highways, more than twice the national average, yet California's rural and urban interstates are some of the worst in the country, ranking 48th and 49th respectively. Before more resources are raised for transportation infrastructure, likely in the form of new taxes, we need to look at why we pay so much for such a bad system right now. Until we reform how funds are raised and spent, a new tax would be another headache for the taxpayers that fails to deliver a real benefit.

Resources & Environmental Protection

Rip-Off of Cap and Trade Funds. The Governor's Budget proposes to spend $850 million of Cap and Trade tax revenues in 2014-15 to support existing and pilot programs that supposedly reduce Greenhouse Gas Emissions (GHG) and meet SB 535 (2012) goals relating to GHG impacts in disadvantaged communities. The investment plan, which identified broad state priorities, continues through the 2015-16 fiscal year. This budget provides the most project specific details to date, however, whether these projects are consistent with the requirements of AB 32 and actually reduce GHG emissions is unclear. What is clear, however, is that the use of Cap and Trade tax revenues to fund the High Speed Rail project (see Transportation Section, Page 33) would not meet the requirements of reducing GHG emissions as the project would actually increase GHG significantly during construction. These programs and pilot projects are summarized in the chart below.

Cap and Trade Expenditure Plan

(Dollars in Millions)

Category	Department	Program	Amount
Sustainable Communities and Clean Transportation	High-Speed Rail Authority/Caltrans	Rail Modernization	$300
	Strategic Growth Council	Sustainable Communities	$100
	Air Resources Board	Low Carbon Transportation	$200
Energy Efficiency and Clean Energy	Department of Community Services and Development	Energy Efficiency Upgrades/Weatherization	$80
	Department of General Services	Green State Buildings	$20
	Department of Food and Agriculture	Agricultural Energy and Operational Efficiency	$20
	Department of Water Resources	Water Action Plan - Water and Energy Efficiency	$20
Natural Resources and Waste Diversion	Department of Fish and Wildlife	Water Action Plan - Wetlands and Watershed Restoration	$30
	Department of Forestry and Fire Protection	Fire Prevention and Urban Forestry Projects	$50
	CalRecycle	Waste Diversion	$30
Total			**$850**

To date, the Air Resources Board has held five auctions with two remaining auctions in the 2013-14 fiscal year to be held in February and May of 2014. Currently, the sales have generated $532 million in state revenues of which $500 million was borrowed for General Fund use in the 2013-14 budget. The 2014-15 budget proposes to repay $100 million of those monies with the remaining amount to be repaid after 2017-18. This leaves a total of $132 million currently available for the expenditures identified in the chart above. The remaining $718 million is expected to be generated from the future auctions in the 2013-14 and 2014-15 fiscal years. Past auctions have also generated an additional $836 million for investor owned utilities and public owned utilities with the revenues to be used as directed by the California Public Utilities Commission or governing boards for ratepayer benefits pursuant to AB 32.

Beverage Container Recycling Program Reform Imposes Fee Increases on Manufacturers. The Governor's Budget attempts to reform the Beverage Container Recycling Program to address the approximately $100 million annual structural deficit within the Beverage Container Recycling Fund (BCRF) that is driven by mandated program expenditures. The program currently has a recycling rate of 82 percent which means the program has become successful in its recycling efforts. Unfortunately, when the recycling rate was much lower, new programs were established that became dependent on the unredeemed California Redemption Values (CRV). The need for program reform is long overdue; regrettably it appears that the Administration has focused the reform on a few areas of the program which affect beverage manufacturers, processors, and recyclers rather than spreading the reduction more evenly across all program areas. The budget would eliminate millions of dollars in funding that is used to help pay for the cost to recycle containers ($67 million reduction annually by 2016-17), and by reducing administrative program fees paid to processors/recyclers ($26 million reduction annually by 2015-16). The total spending reductions to the program will equal approximately $127 million by 2016-17 with about 74 percent of the cuts affecting these three entities. The fee increases on manufacturers could be a violation of Prop 26 requiring a 2/3 vote threshold as these fees provide an overall public benefit. These new recycling and administrative costs will likely be passed onto beverage consumers.

Other notable changes affect cities and counties by reducing curbside recycling funds by $15 million and redirecting funding of $10.5 million from local recycling efforts to local competitive grant programs aimed at compliance, enforcement, and recycling***.*** This proposal also reduces $15 million in funding from the BCRF to the local conservation corps recycling program, but backfills those funds with monies from the Tire Recycling Management Fund, Electronic Waste Recovery and Recycling Account, and Used Oil Recycling Fund. **It should be noted that two of these special funds combined are owed over $100 million from prior General Fund loans.** The activities that will be funded with these new revenues is unclear, but the continuation of beverage container recycling activities would clearly be an inappropriate if not illegal use of those new funds that are derived from fees on consumers and businesses for a different purpose.

This proposal would also establish 400 new convenience zone recyclers but reduce funding per recycler saving $7 million in handling fees. The impact on existing recyclers is unknown. At this point, the reform seems to heavily impact a few areas of the program while CalRecycle's own administrative costs actually increase by $1.4 million annually. As more information becomes available and stakeholders are engaged in the process, the true impact and effectiveness of this proposal should be more evident.

California Drinking Water Program Transfer. The budget proposes to transfer $200.3 million and 291.5 positions for the administration of the Drinking Water Program from the Department of Public Health to the State Water Resources Control Board. The Administration indicates that this transfer is needed to provide better accountability for water quality issues, comprehensive technical and financial assistance to help small disadvantaged communities with multiple water related issues, and to improve the efficiency and effectiveness of drinking water, groundwater, water recycling, and water quality programs. The transfer of this program is a huge policy issue affecting individuals, local jurisdictions, water agencies, and businesses and requires much scrutiny. At this time, it is unclear whether this transfer will provide a better drinking water program or simply reorganize existing cubicles with little overall improvements to the program. **This proposal could also lead to fee increases on the agricultural communities, water agencies, and businesses depending on the types of new regulations that the State Water Resources Control Board approves. The devil is in the details, but no details are currently available.**

New Fees on Oil Industry for Oil Spill Response. The Department of Fish and Wildlife's Oil Spill Response Program will expand the existing 6.5 cent per barrel fee, currently collected at marine ports, to all crude oil sent to refineries. This will provide additional revenues of $11.3 million annually for the Oil Spill Prevention & Administration Fund (OSPAF) to create a statewide oil program, which includes the existing marine oil spill program and the establishment of a new inland oil spill response program. Additionally, these new fees will help fund the Oiled Wildlife Care Network and backfill current structural deficiencies in OSPAF. **This proposal will also eliminate the January 1, 2015, sunset date on the 6.5 cents per barrel fee making this a permanent program. This is yet another cost on California businesses.**

New Fees on Oil and Gas Industry for SB 4 Implementation. The Governor's Budget proposes $20.4 million from the Oil, Gas, and Geothermal Administrative Fund for the implementation of SB 4 (2013), which requires the Natural Resources Agency to conduct a scientific study of the risks of well-stimulation treatments, including fracking, by January 1, 2015, and establishes a separate permit for well stimulation, and requires the disclosure of chemical constituents and contents of fracking fluids including trade secrets, a groundwater monitoring plan, and public notice of the treatments. These new costs include funding for the Department of Conservation ($13 million and 65 positions), the State Water Resources Control Board ($6.2 million and 14 positions), and the California Air Resources Board ($1.3 million and 6 positions). These new costs will be funded from an increase in the oil and gas assessment rate and additional operator fees.

Inappropriate Special Fund Use to Enforce Marijuana Cultivation Laws. The budget contains proposals for both the State Water Resources Control Board and the Department of Fish and Game to deal with water quality and Endangered Species Act violations due to illegal marijuana production. Although these proposals seem meritorious, the costs are funded with Waste Discharge Permit Fees, Fish and Game Preservation Funds, and Timber Regulation and Forest Restoration Funds. These enforcement programs provide a general purpose benefit and any new enforcement activities should be a General Fund responsibility and not just imposed upon a few fee payers. ***This proposal would likely impose a fee increase on Waste Discharge Permits.***

Implementation of the California Water Action Plan. The budget proposes to expend $618 million in 2014-15 on various existing water programs including expanding groundwater management, safe drinking water projects, water-energy efficiency projects, restoration of coastal and mountain watersheds and wetlands, a Salton Sea Restoration project, increased flood protection, and Integrated Regional Water Management program projects. The funding will be made up of Proposition 84 bond funds, Proposition 1E bond funds, Cap and Trade funds, State Water Pollution Control Revolving Fund, Waste Discharge Permit Fund ***(fee increase),*** various other special funds, and a small amount of General Fund. Future investments in the Water Action Plan are unknown at this time, however, the Administration is planning stakeholder meetings to identify and prioritize any new investments.

Proposition 65 Reform. The budget proposes $785,000 Safe Drinking Water and Toxic Enforcement Fund (two years) for the Office of Environmental Health Hazard Assessment to revise Proposition 65 regulations and to develop a public website providing information on exposure to listed chemicals. According to the Administration, the intent of this reform is to provide the public more meaningful information about exposure to listed chemicals, make regulations clearer to encourage business compliance, and avoid unnecessary litigation**. This appears to be a sensible approach to bring some level of usefulness to a program which has provided very little benefit to the general public while harming California businesses.**

Additional Funding for Fire Protection Services. The budget proposes additional funding of $13.5 million (General Fund) and $670,000 (SRA fee) to reestablish fire protection services in the Tahoe Basin ***(previously eliminated by this Administration in 2011-12)*** and new services for two communities in San Bernardino and Riverside Counties. The United States Forest Service determined that it could not provide adequate protection for 92,600 acres of State Responsibility Area in these three high-risk and high-value areas, therefore, the state is proposing to resume primary protection responsibility. This will provide funding for seven stations (two in Lake Tahoe Basin, three in San Bernardino County, and two in Riverside County). SRA fee funding will also be used for "fire prevention" activities including the Civil Cost Recovery Program. The SRA fees along with the Civil Cost Recovery Program are currently under litigation. Lastly, this proposal includes funding for the operations of a helitack base in San Bernardino County which is currently staffed by the San Bernardino Sheriff's Department (SBSD). The budget indicates that the SBSD will no longer be able to fund these activities.

Additional Funding to Maintain State Park Services. The budget includes additional funding of $16 million (one-time) from the State Park and Recreation Fund (SPRF) to continue existing park service levels and provide reimbursement to the National Park Service for services performed for state parks. ***Apparently, the department has determined that there is excess revenues in the fund (unclear how these revenues materialized) to offset the $16 million in current operational costs.*** In addition, $40 million (one-time) General Fund is proposed for critical infrastructure deferred maintenance needs.

Public Safety

2011 Public Safety Realignment

The Governor's Budget reflects funding for the 2011 Realignment Legislation (Realignment) of $6.8 billion in 2014-15, including $6.3 billion General Fund and $497 million Motor Vehicle License Fee Account. Of the total $6.8 billion, $4.5 billion would support realigned programs in the area of health and human services and $2.3 billion would fund local criminal justice programs. Of the $2.3 billion for criminal justice, $1.2 billion would be allocated to trial court security and local public safety programs that have traditionally been funded by the state, including the Citizens' Option for Public Safety (COPS) program, the Juvenile Justice Crime Prevention Act (JJCPA) program, juvenile probation and camps, booking fees, subventions for small and rural sheriffs, etc. This would leave **just $1.1 billion for local law enforcement** to manage the population of offenders that was shifted from state to local responsibility pursuant to Chapter 15, Statutes of 2011 (AB 109).

Funding Still Falls Short. The Governor’s Budget fails to provide an adequate level of additional operational funding for the local law enforcement agencies tasked with implementing Realignment, leaving sheriffs, probation departments, and district attorneys facing an ongoing uphill battle to manage offender populations and provide programs to reduce recidivism with insufficient resources. Local officials have indicated repeatedly that Realignment funding overall has been inadequate and that the existing allocation methodology favors some counties while leaving others in the lurch, yet the Governor and legislative Democrats continue to insist that local officials have exaggerated the inadequacy of Realignment funding and the disparity in its allocation. Senator Cannella introduced legislation in 2013 (SB 144) that would have redirected more than $800 million in annual state savings resulting from Realignment to provide additional flexible funding (i.e., funding for recidivism reduction programs, drug and mental health treatment, public safety staff, jail space, etc.) for counties to implement Realignment. The funding would have been allocated equitably based on the number of realigned offenders managed by each county. Senate Democrats killed SB 144 in committee on a party-line vote.

Some Improvements Proposed. On the other hand, the Governor’s Budget provides some encouragement in that it finally begins to acknowledge some of the serious flaws with Realignment that Senate Republicans have been pointing out since the policy was introduced in 2011.

Limits Long-Term Jail Sentences. AB 109, the original public safety realignment legislation, required virtually all "non-serious," "non-violent," "non-sex" felony offenders to serve their terms of incarceration in local jails instead of the state prison, regardless of the length of an inmate's term. Senate Republicans pointed out early on that local jails were never intended, let alone designed, to house inmates long term. The Governor's Budget finally concedes that very long-term sentences are not appropriately served in county jails, and proposes changing the law to require offenders with sentences longer than ten years to serve their time in the state prison. While this is definitely a step in the right direction, it does not go far enough. Local sheriffs have indicated that a more appropriate break point would be sentences longer than three years. Senate Republicans introduced legislation in 2013 (SB 255/Cannella) that would have required sentences longer than three years to be served in the state prison, but Senate Democrats killed the bill in committee.

Expands Jail and Programming Space. Since well before AB 109 was enacted, Republicans have maintained that local jails lacked the capacity and programming space to handle the massive influx of offenders they would receive under Realignment. Apparently the Governor now agrees, as his budget proposes an additional $500 million in lease-revenue bond (LRB) funding for counties to build jail facilities that include improved treatment and programming space. The Administration asserts that "old jails do not lend themselves to the kinds of treatment and programming space needed to run effective in-custody programs that lead to success once an offender is released."[15] While the proposed LRB funding would allow some counties to improve their treatment and programming space, it does nothing to ensure adequate operational funding to pay for treatment and programming services. Notably, funding that would have been provided in Senator Cannella's SB 144 could have been used for this purpose, for staffing improved jail space, or for virtually any other need arising from Realignment.

Targets Recidivism Reduction Through Mandatory Supervision. Another Realignment flaw that Senate Republicans pointed out from the beginning is that AB 109 did not require supervision of realigned felons released from county jail. Prior to AB 109, these same felons would have had a mandatory three-year parole term from which they could be discharged after a year of supervision without a major violation. The Governor's Budget references research that shows "when a person is released from incarceration, a reentry plan with structured supervision and programs provides the best opportunity to lower recidivism rates."[16] To that end, the Administration proposes legislation that would require every jail felony sentence to be a split sentence (with a period of incarceration and a period of mandatory post-release supervision) unless the court finds it in the interest of justice to impose a straight sentence (incarceration only) based on the facts of the case. However, it is unclear if the additional supervision will result in less jail time for offenders.

Reinvestment Still Needed. Although the Governor's Budget proposes several improvements to Realignment, it falls short in the areas of funding and accountability. Additional funding is still needed for counties to develop the evidenced-based programs necessary to reduce recidivism rates among the realigned populations. Furthermore, AB 109 required almost no data collection or reporting by counties to measure program success. This type of data collection and reporting is necessary to ensure that the programs implemented by counties actually achieve the intended goals of recidivism reduction, reduced incarceration rates, and successful reintegration of offenders into their communities as productive members of society. The state needs to reinvest resources into this data-gathering effort if Realignment is to achieve statewide success. Senate Republicans will introduce legislation to address this problem.

Court-Ordered Prison Population Cap

In June 2011, the federal three-judge panel (3JP) overseeing the consolidated *Coleman* and *Plata* class-action lawsuits ordered the state to reduce its prison population to no more than 137.5 percent of design capacity by June 30, 2013. The order was later amended to extend the deadline to December 31, 2013. In September 2013, it was clear that Realignment would not reduce the prison population enough to meet the court's deadline, so the Legislature enacted Chapter 310, Statutes of 2013 (SB 105) as a stopgap measure to prevent the early release of dangerous felons into California communities. At that time, the Administration petitioned the 3JP for a two-year extension of time to meet the population cap requirement. SB 105, which received nearly unanimous support from both Democrats and Republicans, provided $315 million for the Department of Corrections and Rehabilitation (CDCR) to reduce the prison population through recidivism reduction efforts and to contract with in-state and out-of-state providers for enough bed space to house the remaining inmates that would otherwise have to be released.

Bipartisan Solution Blocked by the Court. In September 2014, following the enactment of SB 105, the 3JP blocked CDCR from sending additional inmates to out-of-state facilities, ordered the parties to meet and confer to determine how the state could meet the court's population cap, and extended the deadline to January 27, 2014. The court later granted a further extension to April 18, 2014. During the meet-and-confer process, the parties were to focus on ways to meet the cap while providing a durable solution, including examination of policies related to three strikers, juveniles, elderly and medically infirm, and inmates with federal Immigration and Customs Enforcement holds. The parties were also

[15] 2014-15 Governor's Budget Summary, p. 84.
[16] 2014-15 Governor's Budget Summary, p. 83.

authorized to discuss releasing prisoners on the 3JP's "Low Risk List", relocating prisoners within the state, and any other means previously identified by the state to the court. Notably, the order did not authorize the parties to discuss housing additional inmates in out-of-state facilities. It appears that the court was trying to push the state to reduce its prison population by releasing inmates early. On January 13, 2014, the 3JP issued an order declaring the meet-and-confer process a failure and indicating that the court intends to issue an order by February 12, 2014 that will grant, deny, or grant in part and deny in part the state's request for a two-year time extension.

Proposed Solutions Empty Prisons But Do Little to Rehabilitate, Fail to Address Capacity Needs. The Governor's Budget offers a collection of solutions to satisfy the 3JP order, most of which are generally undesirable from a public safety standpoint because they focus too much on early release and not enough on rehabilitation, recidivism reduction, and bed expansion.

Existing Law. The Administration is counting on two recent changes in the law to help drive the prison population down.

- Proposition 36 "Three Strikes" Reform – Proposition 36 (2012) changed the requirements for a life sentence under Three Strikes law to provide that the third strike must be for a serious or violent offense. It also specified that a third-strike offender already serving a life sentence pursuant to Three Strikes law, whose third strike is for a "non-serious," "non-violent" offense, may petition the court for resentencing under the provisions of the new law. The Governor's Budget indicates that 1,300 eligible third strikers have already been resentenced and released. The Administration estimates there will be another 1,000 to 1,500 releases pursuant to Proposition 36.

- Parole Eligibility for Inmates Sentenced to Prison as Minors – Chapter 312, Statutes of 2013 (SB 260) expanded parole eligibility for offenders who were sentenced to prison for committing a felony while under the age of 18. Depending on the term of the offender's sentence, SB 260 made these offenders eligible for a youth offender parole hearing after either 15, 20, or 25 years served. It is important to remember that the reason these offenders were sentenced to prison as minors, rather than adjudicated through the juvenile criminal justice system, is because the crimes they committed were particularly heinous. Virtually all of these offenders are convicted murderers or serial sex offenders. The Administration estimates that approximately 200 inmates could be released by July 1, 2015 as a result of SB 260.

Court-Identified Measures. In a June 2013 order that reaffirmed earlier 3JP orders requiring the state to reduce its prison population, the court listed a number of measures it would accept as means for the state to meet the population cap deadline. The Governor's Budget proposes the immediate implementation of several of these measures, including:

- Medical Parole – Existing law authorizes medical parole for inmates who are "permanently medically incapacitated." The Governor's proposal would expand medical parole to include more inmates with "severe physical or cognitive conditions." This vague and undefined standard could jeopardize public safety.

- Elderly Parole – The Governor proposes referring certain inmates who are at least 60 years old and who have served at least 25 years to the Board of Parole Hearings to determine suitability for parole. According to the Administration, certain categories of inmates would be excluded, though the categories proposed for exclusion have yet to be identified.

- Second Striker Credit Enhancements – Once a legitimate tool to encourage and reward positive inmate behavior, "good-time credits" have become a euphemism for early release. With credits automatically awarded to most inmates at a rate of one day for each day served, the requirements to keep those credits reduced to an inmate simply not having disciplinary action against him or her for a period of time, and generous policies allowing restoration of credits that are taken away for disciplinary reasons, **incentives for an inmate to adopt positive behaviors have been virtually eliminated.** Second strikers, on the other hand, are limited to one day of credit for every five days of discipline-free time served, making the credits they are able to receive more valuable. The Governor's Budget would dilute the impetus for non-violent second strikers to behave by reducing the amount of good time required to receive a day of credit from five days to three days.

Other Proposals. In addition to the measures described above, the Governor's Budget includes several other proposals that could, in theory, reduce the prison population, either directly or by reducing recidivism. These proposals, however, **assume the 3JP will grant a two-year extension to its population cap order.** Otherwise, the funding for these proposals, all of which would come from the Recidivism Reduction Fund established by SB 105, would be used instead to contract for in-state and out-of-state bed capacity to prevent the early release of thousands of dangerous felons.

- Reentry Contracts – The budget includes $40 million Recidivism Reduction Fund to contract with local jails or community-based providers for residential reentry services. By shifting prison inmates with a year or less left of their sentences to jails or community-based residential programs, this proposal would have an immediate effect on the prison population. In addition, assuming that local providers deliver evidence-based programs that actually reduce recidivism, this proposal could also indirectly reduce the prison population when fewer offenders reoffend. However, given the relatively small investment and lackluster performance in the past, it is unlikely this proposal will result in a significant reduction to the prison population.

- In-Prison Substance Abuse Treatment – The budget proposes $11.8 million Recidivism Reduction Fund to expand the existing in-prison substance abuse program to 10 additional facilities. These are the same types of services that have been eliminated in the recent past due to poor implementation, abysmal participation and completion rates, and their failure to significantly reduce recidivism. In a 2003 report that called the state's parole system a "billion-dollar failure," the Little Hoover Commission noted that the state's in-prison drug treatment program lacked adequate and independent oversight and supportive management, all of which ultimately led to the program's failure. Let us hope history does not repeat itself.

- Treatment and Support for Mentally Ill Parolees – The budget includes $11.3 million Recidivism Reduction Fund to expand the existing Integrated Services for Mentally Ill Parolees (ISMIP) program by 50 percent, from 600 program slots to 900. The program provides treatment, housing, and mental health rehabilitative services with a focus on helping mentally ill parolees to develop independent living skills. At about **$38,000 per program slot**, and given the population of offenders with a high propensity to recidivate, especially when they go off their medications, **this proposal is a costly one with limited potential to significantly impact the prison population.**

Too Little, Too Late. The state's prison population has been trending higher than CDCR's projections since Realignment was first implemented. The Governor's Budget adjusts the 2013-14 average daily population estimate upward by more than 6,000 inmates over the May Revision estimate, with an increase of more than 2,800 inmates projected for 2014-15. Even if the 3JP grants a two-year extension and all the measures described above are successfully implemented, it is still likely that CDCR will fail to meet the population cap within the allotted time. On the other hand, the 3JP could refuse to extend the deadline, in which case the Governor's plan would be to use all $315 million of the SB 105 funds to contract for additional in-state and/or out-of-state bed space. In either case, **the very real possibility exists that significant additional funding, possibly in the range of tens of millions to hundreds of millions of dollars, will be required to prevent the early release of dangerous felons into our communities.**

Judiciary

Reinvesting in the Trial Courts. Between 2008-09 and 2012-13, annual baseline General Fund support for the trial courts was reduced by about $724 million. The reductions have been mitigated to a large extent thus far by new revenues from court user fee increases and by backfilling them temporarily from available reserves. Despite these offsets, the reductions have been particularly difficult for the trial courts to implement and have resulted in widespread furloughs and layoffs of court employees, reductions in court services, and court closures.

Beginning in 2014-15, trial court reserves will be exhausted and will no longer be available to offset the ongoing reductions. Accounting for all offsets, including a $60 million baseline increase in 2013-14, the ongoing net reduction to the trial courts now stands at about $315 million. The Governor's Budget proposes a $100 million General Fund augmentation for the trial courts. While this increase will certainly help, the Administrative Office of the Courts (AOC) indicates that another $97 million would be required just to bridge the gap that will occur on the natural beginning in 2014-15 when trial court reserves are exhausted. To maintain a 2013-14 level of service the total increase for 2014-15 would need to be about $260 million. **The Governor's proposal is a step in the right direction, but according to the AOC, it will fall short of preventing further reductions in court services and court closures.**

Access to justice is a societal imperative. However, it should be noted that the courts, like all other state agencies, have a responsibility to operate efficiently. There is some evidence that the courts may still have room for improvement, fiscally speaking. During the recent recession, when virtually all other state agencies were suspending pay raises and cost-of-living adjustments, some courts still provided salary increases to their employees. Furthermore, while most state employees contribute approximately 50 percent of their retirement costs, many court employees still make no contribution to their pensions. As the Legislature determines the appropriate level of funding for the courts, it will be important to ensure that funds are allocated in a manner that promotes efficiency without overburdening the taxpayers.

Labor and Workforce Development

Employment Development Department (EDD)

Unemployment Insurance Loan Repayment. The Governor's Budget includes $231.6 million General Fund to pay interest due to the federal government in September 2014 for an Unemployment Fund loan secured to pay Unemployment Insurance (UI) benefits. The UI fund began incurring this debt in January 2009 at the height of the "Great Recession." In October 2013 the EDD reported that, "The UI Fund deficit was $10.2 billion at the end of 2012. The deficit is projected at $9.7 billion at the end of 2013, $8.8 billion by the end of 2014, and $7.0 billion by the end of 2015 if changes are not made to the financing structure." California borrowed $611.7 million from the State Disability Insurance Fund to make the first two interest payments ($303.5 million in September 2011 and $308.3 million in September 2012), spent $259 million from the General Fund for the September 2013 payment, and will continue to pay interest until the UI loan is fully repaid.

In the interim, **the federal government is ratcheting up federal employment taxes (by 0.3 percent each year; it is currently up 1.2 percent)** to pay down the principal on the federal loan, which is currently projected to be fully repaid by 2020. Federal employment taxes are scheduled to increase by 0.3 percent in tax year 2011, 0.6 percent in 2012, 0.9 percent in 2013 and 1.2 percent in 2014. According to EDD, California employers paid increased taxes of $290.7 million in 2012 and $602.8 million in 2013, with additional tax increases totaling $932.3 million in 2014 and $1.3 billion in 2015. In this case, a lack of action by the Governor and legislative Democrats equates to a backdoor **tax increase on employers**. In California, it seems employers are always picking up the pieces.

The Governor does not have a proposal to right-size UI program, but directs the Legislature and interested parties to come up with a proposal for solvency that achieves the following goals:

- Achieve a prudent reserve by 2021 substantial enough to withstand a recession.
- Repay the Disability Insurance Fund and General Fund for interest payments made by the state.
- Phase in changes to the financing structure to smooth the impact on employers to the extent possible.
- Include reforms to improve the integrity of the unemployment insurance program.

Proposed New Fees/Penalty Increases. Even in a climate of revenue surpluses, the Governor's Budget proposes two new "fees" and a penalty increase on employers to support state programs.

- **Unemployment Insurance (UI) Administration.** The Governor is proposing to increase withholding penalties on employers (deposited in the Contingent Fund) from 10 percent to 15 percent to fund the administration of the UI program. According to the EDD, the federal government continues to underfund the UI Admin grant, providing only about 73 percent of what its own Resource Justification Model calculates California should receive. Instead of pushing the federal government to fully fund its share of UI administration, the EDD conducted a zero-based workload analysis of the program and proposes to make up the $113 million shortfall in 2014-15 with state resources, including **increased penalties on employers.**

- **Process Safety Management Expansion.** The Governor's Budget includes a new regulatory fee based on the amount of crude oil being processed at each refinery to fund a $2.4 million expansion at the Department of Industrial Relations to enforce workplace health and safety regulations in 15 refineries and over 1,600 other facilities that handle hazardous chemicals. The intent of this expansion is to increase the number of refinery inspections as well as the time spent conducting each inspection, with the expected result of avoiding fires and other dangerous occurrences similar to what happened at the Chevron Refinery in 2012. While it may be prudent to ensure increased workplace safety at these types of facilities, it is important to note that this is yet another fee that will contribute to gas price increases (as it will be passed on to the consumer). According to the American Petroleum Institute, California taxpayers already pay the highest sales and excise taxes per gallon of fuel in the nation. A more detailed discussion regarding gas taxes in California can be found in ***Appendix A on Page 48.***

- **Public Works/Prevailing Wage Enforcement.** The Governor's Budget proposes a new registration fee on contractors who work on public works projects to fund an $11.4 million program consolidating all public works and prevailing wage enforcement activities within a single unit at the Department of Industrial Relations. Effectively, this proposal would shift the burden of enforcing the overly burdensome and expensive prevailing wage law from bond proceeds [as required by SBX2 9 (Padilla/2009)], and the General Fund to the contractor, which will continue driving up the cost of public works construction in California. Driving up the cost of construction will result in fewer jobs created and fewer projects being completed within finite bond resources authorized by the voters.

Statewide Debt

Wall of Debt. The "Wall of Debt" reflects the fiscal impact of actions taken from 2001-02 through 2013-14 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. At its height, this "borrowing" totaled approximately $34.7 billion. The Administration estimates that before actions proposed in the Governor's Budget, the remaining "budgetary borrowing" as of June 30, 2014 should be reduced to $24.9 billion.

Wall of Debt as of 2014-15 Governor's Budget							
	Outstanding (as of 6/30/14) before Governor's Budget Proposals	Additional Payments 2013-14	2014-15 Pay Down	2015-16 Pay Down	2016-17 Pay Down	2017-18 Pay Down	Amount Remaining after 2017-18
Totals	**$24,866**	**$4,288**	**$6,709**	**$5,932**	**$3,878**	**$3,310**	**$0**

Source: Department of Finance Wall-of-Debt Table

Detail not included in this table, but available upon request, reflects the Governor's plan to reduce the Wall of Debt in the following areas:

- Nearly $6.2 billion ($3.7 billion in 2013-14 and $2.5 billion in 2014-15) to unwind deferred payments to schools and community colleges.
- $598 million in 2013-14 to restore "underfunded" Proposition 98 costs.
- $3.2 billion in 2014-15 to reflect the scheduled one-quarter cent sales and use tax revenue dedicated to paying down Economic Recovery Bonds ($1.6 billion), as well as supplemental $1.6 billion payment pursuant to the provisions of Proposition 58.
- $927 million in 2014-15 to repay special funds for moneys borrowed in previous years.

Statewide Debt. Combined with the "Wall of Debt," the Governor estimates $355 billion of long-term liabilities, which will constrain the state's finances in the future. The following table reflects the Administration's estimates of long-term liabilities (dollars in billions).

California's Long-Term Liabilities	
Unfunded Retirement Liabilities (State Retiree Health, State Employee Pensions, Teacher Pensions, UC Employee Pensions, and Judges' Pensions)	$217.8
Wall of Debt	$24.9
Proposition 98 Maintenance Factor	$4.5
Unemployment Insurance Debt	$8.8
Deferred Maintenance	$64.6
Unissued Bonds	$33.9
Total	**$354.5**

Unfortunately, while he has identified $355 billion of long-term liabilities, the Governor has neglected to include $80.8 billion of General Obligation debt and $10.3 billion of Lease Revenue debt. This debt has already been issued to investors, and the State Treasurer estimates that the General Obligation debt alone will cost the state about $4.9 billion in 2013-14 and $5.3 billion in 2014-15 (4.9 percent and 5.0 percent of estimated General Fund revenues, respectively).

Miscellaneous Department Issues

Fee Payers Should Get the Service They Pay for From Consumer Affairs. The Governor's Budget includes $12.7 million special funds and 101 positions to handle increases in enforcement and licensing workload within the Department of Consumer Affairs (DCA). The increased workload is driven primarily by increases in the licensee population. It has become increasingly apparent through the examination of enforcement and license data as part of a performance-based budgeting effort that as licensee populations have grown, processing times have increased. Since licensees fund the DCA boards and bureaus they would directly benefit from decreased enforcement processing times and decreased application processing times.

While many DCA boards and bureaus plan to increase fees through the 2014-15 fiscal year, these fee increases would occur on the natural because fund reserves have diminished over many years. Fees are not indexed to keep pace with inflation and the increasing cost of administering these programs, for instance, the rising cost of labor. Additionally, some General Fund loans will be repaid early to help support the cost of these new positions. It is about time that the fee payers benefit from these funds rather than the funds being ripped-off for General Fund programs. The misuse of these fees has been a concern raised by Senate Republicans, which resulted in a special funds hearing last August. Lastly, the Governor's Budget requires the DCA to report to the Legislature on the impact of these additional resources. To that end, it would be more appropriate to make these resources temporary and let the DCA justify the continuation of these resources in the future.

Driver's Licenses for Undocumented Immigrants Begin. Chapter 524, Statutes of 2013 (AB 60) required the Department of Motor Vehicles (DMV) to issue a driver's license to an applicant who cannot verify his or her legal presence in the United States, provided he or she produces documentation establishing his or her identity and residency in California and meets all other qualifications for licensure. The license must be visually distinguishable from a regular license and must include the following notice: "This card is not acceptable for federal purposes; it is acceptable for driving purposes only. It does not establish eligibility for employment, voter registration, or public benefits."

The Governor's Budget reflects the implementation of AB 60, including an augmentation of $67.4 million from the Motor Vehicle Account (MVA) in 2014-15 for DMV for staff, equipment, and office space to accommodate an estimated 1.4 million new applicants over a three-year period. Total costs over the three years are projected to be $141.8 million MVA, offset by an estimated $46.8 million in new fee revenues, for a **net cost of $95 million.** Regardless of how one feels about providing driver's licenses to undocumented immigrants, it is reasonable to expect that the fees should at least cover the full costs of the program.

Major Regulations. Chapter 496, Statutes of 2011 (SB 617), which was supported by many Senate Republicans, requires an in−depth economic analysis for all new major regulations. Beginning November 1, 2013, all state agencies promulgating a regulation with an economic impact over $50 million dollars in any 12−month period are required to conduct a Standardized Regulatory Impact Assessment. The Department of Finance has created standards for agencies to analyze their major regulations, and will be reviewing each agency's assessment and providing comments to the department. The assessments and Finance's comments will become part of the public rulemaking record, and are intended to help the state and affected parties understand the impacts of regulatory choices.

Reliance on Outside Contractors. The Governor's Budget includes numerous proposals that transfer contracted positions to state employees, including proposals within the departments of Health Care Services, Managed Health Care, Public Health, Child Support Services, and Technology. Notwithstanding the details related to the individual proposals, this policy direction runs contrary to past

Republican efforts to reduce state costs via increased private sector competition. Not only do we believe contracting out can provide savings in the near-term, but adding to the ranks of state employees will also drive long-term retirement and health care costs that could be avoided by contracting out.

State Controller's Office. The Governor's Budget includes $6.5 million ($3.2 million General Fund) on a one-time basis in 2014-15 to fund litigation and related support efforts associated with the *MyCalPAYS* payroll system. In November 2013 the Controller's Office cut off mediation efforts with its integration vendor, SAP, and filed suit in Sacramento Superior Court seeking an unspecified amount of money for damages incurred by the state. Republican members should be concerned that the Controller's action to end mediation and proceed with litigation appears to be premature. The state has already spent about $260+ million on the project, with virtually nothing to show for it.   The August 15 oversight hearing left much to be desired. Instead of pursuing litigation, the Controller's office should be focusing on how to reconcile with the company that created the software and figure out a way to remove institutional friction that is making it difficult to move forward with this project. This issue will likely receive significant attention and discussion during 2014 budget committee hearings.

Appendix A - California Tax Rankings

California is a great state to live and work. The state's climate, weather and quality of life are the envy of the country. California leads the nation with its cutting edge high-tech and biotech industries and has a rich and vibrant agriculture industry. It also has large markets, its ports are the gateway to and from Asia and it has a large pool of skilled labor.

For all of California's benefits, it has some significant drawbacks. For the privilege of living, working or operating a business in the state, Californians are required to pay some of the highest personal and corporate income taxes in the nation, and are subjected to unnecessarily burdensome and overly complex laws and regulations.

Over the last decade, California has consistently placed at or near the bottom of many national business climate and tax rankings, which compare the business climates of the nation's 50 states.

CEO magazine, in its 2013 annual survey of 736 CEOs, ranked California as the worst state to do business for ninth year in a row. Keep in mind that they have conducted the survey for only nine years.[17] One CEO commented, "California is getting worse, if that is even possible."

Forbes Magazine rated California as being the 41st worst state for business. This report was based on based on six factors: business costs, labor supply, regulatory environment, current economic climate, growth prospects and quality of life.[18]

According to the Tax Foundation's 2013 *State Business Tax Climate Index,*[19] California has the third worst business tax climate in the nation, behind only New York and New Jersey (see following table). *The **Index rates a state's tax systems*** based on individual income tax, corporate tax, sales tax, and property tax.

State	Overall Rank	Corporate Tax Rank	Personal Income Tax Rank	Sales Tax Rank	Property Tax Rank
California	48	31	50	41	14
New Jersey	49	41	48	46	50
New York	50	25	49	38	45

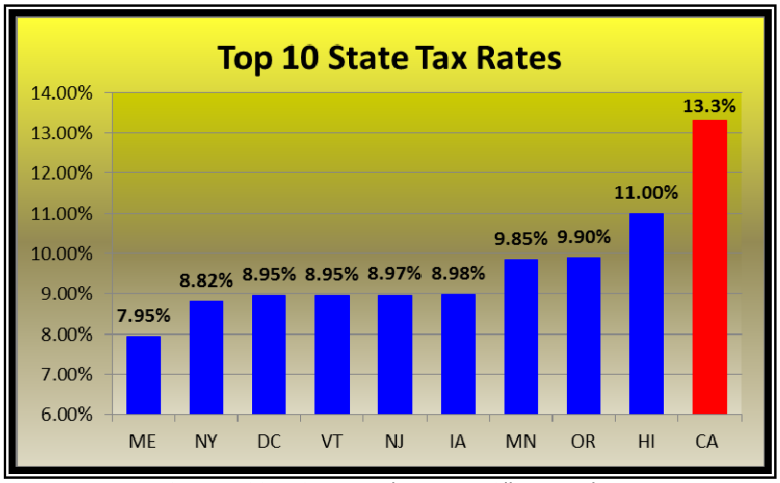
The next couple of pages will dissect a portion of the state's overall tax structure, and provide a comparison of how California compares to other states in terms of the state's major tax rates.

Personal Income Tax: Highest in the Nation

California has the highest, and one of the most progressive, personal income tax systems in the nation. Before the passage of Proposition 30 in November 2012, California had the second highest personal income tax rate in the nation. Proposition 30 pushed personal income tax rates even higher, increasing taxes on those making $250,000 or more. The state's top rate is now 13.3 percent for all personal

[17] Chief Executive Magazine, Iowa's Good at Growing: 2013 Best & Worst States for Business - http://chiefexecutive.net/california-is-the-worst-state-for-business-2013
[18] Forbes Magazine, "Worst States for Business," published December 12, 2012. http://www.forbes.com/sites/kurtbadenhausen/2012/12/12/maine-leads-list-of-the-worst-states-for-business/
[19] Tax Foundation, "2014 State Business Tax Climate Index," published October 9, 2013. http://taxfoundation.org/article/2014-state-business-tax-climate-index

income taxpayers with taxable income over $1 million (this includes the 1 percent surcharge for mental health programs under Proposition 63 of 2004). Hawaii ranks second with a top tax rate 11 percent, which kicks in at $200,000. Seven states do not impose a personal income tax.



Source: 2014 State Business Tax Climate Index

In terms of tax system progressivity, where a small number of higher-income taxpayers pay a larger share of their incomes in taxes, California has one of the most progressive tax systems in the nation. In 2010, the Pacific Research Institute rated California 48 out of 50 on the progressivity of its tax structure, behind only Hawaii and New Jersey.[20] In the 2011 tax year, more than 15.8 million returns were filed with the California Franchise Tax Board (including all classifications). California taxpayers with an adjusted gross income (AGI) greater than $200,000 accounted for about 4.9 percent of the total tax returns filed, but paid 62.8 percent of the taxes collected. Taxpayers with an AGI greater than $400,000 (top 1.6 percent) account for nearly 45 percent of the taxes collected.

Adjusted Gross Income	Returns	Tax Liability
No Taxes Paid	43.03%	0.00%
Less and $50,000	22.15%	3.18%
$50,000 to $100,000	18.55%	11.83%
$100,000 to $200,000	11.33%	22.20%
$200,000 to $400,000	3.35%	17.84%
More than $400,000	1.58%	44.95%

Source: FTB 2011 Annual Report

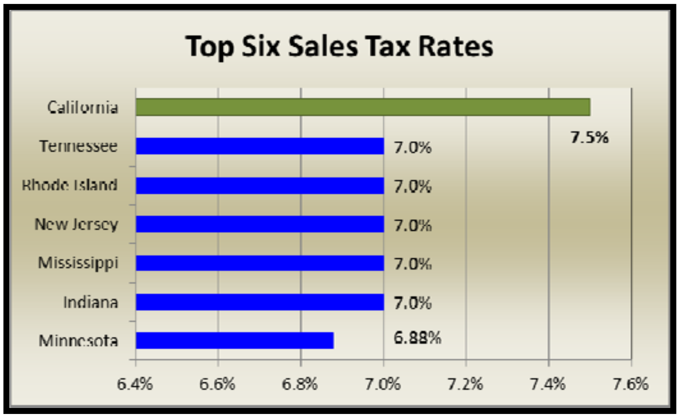
Also note that 43 percent of returns filed (about 6.8 million) either did not have a tax liability or received a full refund of wage withholding. These numbers do not include (a) employees who did not file a return because they did not meet the minimum requirements to do so, and (b) the “scofflaws” who are required to file a return but did not.

State Sales Tax: Highest in the Nation

California imposes a 7.5 percent statewide sales and use tax on the purchase or use of tangible personal property, which is the highest statewide rate in the nation. This rate includes Proposition 30’s quarter cent sales tax increase, which is effective through December 31, 2016. With one exception, city and county voters may also elect to increase the sales tax rate by up to two percent to fund

[20] Pacific Research Institute – Taxifornia: California’s tax system, comparisons to other states, and the path to reform in the Golden State. By Robert P. Murphy, PH.D., and Jason Clemens. March 2010

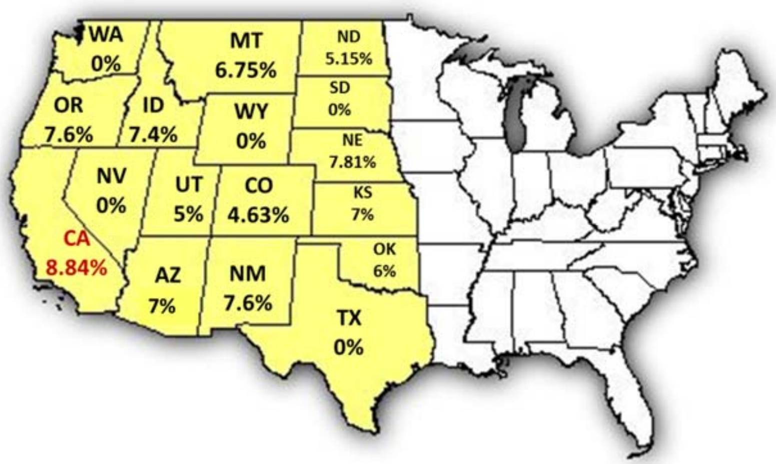
activities within their localities. The exception is Los Angeles County, which may increase the sales tax rate by 2.5 percent. Three counties have at rate of 9 percent (Alameda, Los Angeles, and San Mateo). Eighteen cities exceed nine percent, including three cities that tax its citizens at 10 percent. Statewide, however, the average (including local add-ons) is closer to 8.3 percent. The following table shows how California compares to the next six highest statewide sales tax rates.



Source: 2014 State Business Tax Climate Index

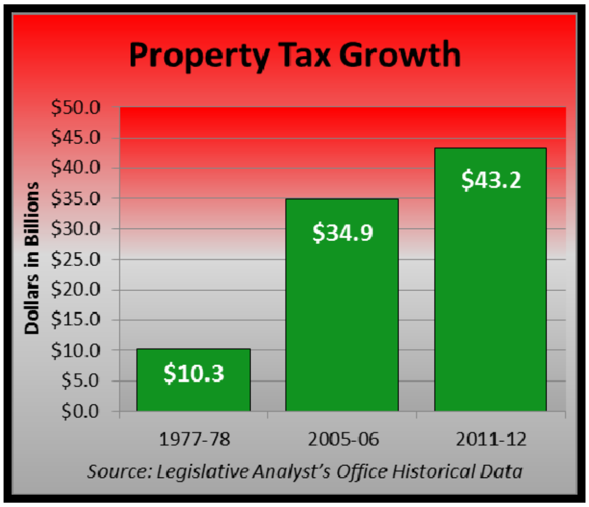
Corporate Income Tax: Highest in the West

California's has the eleventh highest tax rate in the nation at 8.84 percent levied on all corporate income. Only ten states have higher rates (Alaska, Connecticut, Illinois, Iowa, Maine, Minnesota, New Jersey, Pennsylvania, Rhode Island and District of Columbia). Iowa levies the highest tax rate at 12 percent, but that rate only applies to incomes over $250,000. Comparing state's that levy flat rates (every dollar earned is taxed the same), California has the 7th highest of the 50 states. And, California still has the highest rate in the western United States.



Data Source: 2014 State Business Tax Climate Index

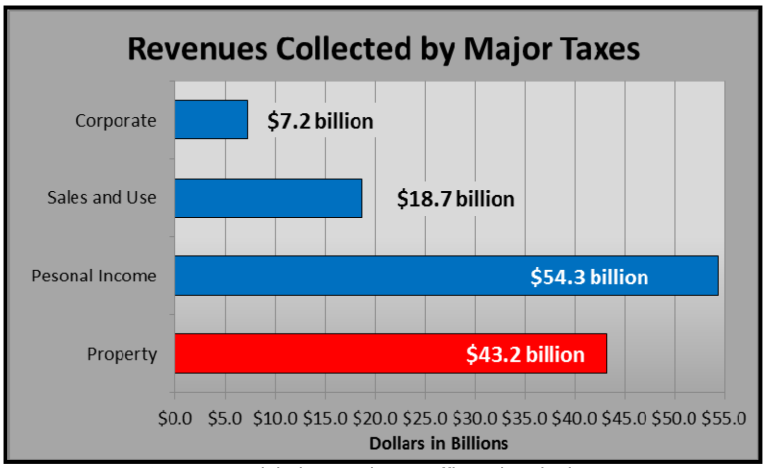
Property Tax: More Favorable, Thanks to Proposition 13



Thanks primarily to Proposition 13, which was passed by the voters in 1978 and capped ad valorem property taxes at 1 percent of assessed value, California ranks number 14 out of 50 states under the *2014 State Business Tax Climate Index*. Notwithstanding the protections commercial and residential property owners receive under Proposition 13, as of July 1, 2013 property taxes in California equated to $1,426 per capita, ranking California as 18th highest in the nation.[21]

In 2011-12, county assessors/collectors collected $43.2 billion in property taxes from taxable real property,[22] which is up from $10.3 billion in 1977-78 (after voters *cut* property taxes via Proposition 13) and $34.9 billion in 2005-06.[23]

As a source of tax revenue, property taxes are the second largest source of tax revenue behind personal income taxes, which accounted for $54.3 billion in 2011-12 and accounts for more tax revenue than the state's sales and use tax and corporate income tax combined.



Source: Legislative Analyst's Office Historical Data

Gasoline Tax: Highest in the Nation

Federal government collects 18.4 cents on ever gallon sold in the United States. In addition, states levy their own sales, use and excise taxes, as well as other taxes and fees. According to the American Petroleum Institute, California imposes the highest state gasoline taxes on consumers in the nation at 53.2 cents per gallon. Combined with the federal gas taxes, California taxpayers pay 71.6 cents for every gallon to the government, nearly three cents more per gallon than taxpayers in Hawaii.[24]

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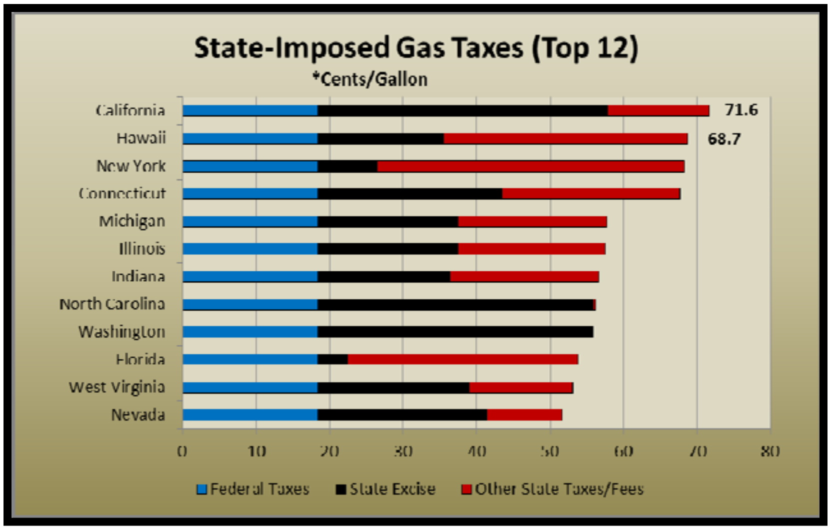
[21] Tax Foundation, "2014 State Business Tax Climate Index," published October 9, 2013. http://taxfoundation.org/article/2014-state-business-tax-climate-index

[22] Data provided by Legislative Analyst's Office, supplementing "Understanding California's Property Taxes," published November 29, 2012. http://www.lao.ca.gov/reports/2012/tax/property-tax-primer-112912.pdf

[23] Legislative Analyst's Office, "California's Tax System: A Primer," published April 2007. http://192.234.213.2/2007/tax_primer/tax_primer_040907.aspx

[24] Oil & Natural Gas Overview, "October 2013 Summary Reports," updated October 21, 2013. http://www.api.org/oil-and-natural-gas-overview/industry-economics/fuel-taxes



Source: American Petroleum Institute

Conclusion:
If past and present policies are any indication of future actions, California will remain a high-tax state for the foreseeable future. With the burdensome government laws and regulations, it has become increasingly difficult for businesses to deliver products and services in this state in a cost-effective manner. As businesses decide to leave the state or expand outside of California there will be an ever-decreasing number of good paying jobs and a general lack of opportunities for all Californians. Evidence of California's utter disregard for the state's job creators comes from another CEO cited in Chief Executive Magazine, who said, "California is completely confiscatory, ever dreaming up new ways to stick it to sub-Apple-sized companies. So far, Washington is smart enough to recognize where its jobs come from."[25] Unless and until California's policymakers take action to change, California will continue to be perceived as having a hostile business climate.

For additional information regarding this tax structure comparison update, call Joe Shinstock or Scott Chavez in the Senate Republican Fiscal Office at (916) 651-1501.

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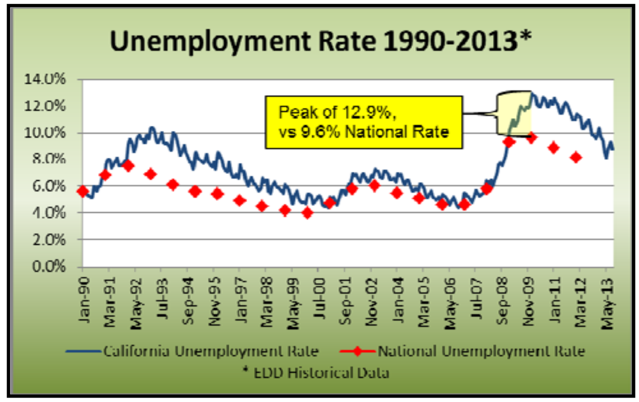
[25] Chief Executive Magazine, Iowa's Good at Growing: 2013 Best & Worst States for Business - http://chiefexecutive.net/california-is-the-worst-state-for-business-2013

Appendix B - What is the Real Unemployment Rate

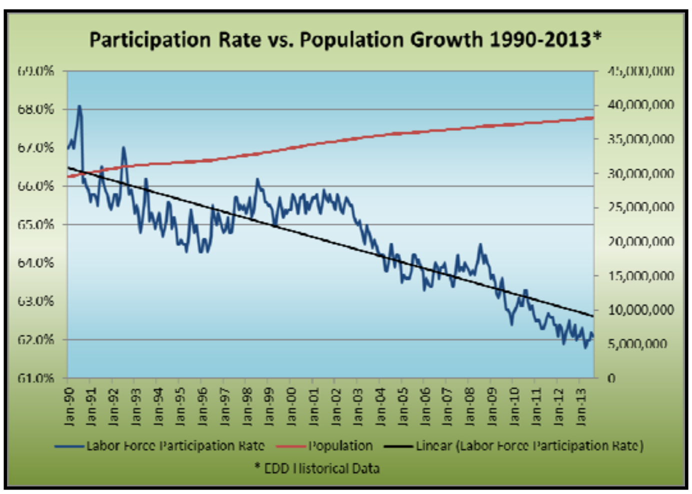


Over the past decade, California has struggled with high unemployment rates that exceeded the national average. At its peak in January 2010, unemployment in California reached 12.9 percent, about 3.3 percentage points above the national unemployment rate.

As of November 2013, the Employment Development Department reported that California's unemployment rate had dropped to 8.5 percent. Before the Administration and legislative Democrats start patting themselves on the back for a job well done, California voters should be aware that the unemployment rate doesn't tell the real story of the labor market (e.g. a low rate doesn't mean more people are going back to work).

A more accurate picture of labor market strength would factor in the labor force participation rate, which is at a 34-year low. In August 2013, *Express Employment Professionals* released a white paper that explores a variety of factors affecting the Labor Force Participation Rate (LFPR), and the growing damage done to workers resulting from current policies around unemployment, welfare, and disability insurance. (http://www.expresspros.com/US/Company/Media/Press/2013/documents/The-Great-Shift.pdf)

According to the report, the LFPR — or percentage of adults who have a job or are looking for one — has declined to a 34-year low. This decreasing labor force participation rate "… is a tragedy in the making, and its impact on the country has been underestimated. ***When Americans quit looking for work because they conclude not working beats working, America faces a significant problem.***"



As this chart demonstrates, even as California's population has increased by about 10 million people over the past 23 years, the LFPR has trended downward over that same time period.

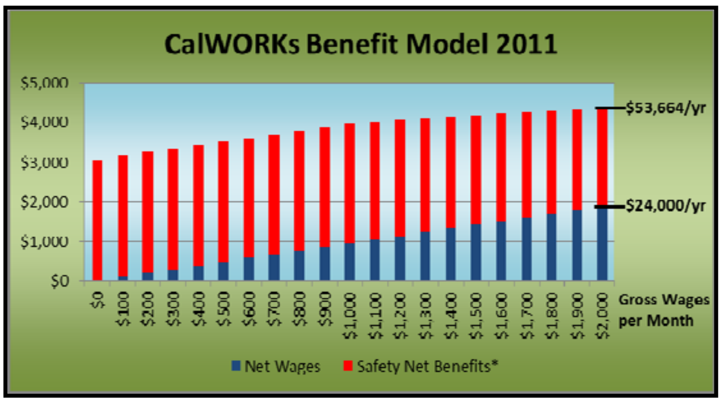
One of the most obvious causes of a declining LFPR is the increase in retirement among Baby Boomers. But the report identifies two unsettling economic trends that factor into the LFPR, but not the unemployment rate.

The bigger of these two trends facing the state and the country is the surprising, unexpected, and unprecedented trend that younger Americans are giving up and leaving the workforce. The number of people on disability (Social Security Disability Insurance/SSDI) is growing at an unsustainable rate, and they are not counted among the unemployed.

As reported by the *Federal Reserve Bank of San Francisco (FRBSF)*, **"the Social Security Board of Trustees and the Congressional Budget Office both project that, absent policy action, the SSDI trust fund will be exhausted by 2016."** The impending insolvency of SSDI owes in part to rapid growth in disability recipiency over the past two decades. According to the FRBSF, while about 56 percent of this growth can be attributed to a series of transitory events (increased normal retirement age, population aging, and increased women's labor force attachment), a **disturbing 44 percent of this growth is attributed to increases in disability benefit receipt across a broad range of gender/age groups** (resulting from changes in eligibility criteria for benefits, financial generosity of the program, and employment opportunities for potential beneficiaries). In simple terms, younger people are leaving the labor market at an alarming rate.

A recent investigation by Planet Money and National Public Radio (NPR) cited the evolution of the "Disability Industrial Complex" as one of the reasons for the nearly threefold increase in SSDI beneficiaries from 1980 to 2011. Lawyers in the *Disability Industrial Complex* profit when they successfully enroll their clients on disability. In many instances, this enrollment shifts a welfare recipient (a state cost) to the rolls of the federal SSDI (a federal cost). And, since a majority of people on federal disability do not work, they are not technically part of the labor force, and are <u>not counted among the unemployed</u>. Also, the California state budget could be at significant risk as a result of this trend. If SSDI becomes insolvent, the cost of funding these benefits will likely fall to the state level as recipients shift from SSDI back to state-funded entitlement programs.

Additionally, more Americans than ever are trapped in taxpayer funded social safety nets. In addition to the increasing value of benefits provided under SSDI, **California also provides a very generous social safety net that presents a moral hazard**, where it is more financially rewarding to rely on the government than to work. In the words of former President Clinton, "A society rooted in responsibility must first promote the value of work, not welfare."



Each year the Department of Social Services (DDS) develops a model to demonstrate the benefits available to CalWORKs families. As noted in this consolidated version of the DSS model, a family of three, a parent with two minor children as an example, would qualify for the CalWORKs Grant and Child Care, CalFresh, Child Tax and Earned Income Tax Credits, Making Work Pay Credit and Medi-Cal (**Safety Net Benefits*). The model shows that this family making $2,000 per month ($24,000 per year) has a standard of living that is equivalent to the same family earning wages of $4,472 per month ($53,664 per year). If California's government can essentially make people feel like they're earning $54,000 per year, there is little motivation to take *a job that pays* $54,000 per year or less.

Promoting the "general welfare" is a noble goal that should focus on caring for those members of our society who truly need help. However, California government should be concerned that the current social safety net is rewarding non-work, and potentially trapping people in a system that provides a more lucrative subsistence than the value provided by a higher paying job and a strong working economy.

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