Highlights and Analysis of the Governor's 2014-15 May Revision

May 19, 2014
SENATE REPUBLICAN FISCAL OFFICE

SEAL OF THE SENATE OF THE STATE OF CALIFORNIA

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SENATE REPUBLICAN FISCAL OFFICE

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Executive Summary

The Governor's May Revision provides a good framework for the budget. It retains a rational focus on addressing past debts and future liabilities, and building a rainy-day reserve. However, it is far from perfect as it still embraces the ill-conceived High Speed Rail boondoggle (*see Transportation page 26*); misuses funds from the new "Cap and Trade" tax that will hurt California's economy by increasing energy and gas costs; and fails to adequately fund the local public safety realignment that has shifted tens of thousands of felons into our local jails and neighborhoods.

Despite complaints from legislative Democrats, public employee unions, and their related spending interest groups, it is by no means an austere budget. ***General Fund spending reaches a new record high at nearly $108 billion, and is $11.5 billion higher than last year's enacted budget.*** Spending for the state's Medi-Cal program grows by $2.5 billion over two years as 2.7 million new people join the rolls driven by more generous eligibility rules and outreach efforts related to Obamacare (*see Health page 21*). State welfare grants are increased and the In-Home Supportive Services program expands as California continues to support one of, if not the most generous government social "safety net" systems in the nation (*see California Safety Net Facts page 39*).

Unfortunately, ***despite the record-high revenues and spending levels proposed by the Governor, there will never be enough generosity to satisfy some,*** as the Democrat chair of the Senate Budget Committee illustrated when he recently said, "It's time to start thinking about the need to extend the Proposition 30 tax increases that voters approved in 2012" – this despite Gov. Jerry Brown's promise that the $6 billion in sales tax boosts and income tax hikes would disappear by the end of 2018.[1] The Chair went on to warn that the plan for a new state rainy day reserve fund could cause financial problems in the future. "If we have $10 billion in reserve, how do we go to the voters in two or three years and say we have to extend their (Prop. 30) tax increase?"

The Legislature recently approved sending a bi-partisan Rainy Day Fund proposal to voters on the November 2014 ballot (*see Rainy Day Fund page 7)* that would protect the state from overspending in high tax revenue years and reduce the need for tax increases and spending cuts when revenues inevitably drop. Ironically, the day before passing the Rainy Day Fund measure, ***the leader of the Senate Democrats proposed to undermine the Governor's current rainy day reserve*** by pulling out $1.3 billion for more state spending in this year's budget plan.

[1] San Francisco Chronicle, May 3, 2014

Spending other people's money for whatever cause you believe in is not altruistic. Spending irresponsibly in a manner that returns California to a new era of budget deficits is not leadership. ***California is a state with one-party rule, and should legislative Democrats repeat the past mistakes of spending money we don't have in order please interest groups that will never be satisfied, it will be disastrous for all the people of California.***

Key Findings:

Budget Sets New Record High for State Spending**.** General Fund spending hits $107.8 billion, eclipsing the pre-recession peak of $103 billion. True General Fund program spending also hits a record $118 billion after accounting for fund shifts and other accounting maneuvers (*see Expenditures* page 9), which is about $10 billion higher than last year. Lastly, **total state spending (from all fund sources) now exceeds $254 billion – nearly $25 billion above the previous record** of $230 billion.

Record-High Revenues but Reserves Still Drop. The May Revision reflects General Fund revenues of nearly $107 billion, which surpasses the pre-recession peak of $102.6 billion. Net General Fund revenues are $2.4 billion higher across 2012-13 through 2014-15 when compared to the January Governor's Budget, but spending increases by $3.2 billion over the January Governor's Budget level. Thus the combined **budget reserves for 2013-14 and 2014-15 are $700 million lower than the January plan in order to accommodate the spending increase**.

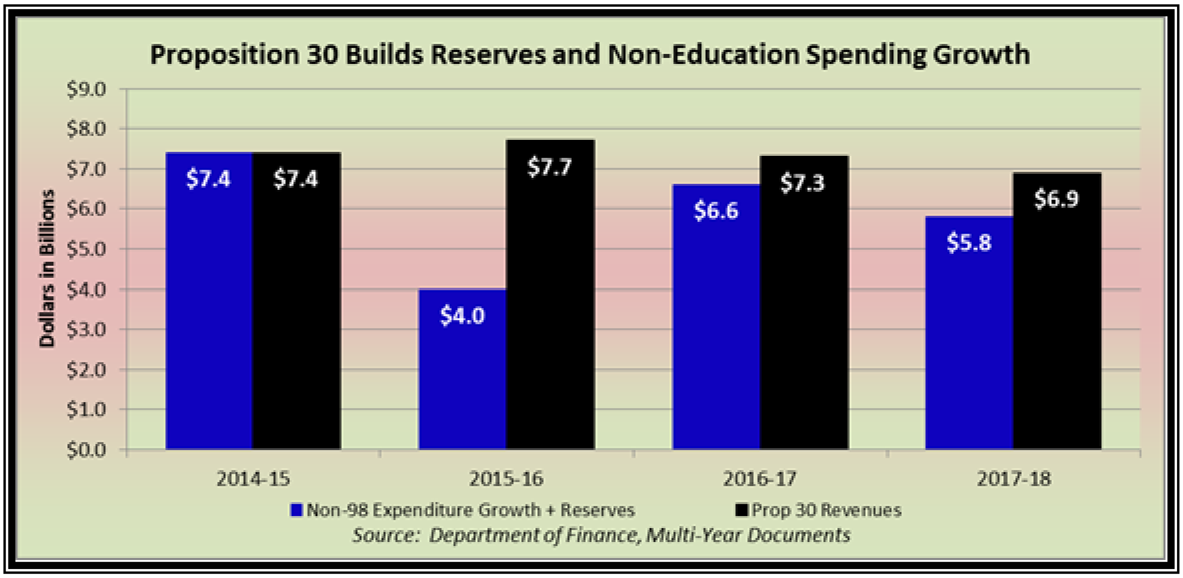
There is no "Surplus" with over $340 Billion of Debts and Liabilities*.* The May Revision revenue estimates include $8.6 billion that were not expected when the budget was adopted last year. Some refer to these as "surplus" revenues suggesting they should be spent for a variety of new government programs. However, **the state has repeatedly taken actions to provide services without paying the full cost** – as a result California has incurred debts and liabilities that exceed $340 billion according to the Legislative Analyst's Office. **The current debt load is nearly $9,000 for every single Californian.** It is not sensible to create new spending commitments when the state still cannot pay for its current services and future promises.

CalSTRS Fix Must Be a Top Priority. Picking up on the Republican proposal contained in SB 984 (Walters), the Governor proposes a plan of shared responsibility among the state, teachers, and school districts to address the massive $74 billion shortfall in the California State Teachers' Retirement System (CalSTRS) (*see Employee Retirement page 18)*. When fully implemented, the additional contributions will cost about $5 billion more per year for about 30 years to eliminate the unfunded liability and guarantee our teachers the pensions they have earned.

Medi-Cal Growth Devours the Budget. Writer P.J. O'Rourke could not have been more correct when he said: ***"If you think health care is expensive now, wait until you see what it costs when it's free."*** Nearly one-third of Californians (11.5 million people) will be enrolled in the state Medi-Cal health program at a cost of over $90 billion (all fund sources). The rapid expansion of Medi-Cal associated with Obamacare is driving explosive enrollment and cost growth far beyond anything that was anticipated. The May Revision proposes $17.4 billion General Fund for Medi-Cal, which now includes 2.7 million new enrollees associated with Obamacare. **The massive cost will divert funds from other core programs such as education, courts, public safety, and the social welfare safety net.**

Essential Charts:

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 $29.3 billion of additional revenue over the next four years, but $23.8 billion (81 percent) of expenditure growth will be spent on state programs unrelated to Proposition 98 (K-14) education and to build the general budget reserve. Some of those programs may be worthwhile, and building a reserve is meritorious, but that is not what Californians were told the funds would be used for by the supporters of Proposition 30.



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 ($3.1 billion) of the almost $7.4 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 May Revise. The promise of Proposition 30 continues to be broken *(see Proposition 30 Promises Not Kept on Page 13).*

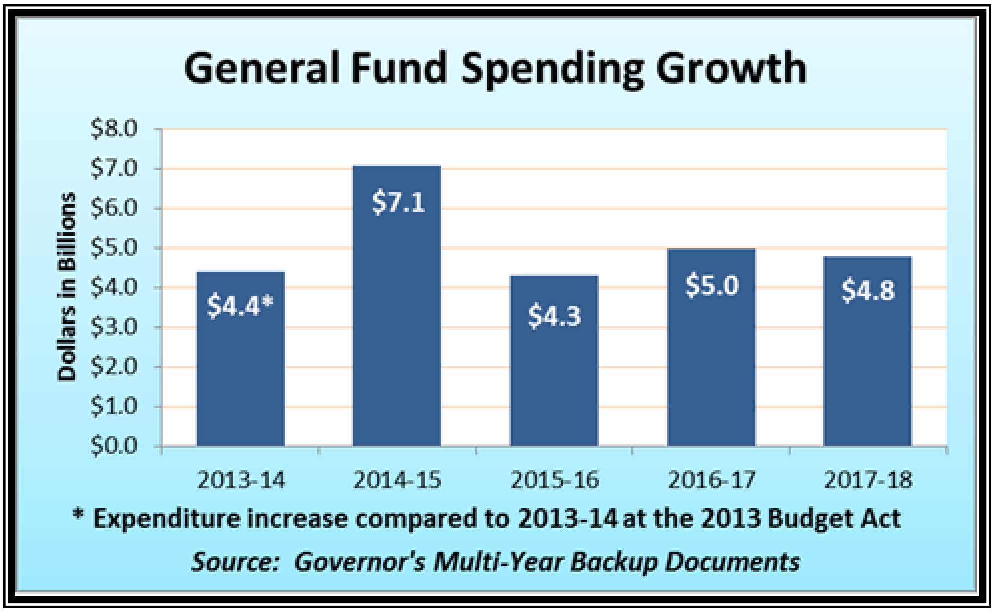
Budget uses Prop 30 revenue for non-education programs

$ in billions

	2014-15
Minimum Prop 98 guarantee with no Prop 30 revenue [1/]	$57.747
Proposition 30 revenue	$7.405
Minimum Prop 98 guarantee plus all Prop 30 revenue	$65.152
Prop 98 funding included in May Revision	$60.859
Prop 30 revenue used for non-education programs	$4.293

[1/] per Legislative Analyst

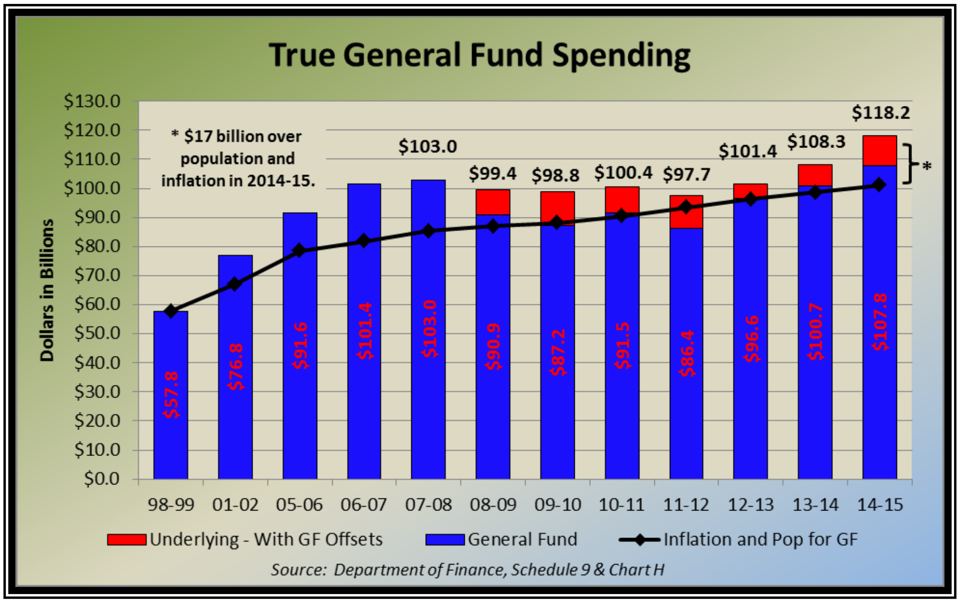
State Spending Grows Rapidly. Under the Governor's May Revision, state General Fund spending in 2013-14 grows by $4.4 billion (4.6 percent) over the 2013 Budget Act level and by $25.6 billion (26.6 percent) over five fiscal years (*see chart below*). **The Governor is still preaching fiscal restraint, but a $25.6 billion spending increase is not exactly a call for austerity.**



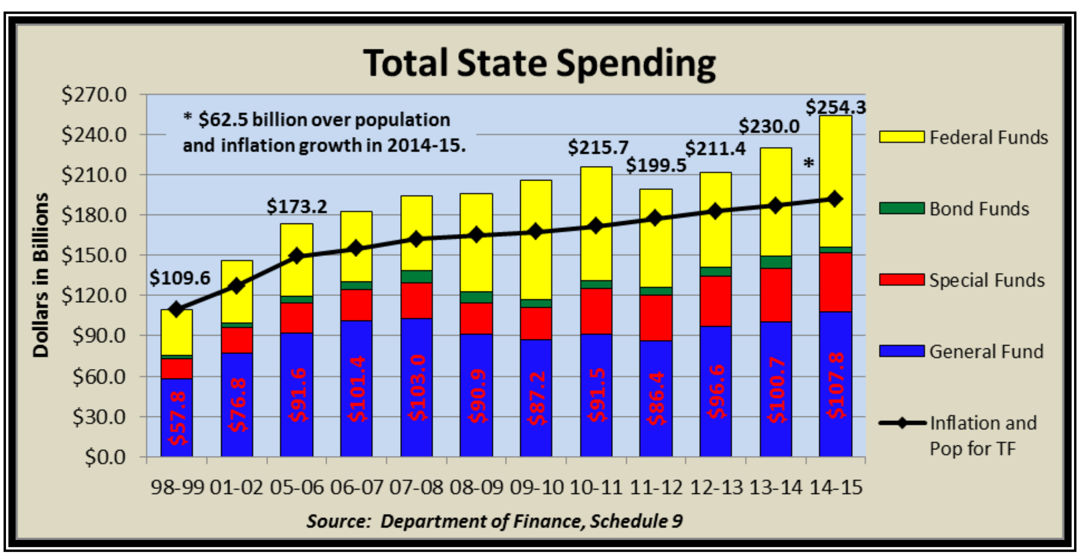
The False Story of Spending Cuts. Legislative Democrats and their allied spending interest groups continue to beat the drum about the need to forego paying off debts and building a reserve because they want to "restore" billions of dollars in cuts from the recession. However, as documented in the Governor's 2011-12 Budget Summary, ***over 80 percent of the budgetary actions taken during the recession were one-time in nature and the vast majority of those were fund shifts, accounting maneuvers, and tax increases***. In reality there were very few ongoing state program cuts adopted during the recessionary years and the most of those have already been reversed. ***The next two charts tell the real story*** – that state government continues to grow at an astounding pace.

1) **<u>True General Fund Program Spending</u>.** In 2007-08, California state government spent $103 billion from the General Fund. It was an all-time high spending level for the state following two dramatic revenue windfalls from the tech sector boom and then the housing market bubble. Then the Great Recession hit, and General Fund revenues plummeted. In response, the Legislature took action to shift funds around, transfer resources to the General Fund, and offset General Fund expenditures, which allowed spending on General Fund programs to continue even though General Fund revenues could not keep pace. The Legislative Analyst refers to this as taking "*actions that allowed it to provide services without at the same time paying for their full costs…"*

As noted in the chart below, true General Fund program spending hovered right around $100 billion for each of the five fiscal years following the peak in 2007-08. It does not suggest deep spending reductions. The May Revision now anticipates that California will spend $118.2 billion on General Fund programs in 2014-15, which is **$15.2 billion more than the pre-recession peak General Fund spending level.** This suggests that claims about billions of dollars in cuts not being restored are mostly false.



2) **Total State Spending.** General Fund spending is only a part of total state spending. Special funds, bond funds, and federal funds bring total state spending for 2014-15 to about $254.3 billion (*see chart below*). **Despite the Great Recession and Democrats' claims of "cutting to the bone," total state spending has hit record high levels**, and is $62.5 billion above population and inflation growth trends since the last stable budget in 1998-99 (i.e., stable being defined as normal spending growth with no state spending reductions or significant new taxes). Even when the state was tightening its belt during the Great Recession, California continued to grow total spending in all years except 2011-12.



Rainy Day Fund

Governor's Proposal Lacked Teeth. In January the Governor proposed a new rainy day fund (RDF) to replace ACA 4 (2010), which had already been scheduled for a vote on the November 2014 ballot. The Governor's proposal relied solely upon the state's capital gains revenues to make deposits into two reserves, one general account and one account for Proposition 98 expenditures. However, the focus on capital gains alone would have resulted in many good tax revenue years in which the state set aside no funds for a rainy day. The Governor's proposal also left the door open for legislative Democrats to use the RDF as a slush fund rather than a true "locked box" reserve for economic downturns because it could have been raided by a majority vote.

Republicans Gain Real Improvements. Republicans negotiated to improve upon the Governor's proposal, and the resulting bipartisan compromise bill, ACA 2X 1 (Perez), reflects the following key improvements secured by Republicans:

- *Up-Front Annual Deposits.* Provides for annual tax revenue transfers of 1.5 percent of all General Fund revenues to the general reserve or to debt reduction. In addition, the "windfall" capital gains in excess of 8 percent of revenue would also increase the reserve or reduce debt, after shifting the Proposition 98 portion to the education reserve. This greatly increases the funding available for reserves or debt reduction compared to the Governor's proposal to use only capital gains over 6.5 percent of revenue.

- *Objective Withdrawal Standards.* Sets objective measures for when withdrawals can be made in order to ensure the RDF is a "locked box" for economic downturns, not a slush fund that could easily be raided on a majority vote. Also limits the amount that can be withdrawn to the lesser of 50 percent of the reserve balance if no funds were withdrawn the previous year, or the amount needed to maintain a "current services" budget adjusted for population growth and inflation.

- *Ensuring the Reserve Is Built.* For the first 15 years, requires half of the RDF transfer amount to go into the reserve fund while the other half is used to reduce budgetary debts, including unfunded pensions and other retiree benefits. After 15 years, all of the RDF transfer will go into the reserve by default, but the state still would have the option to use up to half the transfer to reduce the same debts or unfunded obligations.

Billions in Reserves Projected. The RDF bill (ACA 2X 1) was recently approved in special session, rather than as part of the budget process, but the Governor's May Revision already reflects billions in contributions to the RDF and to debt reduction. As shown in the table on the next page, the Department of Finance projects rainy day transfers of $6.1 billion over three years beginning in 2015-16, including $3 billion for debt reduction and $3 billion for the general reserve. Notably, $5.3 billion of these combined amounts results from the up-front 1.5 percent set-aside that Republicans negotiated.

Rainy Day Fund Forecast *Dollars in Millions*	2015-16	2016-17	2017-18	Total
Annual 1.5% of General Fund Revenues	$1,698	$1,773	$1,854	$5,325
Capital Gains Taxes in Excess of 8% of General Fund Revenues	$174	$233	$341	$748
Total Rainy Day Amount	**$1,872**	**$2,006**	**$2,195**	**$6,073**
Debt Repayment (50%)	$936	$1,003	$1,098	$3,037
Deposit to General Reserve (50%)	$936	$1,003	$1,098	$3,037

Note: Capital gains amounts are net of amounts attributable to Proposition 98. All estimates assume there are no budget shortfalls that would allow other uses of Rainy Day amounts to maintain spending.

Source: Department of Finance, May Revision 2014

The compromise ballot measure clearly demonstrates the benefits of a two-thirds vote requirement and having Republicans at the negotiating table. This new RDF will redirect billions of tax dollars that normally would have been used expand state government programs. Instead, the funds will be used to build the reserve and for one-time purposes that do not grow “base” spending—reducing budgetary debts and unfunded liabilities for public employee pensions and retiree health care. If the reserve ever builds up to the cap of 10 percent of General Fund revenue, RDF transfers would be used for infrastructure projects. Thus, it is likely this measure will restrain state spending by billions of dollars.

Long-Sought Protections Now in Sight. Republicans have long fought to protect Californians against the spendthrift tendencies of the ruling party. Although there was a previous bipartisan agreement for a potentially stronger rainy day fund (ACA 4, 2010), legislative Democrats reneged on their agreement and refused to allow that measure to see a vote of the people. However, even if ACA 4 were allowed on the ballot, well-funded special interests such as public employee unions would have ensured its defeat. The compromise RDF may not be the “hard spending cap” that some would like, but **it is a great improvement over the reserve requirements currently in effect** and presents a real opportunity for approval by voters. Ultimately, the RDF and the limitations on use of excess tax revenues proposed in ACA 2X 1 are common sense, pragmatic improvements that will significantly reduce the pressure for new tax increases in the event of an economic downturn or emergency.

Expenditures

The 2014-15 May Revision proposes total General Fund expenditures of $100.7 billion in 2013-14 and $107.8 billion in 2014-15. As reflected in the table below, since the 2013-14 Budget Act was signed last June, total General Fund spending in 2013-14 has increased by $4.4 billion (4.6 percent). General Fund spending would increase by $11.5 billion from the 2013-14 Budget Act to 2014-15, bringing combined spending growth to $15.9 billion for the two years since the 2013-14 Budget Act was signed. Details regarding specific expenditure changes can be found throughout this document.

General Fund Expenditures by Agency

(Dollars in Millions)

Agency	Budget Act 2013-14	May Revision Revised 2013-14	May Revision Proposed 2014-15	Year over Year Change
Legislative, Judicial, Executive	$2,778	$2,696	$2,919	$141
Business, Consumer Services, Housing	$646	$643	$750	$104
Transportation	$206	$73	$216	$10
Natural Resources	$2,124	$2,234	$2,258	$134
Environmental Protection	$46	$51	$63	$17
Health and Human Services	$28,084	$28,858	$29,633	$1,549
Corrections and Rehabilitation	$8,911	$9,332	$9,600	$689
K-12 Education	$39,661	$42,892	$44,743	$5,082
Higher Education	$10,923	$11,373	$12,495	$1,572
Labor and Workforce Development	$299	$300	$303	$4
Government Operations	$742	$754	$692	-$50
General Government/Other	$1,861	$1,505	$2,490	$629
Supplemental ERB Payment			$1,604	$1,604
Total, General Fund Expenditures	**$96,281**	**$100,711**	**$107,766**	**$11,485**
Difference since the Budget Act		$4,430	$11,485	**$15,915**
- As a Percentage		4.6%	11.9%	**16.5%**

Source: Department of Finance Schedule 9

The May Revision also increases spending by $3.2 billion when compared to the January Governor's Budget. The table below provides a simple comparison of how spending projections for 2013-14 and 2014-15 have changed since the January budget.

Total General Fund Expenditures

(Dollars in Millions)

	Budget Act 2013-14	Revised 2013-14	Projected 2014-15	
Governor's Budget Projections	$96,281	$98,463	$106,793	
May Revision Projections	$96,281	$100,711	$107,766	**Total**
Change in Projections Since Governor's Budget		**$2,248**	**$973**	**$3,221**

Source: Department of Finance Schedule 9

General Fund spending represents only 42.4 percent of total state spending in 2014-15. As shown on *Pages 6 of the Executive Summary*, adding special funds, bond funds, and federal funds brings total state spending for 2014-15 to about $254.3 billion (including an additional $13.6 billion of federal funds related to the mandatory and optional health care reform Medi-Cal expansions and increased managed care tax revenues). This level of **total state expenditures is $24.3 billion higher than total expenditures in 2013-14 ($230.0 billion)**, and continues to exceed population and inflation growth since 1998-99 by $62.5 billion.

True state General Fund program spending, which accounts for fund shifts, transfers, and General Fund offsets that allow General Fund programs to continue growing, now totals $118.2 billion in 2014-15, **this is $15.2 billion (18.2 percent) higher than peak General Fund program spending in 2007-08** (prior to the "Great Recession"). As shown in the chart below, past solutions are no longer being used to "maintain General Fund program levels," but are fueling billions of dollars of growth in those programs.

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**	**$96.3**	**100.7**	**107.8**
"Offsets" to Maintain General Fund Program Levels*	--	$8.5	$11.6	$8.9	$11.3	$4.8	$7.6	$10.4
Total, General Fund Program Expenditures	**$103.0**	**$99.4**	**$98.8**	**$100.4**	**$97.7**	**$101.1**	**$108.3**	**$118.2**
Percentage Change from Peak 2007-08 General Fund Spending		-3.5%	-4.0%	-2.6%	-5.1%	-1.9%	5.2%	18.2%

Department of Finance – Schedule 9

Direct General Fund spending of $107.8 billion exceeds levels attained in 2007-08 (at $103 billion). True General Fund program spending tops $108.3 billion in 2013-14 and reaches $118.2 billion in 2014-15. In addition to $107.8 billion General Fund, the 2014-15 May Revision relies on an assortment of "offsets" that boost funding for General Fund programs including: (1) nearly $785 million of property taxes from redevelopment agencies to fund education, (2) realigning $6.7 billion of public safety programs to the local level, (3) $1.1 billion of weight fees to pay general obligation bond debt, (4) $1.8 billion of hospital fees and managed care taxes to fund health programs, and (5) a variety of smaller transactions to offset General Fund reductions and maintain General Fund programs. In prior years, the Legislature has relied on additional federal funds, redevelopment agencies, inter-year Proposition 98 deferrals, employee compensation deferrals, and local property tax borrowing to maintain General Fund programs in the absence of General Fund revenues.

Revenues

In addition to the $6.3 billion of revenue growth identified in the January Governor's Budget, **the May Revision increases General Fund revenue projections by more than $2.4 billion.**

The 2014-15 May Revision projects total General Fund revenues of $102.2 billion in 2013-14 and $107.0 billion in 2014-15. As noted in the table below, the Department of Finance projects that General Fund revenues will be nearly $2.4 billion higher (over the three year projection period) than projections used to build the January Governor's Budget. As noted near the bottom of the table, General Fund revenues available for programmatic expenditures in 2014-15 will be about $105.3 billion, resulting from a $1.6 billion transfer to the Budget Stabilization Account pursuant to Proposition 58 (2004). For reference purposes, May Revision revenue projections over the three-year period are estimated to be a combined $8.6 billion higher than was forecast in the 2013-14 Budget Act.

The Department of Finance indicates that its economic forecast has not changed significantly since the January budget – the majority of the changes to the forecast reflect current data on cash receipts as well as new tax return data. Cash trends since January have been generally positive.

On net, cash tax receipts are up by about $1.9 billion over the January Governor's Budget forecast through the end of April.

General Fund Revenue Projections
(dollars in millions)

2012-13 Revenue Source	Governor's Budget	May Revision	Forecast Change	%△
Personal Income Tax	$65,332	$64,484	-$848	-1.3%
Sales & Use Tax	$20,482	$20,482	$0	0.0%
Corporation Tax	$7,462	$7,783	$321	4.3%
Other Revenues	$4,825	$4,840	$15	0.3%
Transfers	$1,813	$1,813	$0	0.0%
Total Revenue	**$99,914**	**$99,402**	**-$512**	**-0.5%**
2013-14 Revenue Source	**Governor's Budget**	**May Revision**	**Forecast Change**	**%△**
Personal Income Tax	$64,287	$66,522	$2,235	3.5%
Sales & Use Tax	$22,920	$22,759	-$161	-0.7%
Corporation Tax	$7,971	$8,107	$136	1.7%
Other Revenues	$4,623	$4,450	-$173	-3.7%
Transfers	$346	$347	$1	0.3%
Total Revenue	**$100,147**	**$102,185**	**$2,038**	**2.0%**
2014-15 Revenue Source	**Governor's Budget**	**May Revision**	**Forecast Change**	**%△**
Personal Income Tax	$69,764	$70,238	$474	0.7%
Sales & Use Tax	$24,071	$23,823	-$248	-1.0%
Corporation Tax	$8,682	$8,910	$228	2.6%
Other Revenues	$4,342	$4,782	$440	10.1%
Transfers	-$765	-$803	-$38	5.0%
Sub-Total Revenue	**$106,094**	**$106,950**	**$856**	**0.8%**
BSA Transfer	-$1,591	-$1,604		
Total Revenue	**$104,503**	**$105,346**		
Three-Year Total (without BSA Transfer)			**$2,382**	

Source: Department of Finance Schedule 9

Personal Income Tax (PIT)

The cash surplus in PIT is mostly due to withholding in early 2014, and has been realized in months that are usually associated with high levels of withholding for annual bonus payments. Given the timing of the increased withholding and minimal changes forecast for wage growth, the higher PIT receipts so far this year are not expected to translate into significant increases in PIT revenue for the remainder of 2013-14 or 2014-15.

Corporations Tax

Although corporation tax cash is up almost $600 million through April, the 2013-14 revenue forecast increases only $136 million in the current year. The Franchise Tax Board (FTB) indicates that much of the strength in corporation tax cash is related to the timing of refunds, which were down by almost $400 million through April. FTB expects a large amount of refunds to be paid out through the end of June.

<u>Sales and Use Tax</u>
Cash from the sales and use tax is lower than the January projection and this reduces revenues through 2014-15.

Revenues from November 2012 Ballot Initiatives
For the past year and a half, we have been tracking revenues generated by two major tax-related initiatives that were anticipated to contribute significant revenues to the state (Propositions 30 and 39). With the May Revision, the Governor has revised the revenue estimates related to these initiatives.

Proposition 30 was originally estimated to generate $47 billion of new tax revenue spread over eight fiscal years. In January, the Governor's Budget reflected revenue of about $47.2 billion over that timeframe. As of the May Revision, the following table reflects total revenues of $48.7 billion, an increase of about $1.5 billion since January.

Proposition 30 Revenue Estimates Dollars in Millions									
	2011-12	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**Total**
PIT	$3,356	$5,516	$5,705	$5,965	$6,131	$6,511	$6,878	$2,811	$42,873
SUT		$640	$1,371	$1,440	$1,554	$827	$0	$0	$5,832
Total	**$3,356**	**$6,156**	**$7,076**	**$7,405**	**$7,685**	**$7,338**	**$6,878**	**$2,811**	**$48,705**

Source: Department of Finance Multi-year Backup Documents

Proposition 39 was projected to generate annual General Fund revenues of $1.1 billion, and required at least half ($550 million) to be used to fund projects that create energy efficiency and clean energy jobs in California. A year and a half after voters approved the initiative (November 2012), revenues from Proposition 39 are only 60-70 percent of what the ballot pamphlet estimated. The Department of Finance estimates Proposition 39 revenues to have been $293 million in 2012-13, and projects revenues of $613 million in 2013-14 and $705 million in 2014-15.

Legislative Analyst's Office (LAO) Revenue Projections Differ
Today the LAO released its *Overview of the May Revision*, which indicated that the Administration underestimates the strength of revenues throughout its projections.

> **"Across the four fiscal years (2011-12 through 2014-15), our General Fund revenue forecast is $2.5 billion higher than the administration's."**

Driven primarily by a more optimistic view of near-term trends in stock prices, home prices, and net capital gains realizations, the LAO forecasts personal income tax revenues to be about $2.8 billion higher than the Administration in 2014-15. However, given the volatility of the personal income tax and the ebbs and flows of capital gains over time, the LAO also emphasizes the importance of "setting aside reserves when revenues or capital gains climb sharply, as seems to be happening now."

The LAO may be a bit more optimistic than the Governor on the amount of state revenues that will come in, but he clearly recognizes that if legislative Democrats spend it and then the revenues don't materialize, they will drive us right back into budget deficits. Its one-party rule in California, and it will be a big mistake by the legislative Democrats if the state returns to cuts and taxes again so soon after getting another revenue windfall.

Proposition 30 Promise Not Kept

Proposition 30 Spending on Education. Proposition 30's new taxes were sold to the voters in 2012 primarily as a benefit to education, but rather than spend all of the resulting revenue in support of education, the Governor continues to direct much of it toward other priorities, e.g., to eliminate state employee work furlough days and fund salary and benefit increases ($650 million), increase pension contributions for PERS and CalSTRS ($400 million), to grow health and human services spending (about $775 million), and build a reserve ($1.6 billion). As the chart below shows, the 2014-15 May Revision continues to divert about $4.3 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 [1/]	**$57.747**
Proposition 30 revenue	**$7.405**
Minimum Prop 98 guarantee plus all Prop 30 revenue	**$65.152**
Prop 98 funding included in May Revision	**$60.859**
Prop 30 revenue used for non-education programs	**$4.293**

[1/] per Legislative Analyst

- 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 $57.7 billion.
- Estimated revenue from Proposition 30 in 2014-15 is about $7.4 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.
- 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.

Bottom line: California voters signaled their willingness to prioritize education when they agreed via Proposition 30 to pay higher taxes for the benefit of education. The Governor and Legislature should honor that bargain by using *all* of the Proposition 30 tax revenue to support education, instead of redirecting it to other uses. In addition, should the Legislature ultimately adopt a higher revenue estimate, any additional spending beyond that proposed in the Governor's May Revision should be restricted to increasing funding for education, building a rainy-day reserve, and reducing the state's "wall of debt."

Education

K-14

Funding rises in 2013-14, falls in 2014-15. The chart below displays proposed Proposition 98 funding for K-14 education in January, and at the May Revision:

Proposition 98 Funding at 2014-15 May Revision

Source: Legislative Analyst's Office

($ in millions) [1/]

	2012-13 January	2012-13 May	2012-13 change	2013-14 January	2013-14 May	2013-14 change	2014-15 January	2014-15 May	2014-15 change
K-12 education [2/]									
General Fund	$38,221	$37,752	-$469	$36,868	$38,465	$1,597	$40,588	$40,046	-$542
Local property tax revenue	$13,895	$13,848	-$47	$13,633	$13,405	-$228	$14,171	$14,089	-$82
K-12 subtotal	$52,116	$51,600	-$516	$50,501	$51,871	$1,370	$54,759	$54,135	-$624
California Community Colleges									
General Fund	$3,908	$3,853	-$55	$4,001	$4,187	$186	$4,396	$4,338	-$58
Local property tax revenue	$2,241	$2,264	$23	$2,232	$2,167	-$65	$2,326	$2,309	-$17
CCC subtotal	$6,149	$6,117	-$32	$6,233	$6,354	$121	$6,722	$6,647	-$75
Other Agencies	$78	$78	$0	$78	$78	$0	$77	$77	$0
Total Proposition 98	$58,342	$57,795	-$547	$56,813	$58,302	$1,489	$61,559	$60,859	-$700
General Fund	$42,207	$41,682	-$525	$40,948	$42,731	$1,783	$45,062	$44,462	-$600
Local property tax revenue	$16,135	$16,112	-$23	$15,866	$15,572	-$294	$16,497	$16,397	-$100

[1/] some numbers may not tie due to rounding
[2/] includes state preschool

As the chart shows, the 2013-14 Proposition 98 minimum guarantee of funding for K-14 education rises to $58.3 billion (up from $56.8 billion in January, an increase of about $1.5 billion), and the 2014-15 guarantee falls to $60.9 billion (down from $61.6 billion projected in January, a decrease of about $700 million since January, but still a year-over year increase of almost $2.6 billion from the 2013-14 level).

Local control funding formula poverty counts. The state's new local control funding formula (LCFF) will enter its second year of implementation in 2014-15. Under the new formula, local educational agencies (LEAs) receive per-pupil base grants based on average daily attendance, according to grade span (K-3, 4-6, 7-8, and 9-12), with base rates enhanced for grades K-3 (by 10.4 percent) and grades 9-12 (by 2.6 percent). In addition, they get supplemental grants worth an additional 20 percent of base grant funding for each low-income student,[2] English learner, or foster youth,[3] and concentration grants worth an additional 50 percent of base funding for these same students, to the extent that they exceed 55 percent of an LEA's total enrollment. For consistency with federal school lunch program rules, the May Revision proposes to relax LEAs' annual poverty count requirements. Certain schools that conduct comprehensive poverty counts only once every four years under the federal program would be

[2] Poverty is measured by eligibility for free or reduced-price lunches.
[3] A student who falls into one of these three categories is funded the same as one who falls into all three.

allowed to do the same for purposes of LCFF funding, but would still have to update their poverty counts annually to reflect newly enrolled or disenrolled students.

Inter-year funding deferrals. The Governor's January budget proposed to fully extinguish the state's deferrals of funding to schools and community colleges by the end of 2014-15. However, because the Proposition 98 minimum guarantee of funding for K-14 education for 2013-14 has risen since January, and the 2014-15 estimated guarantee has fallen, the May Revision would increase deferral payments in 2013-14 and decrease them in 2014-15. All of the inter-year deferrals would still be fully extinguished by the end of 2014-15.

Teachers' retirement fund contributions. Despite a $700 million reduction in the 2014-15 Proposition 98 guarantee from the level proposed in January, the May Revision makes no reduction to the Governor's January proposal to increase schools' LCFF funding by $4.5 billion in 2014-15. Rather, it would reduce 2014-15 deferral payments as discussed above. However, it would impose an additional local expenditure requirement intended to bring the State Teachers' Retirement System (CalSTRS) into solvency over time through increased contributions from employees, employers (LEAs), and the state (see Page 18 for a more complete discussion of the CalSTRS proposal). Specifically, employer contributions would rise from the current 8.25 percent to 9.5 percent of pay in 2014-15, requiring LEAs to spend about $350 million for this purpose that would otherwise have been available for other uses (e.g., smaller class sizes, instructional materials, transportation, etc). Employer contributions would continue to rise over time until they reach 19.1 percent of pay in 2020-21.

Internet connectivity for student testing. The May Revision provides $26.7 million in one-time funding to 1) assess schools' internet connectivity needs by Spring 2015, and 2) create a needs-based grant program to improve that connectivity where needed. This proposal is intended to ensure that the state's new testing system, under which most students will take computer-based tests, is functional statewide.

Proposition 39 energy efficiency projects. In January, the Governor proposed to spend $355 million in revenue resulting from voter approval of Proposition 39 in 2012 for energy efficiency projects at schools ($316 million) and community colleges ($39 million). The May Revision revenue estimate anticipates slightly less revenue, and reduces proposed allocations accordingly, to $344.5 million ($307 million for K-12 schools and $37.5 million for the community colleges).

Adult education. The May Revision proposes to suspend for one year the formation of new charter schools intended to serve adults, until the state's pending effort to develop a more comprehensive adult education plan is completed.[4] The Governor indicated last year that he plans to propose a $500 million adult education expansion in 2015-16. This proposal could be improved if its suspension was applied only to schools not yet authorized, as authorized schools may already have invested substantial funds to gear up for operation.

California Community Colleges (CCC). In January, the Governor proposed Proposition 98 support of the community colleges at about $6.72 billion. The May Revision reduces that proposal to about $6.65 billion, which is still up almost $300 million from the revised 2013-14 funding of $6.36 billion. Specific adjustments to the CCC budget most notably include:

- $148 million for deferred maintenance (up from about $88 million in January), with a one-year suspension of local match requirements

- $140 million for enrollment growth of 2.75 percent, down from $155 million for 3 percent growth in the Governor's January proposal

[4] Existing schools of this type would not be affected by this proposal.

- Retraction of an $88 million January proposal for instructional equipment (most of which is redirected to the deferred maintenance augmentation referenced above)

- $50 million in one-time funding to build regional capacity for career technical education

- $6 million to upgrade bandwidth and replace technology equipment at local campuses

- Full extinguishment of inter-year funding deferrals by the end of 2014-15, as noted above

- An increase in the state reimbursement rate for enhanced non-credit courses to match that of for-credit courses, effective in 2015-16

University of California and California State University (UC and CSU)

Funding proposed for UC and CSU at the May Revision is almost identical to that proposed in January – virtually the only funding change proposed in the May Revision is a $340,000 reduction reflecting lower general obligation bond debt service payments in 2013-14.

UC & CSU Funding at 2014-15 May Revision

(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 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

The Governor continues to make his proposed funding for UC and CSU contingent on the segments' agreement not to increase tuition during a four-year period starting in 2013-14.

Employee Compensation

Salary Increases Ramp Up. Fourteen bargaining units have contract agreements that include negotiated salary increases tied to a revenue-based “trigger” provided the Director of Finance makes the determination that revenues at the 2014-15 May Revision are sufficient to fully fund existing statutory and constitutional obligations, existing fiscal policy, and the cost of the trigger-based salary increases. The Governor’s January budget included funding for these increases ($173.1 million total funds, $82.4 million General Fund), and the May Revision confirms that revenues will indeed be sufficient to meet the criteria listed above. The May Revision proposes additional funding of $10.6 million ($7.9 million General Fund) to reflect updated salary information, bringing the total funding for these **salary increases to $183.7 million ($90.3 million General Fund)**. This increase is the first of two salary adjustments, a two percent salary increase effective July 1, 2014, and an additional 2.5 percent increase effective July 1, 2015. **The full cost of the 4.5 percent salary increase is projected to be about $775 million ($515 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 cost the state another $502.1 million ($247 million General Fund) in 2013-14.

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 automatic 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 increased. 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.

Employee Retirement

<u>CalSTRS</u>

Republican Plan to Fund Liabilities Stalled in Legislature. SB 984, introduced March 19, 2014 by Senator Walters would provide up to $2 billion to the Teachers' Retirement Fund to begin to offset the current $74.4 billion unfunded liability. Although the funding is critical to the long-term health of the fund and would result in savings down the road, the bill languishes in the Legislature. The cost to California families for CalSTRS' unfunded liability grows by $15 million each day, which means that **since SB 984 has been introduced (about 57 days) the unfunded liability has grown by $855 million.** The longer legislative Democrats delay action the greater the cost to other state programs such as education, courts, public safety, health care, and the social safety net.

Governor Proposes Shared Responsibility. Perhaps the Governor will have better luck than Republicans in his efforts to fix CalSTRS. The May Revision seeks to eliminate the $74.4 billion unfunded pension liability of the California State Teachers Retirement System (CalSTRS) over the next 33 years. The plan includes shared responsibility for the fund's unfunded liability among the state, school districts, and teachers. Additional state and teacher contributions would be fully implemented after three years, with contribution rates ramping up slightly each of the next three years (state contributions would increase from about 5.5 percent to 8.8 percent of payroll and teachers would increase from 8 percent to 10.25 percent of payroll). The Administration's plan would grant teachers a vested right to an annual 2 percent cost-of-living adjustment (COLA) during retirement as a bargaining offset to the increase in teacher's contributions (retired teachers receive this COLA annually but it is not considered a vested right). For school districts, which would bear most of the cost under the Governor's plan, the increased contribution rates would be phased-in over seven years, starting with a 1.25 percent increase in 2014-15, and increasing slightly each year until reaching a contribution level of 19.1 percent of payroll by 2020-2021 (school districts contribute 8.25 percent currently). For comparison purposes, employer contribution rates for CalPERS' School Plan will reach 20.1 percent by 2020-2021 and current state contributions for miscellaneous state employees are about 24 percent, plus the state pays another 6.2 percent for social security benefits, which the school districts do not pay.

The May Revision includes $446 million ($59.1 million General Fund) in additional CalSTRS contributions for the proposed plan in 2014-15 from all three sources (school districts, teachers, and the state); with **total 2014-15 contributions to CalSTRS projected to be about <u>$5.7 billion</u>.** By 2020-21, state contributions would equal $2.4 billion General Fund, up from $1.5 billion General Fund in 2014-15, and **funding from all three sources would be <u>$13 billion</u> and growing.**

Unfortunately, school districts bear the biggest financial burden and the additional cost to meet this obligation will ultimately hurt students. Had the legislative Democrats been willing to address this problem sooner, teacher pensions would be secure and our children wouldn't have to pay for it.

Governor Assuming Responsibility for Pre-1990 Unfunded Benefit Level. In 1990, the Legislature enacted the Elder State Teachers' Retirement Full Funding Act, which contributed (along with healthy investment returns during the 1990's) to the system reaching 100 percent funded status in the late 1990's. The Administration contends that the legislation also assumed that whatever happened in the future with regards to benefit enhancements or weak investment returns, the state would only be responsible for the funded status of those pre-1990 benefit levels, and the school districts and teachers would be responsible for any other unfunded liabilities created thereafter. This policy is at the heart of the Governor's plan, the state's additional contributions tie to the unfunded liability of the pre-1990 benefit levels (about $20 billion of the $74.4 billion unfunded liability). The teachers would be responsible for $7.6 billion and the school districts would be responsible for about $47 billion of the $74.4 billion unfunded liability.

The Elder State Teachers' Retirement Full Funding Act provided that if the actuarial valuation of the 1990 benefits should become underfunded in the future, the state contribution rate would increase (ramping up to an additional 1.505 percent annually). The state has been contributing additional General Fund to CalSTRS as a result of this policy since 2011-12 and the Governor's January budget included $316.4 million General Fund in 2014-15 to fund the pre-1990 benefits. The proposed plan would have the state continue to assume responsibility for the pre-1990 benefit levels, increasing contribution rates from 1.505 percent to 4.311 percent of compensation for the next 33 years, with fully funded status of the plan achieved by 2045-46. Including current statutory contribution requirements of 4.5 percent of payroll, under the Governor's proposal, the state would be contributing a total of 8.8 percent of compensation ($2.4 billion General Fund) annually to CalSTRS by 2016-17.

CalPERS

Public Employees Living Longer. The May Revision reflects an increase to state retirement contributions of $576.7 million ($342.7 million General Fund) because the CalPERS Board adopted new demographic assumptions in February 2014 as part of a regular review of demographic experience. Key assumption changes included longer post-retirement life expectancy for all retirees, earlier retirement ages, and higher-than-expected wage growth for State Peace Officers/Firefighters and California Highway Patrol members. The average life expectancy of a public employee is considerably longer than the average person (US average is 76 years, California's average is 80 years, and CalPERS average is 85 years). Those "Cadillac" health benefits really pay off.

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 shown below).

Fiscal Year (millions)	Schools	Cities	Counties	Special Districts
2011-12 & 2012-13	$2,200	$620	$875	$310
2013-14 & 2014-15	$1,900	$541	$662	$209

Source: Department of Finance

On an ongoing basis, Proposition 98 General Fund savings are estimated to be $1 billion annually by 2016-17, while cities, counties and special districts will receive approximately $700 million annually. The May Revision estimates in the table above are slightly higher than what was reported in the Governor's January budget, but are generally of the same magnitude. Additional detail can be provided upon request.

Revise and Expand Infrastructure Finance Districts (IFD). In response to concerns and issues raised by cities and interested parties since the January budget was released, the Governor proposes to revise his IFD proposal. For reference, our January *Highlights and Analysis* document provides details regarding existing tools available to local governments for economic development activities and identifies the major components of the Governor's January proposal. Now, the May Revision proposes to leave the existing IFD statute as it is, and create a new "Enhanced IFD" statute that would include all of the new "flexibilities" included in the Governor's Budget proposal, as well as the following new allowances:

- Monies received by cities and counties pursuant to the Vehicle License Fee Swap may be securitized to fund Enhanced IFD projects.
- Affordable housing projects would be considered projects of community-wide significance that may be funded by an Enhanced IFD.
- Requires Enhanced IFDs to replace any low-or moderate-income housing that is removed as part of a project plan, as is required under current IFD law.

According to the Department of Finance, the Enhanced IFDs, with their 55 percent voter approval requirement and greater scope of projects, would be available to cities in compliance with the RDA-dissolution statutes, and who have settled their RDA-related litigation. For entities not in compliance, or with outstanding litigation, they will still be able to use the existing IFD provisions, but with the two-thirds vote requirement and a more limited scope of projects. We continue to raise the same issues and concerns we raised in January, especially related to (1) decreasing the voter threshold for establishing IFDs and issuing debt from two-thirds to 55 percent, and (2) the fact that IFDs are seldom used.

Health & Human Services

Health

The May Revision update for Health includes massive cost increases associated with the implementation of federal health reform, which is the single largest factor using up California's unanticipated tax revenues in 2014-15. These changes are discussed in more detail below. The following table summarizes changes in proposed General Fund spending levels and significant changes since January 2014 for the largest departments that administer state health programs.

Summary of Department General Fund Spending
(Dollars in Millions)

Department	2012-13 Actual	2013-14 May Estimate	2014-15		2014-15 Proposal Change from January to May		Key Changes Since January
			January Proposal	May Proposal	$	%	
Health Care Services: Medi-Cal	$14,862	$16,647	$16,899	$17,402	503	3.0%	Major increase in number of new Medi-Cal enrollees following program expansion under the federal Affordable Care Act.
Public Health	129	130	111	111	0	0.0%	Received $15 million for drought relief in 2013-14 via SB 103 that was not in original 2013 Budget Act.
MRMIB	178	23	-	-	-	-	None.
Developmental Services	2,674	2,810	2,935	2,949	14	0.5%	Proposed increase for new crisis services at two developmental centers and for developing new community models.
State Hospitals	1,277	1,505	1,515	1,520	5	0.3%	Proposed expansion of county-based restoration of competency unit.

Medi-Cal Health Reform Implementation

As writer P.J. O'Rourke once said, "If you think health care is expensive now, wait until you see what it costs when it's free." The expansion of Medi-Cal related to the federal Affordable Care Act (ACA), which began enrollment on January 1, 2014, is showing greater enrollment and costs than previously expected even four months ago in the January budget. When compared to the enacted budget for 2013-14, the cost increase over the two-year budget period is expected to be $1.2 billion, and the revised budget proposal for 2014-15 is $2.5 billion General Fund higher than 2012-13 expenditures. Key Medi-Cal expansion updates include:

Enrollment Skyrockets. Total Medi-Cal enrollment is now projected to be 11.5 million, or **30 percent of the state's population.** This is an increase of 3.6 million, or 46 percent, compared to Medi-Cal's enrollment of 7.9 million prior to implementation of the ACA, and includes the following:

- The "optional" Medi-Cal expansion, which covers low-income adults who do not have children, is now projected to reach 1.6 million enrollees in 2014-15, roughly doubling the Governor's projection from January. The federal government pays all costs for this group, totaling $12.6 billion in 2014-15, for the first few years, but the state must pay 10 percent of this group's costs by 2020-21, when **inflation and caseload growth could push the state's share to $1.5 billion General Fund.**

- The "mandatory" portion of the expansion is now expected to reach 815,000 enrollees. The mandatory changes standardize the income ceiling and allow people to enroll in Medi-Cal regardless of the value of any assets they might have. The state pays half the costs for this group or $918 million General Fund in 2014-15.

Republican Concerns. All Californians should have the means to obtain the health care they need. However, the extraordinary growth in Medi-Cal enrollment raises several practical issues and highlights the imprudence of past decisions in Medi-Cal administration.

- Expansion of health **spending for Medi-Cal is likely to crowd out other state priorities**, such as education, public safety, and safety net programs, particularly beginning in 2017 when the state must begin to pay a portion of the costs for the optional expansion.

- California has pretended for many years that Medi-Cal could run an effective health care program **without paying fair reimbursement rates to providers who actually treat patients**, such as doctors, pharmacists, and technicians who custom-fit wheelchairs for disabled children. The organizations that represent these providers have supported the program's expansion, but apparently did not realize they would have to pay for it.

- The May Revision continues to implement a previously authorized 10 percent rate cut for most providers, including a retroactive cut in many cases, while this massive enrollment expansion is occurring. This rate cut is now estimated to provide $242 million in General Fund savings in 2014-15. However, problems accessing care in Medi-Cal already exist, with only 57 percent of Medi-Cal doctors accepting new patients according to a recent study, compared with 73 percent accepting federal Medicare patients. These **access issues will only get worse as enrollment grows.**

- The state has also exacerbated the increase in costs by continuing to rely on inflexible and costly county public employee unions to administer Medi-Cal enrollment. **There is now a backlog of 900,000 Medi-Cal applications in county processing,** and Medi-Cal has decided to simply forego processing annual re-evaluations for people already enrolled in Medi-Cal until at least July 2014, which is expected to add $94 million in General Fund costs over two years.

Medi-Cal Deficiency. As a result of the Medi-Cal enrollment increase and some other factors, the May Revision also reports a Medi-Cal deficiency of $553 million General Fund for 2013-14. The Administration plans to seek a supplemental appropriations bill to fund this deficiency.

County Clawback Declines. The amount of state funding that the state is "clawing back" from counties following implementation of the ACA is now expected to decline in 2014-15 from $900 million in the January budget proposal to $725 million. Because this clawback involved a swap of local health funds for CalWORKs General Fund, this change shifts the $175 million difference to augment CalWORKs. It is not yet clear why the clawback has decreased, given that Medi-Cal enrollment projections have increased.

Information Systems Costs Rise Significantly. Adding to a long list of over-budget or failed state information technology projects, the May Revision proposes an increase of $73 million in systems development costs for the California Healthcare Eligibility, Enrollment, and Retention System (CalHEERS), which processes applications for both Covered California and Medi-Cal. Most of the increase would be paid by federal funds, but nearly $19 million of it would be a General Fund cost. CalHEERS has experienced numerous difficulties, caused in part by the complexity of trying to force the system to interact with three different county-based Medi-Cal enrollment systems.

Significant Proposals for Other Departments

Institutional Law Enforcement Unit Proposed for Health Agency. The May Revision proposes to establish a new unit at the Health and Human Services (HHS) Agency to oversee law enforcement and investigations at state institutions operated by the Department of Developmental Services (DDS) and the Department of State Hospitals. This new unit would include 9 positions at a cost of $1.8 million annually, including a $600,000 contract with the California Highway Patrol to establish policies and procedures.

Incompetence in conducting criminal investigations by the internal law enforcement units at these institutions has received significant attention in recent years after several reports by the Center for Investigative Reporting identified numerous tragic incidents in DDS developmental centers. **However, locating a new oversight unit at the HHS Agency may not address the conflicts of interest inherent in having in-house investigators and officers.** It would be better if the actual enforcement and investigation functions at these institutions were contracted out to an independent organization such as the California Highway Patrol or a local police department or sheriff.

Developmental Services Crisis Centers. Following up on an extensive planning process for the future of DDS community and institutional services, the May Revision proposes to spend $2 million General Fund for 43 positions to maintain “crisis center” facilities at two developmental centers. The May Revision also proposes to reappropriate $13 million General Fund from previous years to develop more residential options in the community, which would include two larger crisis management homes of 8 to 10 beds and six smaller homes of four beds each. While these proposals have merit, the May Revision continues to overspend substantially on staffing at the Lanterman Developmental Center. **Savings that would be generated by reducing Lanterman staffing at a more appropriate pace could offset initial costs for the newly proposed programs.**

Human Services

For the 2014-15 fiscal year, the Governor’s May Revision provides $25.9 billion ($7 billion General Fund) for programs such as CalWORKs, In-Home Supportive Services (IHSS), Supplemental Security Income/State Supplemental Payment (SSI/SSP), CalFresh, and Child Welfare Services administered by the Department of Social Services. The May Revision increases spending by $1.2 billion ($277.1 million General Fund) compared to the January budget, with the most notable increases including $104.6 million General Fund in CalWORKs, $160 million General Fund in IHSS, and about $65 million General Fund for Cal Fresh administration and drought related food assistance.

CalWORKs

“Clawback” Funds Less than Projected. As a way to better reflect state costs for health care reform and ensure counties pay their share, the 2013 Budget Act assumed withholding $300 million in 2013-14, $900 million in 2014-15, and $1.3 billion in 2015-16 from county realignment health funds in order to recognize the shift of health care costs from counties to state Medi-Cal. The May Revision includes **an increase of $175.1 million General Fund within CalWORKs** to reflect a decrease in the estimated level of county indigent health savings associated with the Medi-Cal expansion under health care reform. County indigent health savings are redistributed to counties via a redirection of 1991 health realignment funds for CalWORKs expenditures, offsetting General Fund costs within the CalWORKs program.

General Fund is Backstop for Welfare Grant Increases. The May Revision includes $176.8 million for full-year costs of the March 1, 2014, five percent CalWORKs grant increase. The General Fund portion of this is $13 million, an increase of $6.8 million General Fund from the Governor's January budget. 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.** Once the grant increases are established in the base, the state General Fund must pick up the tab if Realignment revenues fall short in subsequent years.

In-Home Supportive Services

Caseload Continues to Grow. The May Revision assumes IHSS caseload will increase 2.4 percent from 2013-14, up to 463,939 cases in 2014-15, and it includes an additional $270 million ($137.8 million General Fund) as a result. The average number of hours per case has also increased, from 89 hours per month in 2013-14 to 91 hours per month in 2014-15. **With more people getting more hours, IHSS continues to be one of the leading cost drivers in the state budget.**

Lack of Cost Share Always Leads to Higher Costs. The May Revision includes $100.2 million General Fund in 2013-14 and $118.4 million General Fund in 2014-15 as a result of the IHSS county maintenance of effort (MOE) policy change that holds counties harmless for any new costs within the IHSS program above the 2011-12 expenditure level. **With this policy, counties have little incentive to maintain program integrity since they will not have to pay for any additional cost growth.**

Health Reform Drives Caseload and Costs. In 2014-15, the IHSS caseload is projected to increase by approximately 40,000 recipients due to implementation of health care reform. The May Revision includes **$535.3 million (federal funds) in 2014-15 as a result of this expansion.** Although the federal government is paying for all of the new costs under health care reform for the next several years, beginning in 2020 the federal/state sharing ratio will be 90/10, resulting in additional General Fund costs of about $55 million annually and likely growing as caseload and authorized hours continue to increase. Due to the IHSS county MOE policy mentioned above, any additional non-federal costs within the IHSS program will be fully supported with state General Fund.

Cal Fresh

State to Provide a Utility Allowance Subsidy to CalFresh Recipients. The May Revision includes $10.5 million General Fund to provide an energy assistance subsidy for CalFresh recipients, to comply with recent federal changes regarding the minimum energy assistance benefit that a household must receive in order to access the standard utility allowance. Prior to the federal changes, states could provide any amount of home heating aid and recipients could still qualify for food stamp benefits, but now the state must provide more than $20 a month to qualify for the standard utility allowance for food stamp benefits. This proposal will result in an average increase of $62 a month in federal food stamp benefits for more than 320,000 families. This is **a fine example of the federal government creating a dependency and then changing the rules, leaving California to spend even more money** chasing the additional benefits.

Health Care Reform Drives Caseload and Costs. The May Revision includes $196.6 million ($76.6 million General Fund) in 2014-15 to support 279,000 newly eligible CalFresh recipients who are referred to other government programs such as CalFresh when they sign up for Medi-Cal. Food stamp benefits are paid for entirely with federal funds, and the additional costs are for administering the program at the county level.

Drought Related Food Assistance

Funding for Food Banks. The May Revision includes $5 million General Fund for food banks to provide food assistance to severely drought-impacted counties with high levels of unemployment. The additional $5 million General Fund brings the total amount available for drought related food assistance to $20 million General Fund in 2014-15.

Transportation

Caltrans' Capital Outlay Support Program Tremendously Overstaffed. The May Revision proposes to reduce Caltrans' Capital Outlay Support Program (COS Program) by a decrease of $21.8 million (various special, bond, and reimbursement funds) and 210 full time equivalent (FTE) positions. This reduction is in addition to the redirection of 48 positions and a reduction of $5.2 million included in the Governor's Budget. However, the Legislative Analyst's Office (LAO) report on the review of the COS Program estimates that even with these reductions, **the COS Program will still be overstaffed by 3,500 FTEs at a cost of more than $500 million (various non-General Fund sources) annually**.

The COS Program provides the resources necessary to deliver highway capital outlay projects to construction, as well as, administer and oversee projects in construction. Work conducted in the program includes completing environmental reviews, designing and engineering projects, acquiring rights-of-way, and managing and overseeing construction. The department accomplishes about 90 percent of its COS work with state staff, and about 10 percent of work with private consultants.

During the 2013-14 budget process, the Legislature directed Caltrans, the LAO, and the Department of Finance to review the COS Program and identify ways to increase accountability and efficiency of the program. As a result of this review, the Administration made several recommendations, including requiring detailed staffing and workload projections, conducting hindsight review on a sample of projects, and development of a quality management plan. While these recommendations are initial steps to address a few of the program's shortcomings, they do not address the programs projected overstaffing.

The LAO found many concerns during the review of the program. First, the project data entered into database systems contains errors and is largely unreliable. This inaccurate data is used to build the COS Program's annual budget request. **Even more troubling is the indication that data inaccuracies are resulting not only from a lack of internal control but also from an incentive for project managers to report inaccurate data to reflect that projects are completed ahead of schedule or under budget.** Additionally, some pertinent data, for instance actual staff resources used, is not collected, making program evaluation nearly impossible.

Second, the COS program workload is declining substantially as one-time Proposition 1B bonds and the federal American Recovery and Reinvestment Act funds are used up. The COS Program experienced peak workload between 2007-08 and 2013-14 when the level of funding available for new construction projects averaged $4.4 billion annually. However, Caltrans projects the funding will decline by about 40 percent to $2.6 billion in 2014-15. **Because of this large decline in workload, the COS Program will be substantially overstaffed by about 3,500 FTEs and $500 million, resulting in expending limited transportation resources inefficiently on staff with no workload rather than on our roads and highways, which are some of the worst in the country.**

Lastly, the LAO notes that Legislative oversight of the COS Program is restricted because the budget request for program resources is based on poor estimates of projected staffing needs and because the Legislature has limited time to review the budget request, which is submitted as part of the May Revision each year. In review of a sample of approximately half of the projects within COS Program in 2012-13, the LAO found that Caltrans requested funding for 4,559 FTEs but only spent funding for 3,337 FTEs (73 percent). This is likely a result of the poor data used to build the workload projections.

As a result of the program review, the LAO makes several recommendations to improve accountability and efficiency of the program, including a multiyear approach to reducing the staffing levels. For instance, an initial reduction of 1,750 FTEs would address half the problem and free up about

$250 million annually for transportation needs. The LAO also recommends requiring a staffing plan, several steps for improving data quality, requiring earlier submittal of the annual budget request, and an increased oversight role for the California Transportation Commission in order to improve accountability.

While all of the recommendations should certainly be considered by the Legislature, there is one component not mentioned in the LAO report. Legislative Democrats have held Caltrans to a ratio of 90 percent state staff and 10 percent Architectural and Engineering (A&E) contract staff for the COS program. In fact, in 2012-13, the Administration proposed to alter the ratio by 1 percent to an 89/11split and Legislative Democrats denied the ratio change and restored the 90/10 split. Proposition 35, passed by voters in 2000, allows the state to contract for A&E services in all situations for public works projects. Since the passage of Proposition 35, only 10 percent of A&E services have been contracted out by Caltrans. This stringent requirement placed on Caltrans restricts their ability to adjust staffing levels. **By using more contract staff, the state could prevent the build-up of civil service staff which requires increased time to reduce as workload declines and adds to the state's unfunded pension and retiree healthcare burden. The use of more contract employees would likely save millions of taxpayer dollars and result in projects completed more quickly, benefiting all Californian motorists.**

A Blank Check for High Speed Rail. Lacking federal and private sector funding, Governor Brown proposes the Legislature provide a blank check for his bullet train project. In addition to the $250 million Cap and Trade funding proposed for the high speed rail (HSR) project in 2014-15, the Governor's Cap and Trade plan would allocate 33 percent of future Cap and Trade revenues, beginning in 2015-16, to the HSR project through a continuous appropriation. The Cap and Trade plan provides a second continuous appropriation of $400 million to the HSR project, upon repayment of Cap and Trade General Fund loans, in 2015-16. This will equate to **hundreds of millions of dollars spent annually on HSR without a vote of the Legislature**, despite LAO warnings that it is legally risky to link the bullet train to Cap and Trade funds. **Not to mention that it appears the HSR Authority plans to use this revenue stream to securitize financing,** likely in the form of a revenue bond, which would further divert Cap and Trade revenues to pay interest on the bond. The Wall Street Journal quoted Dan Richard, chairman of the HSR Authority, "An ongoing revenue stream is very important to us, because that would allow us to use financing, whether it is some type of revenue bond or some other financing mechanism." This quote came only 10 weeks after a Full Budget Committee hearing in which the Administration stated there were no plans to securitize the revenues.

The HSR Authority acknowledges the project risk has increased, as it stated in a budget document, "…due to vacancies the Authority cannot proactively implement its risk mitigation strategies, which results in greater project risk and a reactive approach to risk mitigation." The increased risk results from a 68 percent vacancy rate for HSR Authority's current management positions. Yet, despite the increased risk and the HSR Authority's inability to fill its current positions, the May Revision proposes more funding for the project via language allowing the director of the Department of Finance to augment the HSR Authority's budget by up to $5.3 million Proposition 1A Bond Funds and 35 positions upon the award of the next construction packages. The language would also allow the HSR Authority to borrow $5.3 million from the Public Transportation Account (PTA) to fund support costs while the bond authority remains unavailable as a result of a court decision, currently under appeal. The HSR Authority has already borrowed $26.2 million from the PTA in the current year and the 2014-15 Governor's Budget includes another $29.3 million. Without access to the bond funds, there is no ability to repay these loans, unless another source, perhaps the General Fund or Cap and Trade funds, pick up the tab.

Allowing midyear administrative budget augmentations and hundreds of millions of dollars of funding annually without a Legislative vote is writing a blank check for this risky $68 billion megaproject managed by an agency with little oversight**. It's fiscally irresponsible and California taxpayers deserve better.**

Resources, Environmental Protection & Energy

Administration Moves To Change Greenhouse Gas Emissions Targets without Statutory Authority. The Governor's May Revise proposes to provide additional funding to the Natural Resources Agency ($529,000) and the Department of Food and Agriculture ($140,000) from the AB 32 Costs of Implementation fee to implement aspects of the AB 32 Scoping Plan Update. This includes the development of a Forest Carbon Plan, forest biomass sustainability criteria, and the implementation of initiatives that will lead to measurable and quantifiable greenhouse gas (GHG) reductions by California's agricultural sector. The AB 32 Scoping Plan Update proposes GHG reductions beyond 2020 and below 1990 levels. Specifically, the update defines ARB's climate change priorities for the next five years and sets the groundwork to reach California's long-term climate goals set forth in Executive Orders S-3-05 and B-16-2012. These Executive Orders establish greenhouse gas emissions reduction targets by 2050 at 80 percent below 1990 levels. **According to an opinion from Legislative Counsel, ARB does not have the legal authority to require emission reductions below 1990 levels.** The executive branch maneuver is an attempt to undermine the two-thirds vote requirement per Proposition 26 (2010).

Air Resources Board wants California Taxpayers to Fund Climate Change Trips. The May Revision includes $1.1 million from the Cost of Implementation Fee and Motor Vehicle Account to add six new positions so the ARB can "engage" other governments, such as, Brazil, Canada, Chile, China, Costa Rica, Kazakhstan, Mexico, New Zealand, South Korea, South Africa, Turkey, and the European Union through ***policy sharing***, ***capacity building***, ***and information exchange***. To date, no other western states are interested in the ARB's policies on climate change or air quality standards so why other counties would be interested in these programs is unclear**. To require California businesses and the general public to fund ARB excursions to exotic locations to promote their environmental platform is ludicrous.** If these counties are truly interested in our burdensome regulations, they should pay for their own travel expenses to California.

More New Fees on Oil and Gas Industry. The Governor's May Revise requests a one-time appropriation of $5.7 million from the Oil, Gas, and Geothermal Administrative Fund to be used to address increased costs to conduct and complete the Independent Scientific Study on Well Stimulation Treatments and the Environmental Impact Report, and to fund additional legal services. These costs would be in addition to the Governor's January budget proposal which requests $20.5 million from the Oil, Gas, and Geothermal Administrative Fund for the implementation of SB 4 (2013). These new costs will be funded from an increase in the oil and gas assessment rate. Ultimately, these regulatory costs show up as higher gas and energy costs for California families.

Evaluation of California's Petroleum Fuel Price Vulnerability. The California Energy Commission requests $342,000 from the Energy Resources Program Account to continually evaluate California's vulnerability to petroleum fuel price fluctuations and recommend actions to minimize adverse impacts of price changes on the economy and the transportation energy sector. One element includes creation of a petroleum market advisory committee of external experts to provide guidance, insights and comments on petroleum market activity***.*** This proposal supports the work of the California Attorney General's Office and the Federal Trade Commission that use petroleum industry data to evaluate business mergers and acquisitions and potential anti-trust violations. ***It doesn't take a rocket scientist to figure out that the over regulation of petroleum markets in California has led to price increases and fluctuations. The Legislative Democrats and the Governor need only look in the mirror to understand the root cause.***

More Funding for New Statewide Groundwater Management Program. The Administration is proposing additional funding of $2.5 million General Fund in 2014-15 increasing to $5 million annually for four years for the Department of Water Resources to start developing and implementating the

California Statewide Sustainable Groundwater Management Program. This funding is be used to support local groundwater management efforts including the planning and oversight of local groundwater monitoring programs, the assesment of local groundwater plans, and to provide local and regional technical assistance. This funding is in addition to $1 million General Fund already provided to the department for groundwater monitoring and reporting through SB 103 (Committee on Budget) of 2014, $800,000 to the State Water Resources Control Board (SWRCB) for sustainability of groundwater resources in critical basins (SB 103), and the $1.9 million General Fund proposed in the Governor's January budget for groundwater protection activities.

What is still unclear is the structure and requirements for this new state groundwater management program. ***<u>To date, the Adminstration has not provided any detailed language for the Legislature to review.</u>*** ***Groundwater is a key component of the state's complex water system and should not be treated as an isolated resource. Any change in the law that affects the management and regulation of groundwater must be done thoughtfully and with appropriate input from stakeholders and a robust public debate. Pushing this proposal through the budget process at the last minute is inappropriate.***

Additional Funding for Drought Related Activities. The May Revise provides the following additional resources for "drought related" efforts:

- Department of Forestry and Fire Protection - $53.8 million General Fund and $12.2 million SRA fees to respond to increased fire conditions due to the drought conditions. Of the $53.8 million General Fund, $23 million will be added to the Emergency Fire Suppression (E-Fund) baseline in anticipation of an extreme fire season. The Administration is also proposing an additional $44 million be added to the department's E-Fund in the 2013-14 fiscal year to fund firefighting activities. The SRA fees will be used to address critical fire prevention, emergency preparedness, outreach activities, and for fire prevention grants to address the increased fire risk brought on by drought conditions. ***It is unclear why these activities aren't already taking place given that the SRA fee was meant to provide direct fire prevention benefits to the landowners who pay the fees on an annual basis.*** CalFire has also indicated that $10 million of the SRA fees will be used for a fire prevention grant program that will be targeted toward certain SRA locations with the biggest threat of fires. Again, targeting these funds to specific areas instead of providing a direct benefit to each landowner that has paid the SRA fee seems inappropriate. The legality of the SRA fee is currently under litigation.

- Department of Fish and Wildlife - $30.3 million General Fund and $8.5 million special and bond funding to implement enhanced salmon monitoring, restore certain habitat, expand the fisheries restoration grant program, improve water infrastructure for wildlife areas, and remove fish barriers for fish passage. ***These are existing Biodiversity Program projects which may have merit but the urgent need for additional funding at this time due to the drought conditions seems suspect.***

- Department of Water Resources - $18.1 million General Fund to assess current surface and groundwater conditions, expedite water transfers, provide technical assistance to water agencies, and public outreach through the Save Our Water campaign. ***The Administration plans to identify saving offsets for the 72 existing positions that would transfer to General Fund from special and/or bond funding. Those existing funding sources were determined to be inappropriate for drought related activities. Those savings are unknown at this time.*** In addition, the May Revise would redirection $28 million of previously appropriated bond funds to install temporary barriers to prevent salt water intrusions into the Sacramento-San Joaquin Delta and includes provisional language giving the department authority to spend another $19.3 million General Fund to operate, maintain and remove the barriers pursuant to Department of Finance approval.

- Department of General Services - $5.4 million special funds to implement water efficiency and conservation measures in state-owned facilities.

- Department of Social Services - $5 million General Fund for food assistance for communities most impacted by the drought.

- Office of Emergency Services - $4.4 million General Fund for the State Operations Center to provide technical assistance and disaster recovery support to local communities affected by the drought.

- State Water Resources Control Board - $4.3 million General Fund to continue the enforcement of drought-related water rights and water curtailment actions. This funding is in addition to the $2.5 million General Fund that the SWRCB received in SB 103 for drought-related water rights and water conservation actions including increased enforcement actions against water rights holders. ***The Administration plans to identify saving offsets for the 75 existing positions that would now transfer to General Fund from special funding. At this time, it is unclear how many positions currently work on water rights or water quality activities that would be transferred to new drought responsibilities. The savings that should materialize to special fund fee payers has not been accounted for yet.***

California Boarder Protection Station Program Recieves Additional Funding. The May Revise proposes an additional $3.3 million General Fund beginning in 2014-15 to enhance the existing program and enable the Department of Food and Agriculture to operate all sixteen stations year-around with additional permanent and temporary staff. This new funding will allow the department to protect California against the invasion of exotic pests and diseases while promoting a safe and healthy food supply.

More Rebates to Californians Who Can Afford Expensive Environmentally Friendly Vehcles. The Administration proposes an additional $30 million in smog abatement fee revenues for rebates to consumers who have purchased light-duty zero emission and plug-in vehicles. To date, this program has provided over $115 million in rebates for about 56,000 vehicles since 2009-10. These new funds will be available for the 2013-14 fiscal year to provide rebates to individuals already on waiting lists. This would increase overall spending in 2013-14 to $90 million. AB 118 funds are derived ***from increases to the smog abatement, vehicle registration, and vessel registration fees and provides approximately $200 million annually*** for three programs to fund air quality improvement projects and develop and deploy technology and alternative and renewable fuels. All Californians who own vehicles must pay this smog fee, however, only a select few will receive the benefit of a $900 to $2,500 vehicle rebate. Those rebates are reserved for the individuals with average incomes over $100,000 per year who can afford these cars.

Public Safety

<u>Department of Corrections and Rehabilitation</u>

The May Revision holds funding flat for the Department of Corrections and Rehabilitation (CDCR) when compared with the January Governor's Budget. Proposed General Fund spending for the Department remains at $9.5 billion, while spending from other funds increases slightly, from $320 million to $329.1 million.

Prison Population Continues to Increase, Though by Less than Governor's Budget Estimates. The May Revision projects adult prison inmate average daily populations (ADP) of 134,215 in 2013-14 and 136,530 in 2014-15. Up to now, the state's prison population following the 2011 Public Safety Realignment (Realignment) has consistently exceeded CDCR's projections, suggesting that the Administration seriously overestimated Realignment's population-reducing potential. In fact, the January Governor's Budget adjusted the adult prison ADP projection upward by more than 6,100 inmates in 2013-14 and by almost 8,900 inmates in 2014-15 compared to projections from a year earlier. The May Revision ADP estimates are still higher than last year's projections, although the amounts by which they exceed those projections are now only 5,330 in 2013-14 and 7,636 in 2014-15. None of the court-ordered population reduction measures are factored into these figures, so it appears that the post-Realignment population may be stabilizing.

Receiver Botches Activation of New Prison Hospital. In January 2014, just months after opening the doors of the California Health Care Facility (CHCF), the new prison hospital in Stockton, the Receiver abruptly halted intake amid news stories of serious operational issues, including unavailability of medications and medical supplies, conflicts between custody and clinical staff, general failures in plant operations, <u>and a scabies outbreak</u>. The Receiver and CDCR have been working since that time to address the problems, though intake continues to be suspended. The May Revision proposes an increase of $12.5 million General Fund to address the remaining issues and to meet licensing standards. Because the facility has been activated and is currently housing the offenders that were transferred before the Receiver stopped intake, the full bed capacity can be counted toward the court-ordered prison population cap. However, the facility also supports the adjacent DeWitt facility, so remedying the facility's operational problems is critical not only to continue serving the medical needs of the high-acuity inmate population at CHCF, but also to serve the mental health needs of the inmates at DeWitt. **After spending more than $1 billion on the two facilities, the individual appointed by the federal courts to fix the problems with California's prison medical care delivery system has been unable to successfully activate his own medical facility and nobody is holding him accountable.**

<u>Court-Ordered Prison Population Cap Update</u>

SB 105 Funding Changes. In September 2013, it was clear that Realignment would not shift enough felons to the counties to meet the three-judge panel's (3JP) December 31, 2013 deadline to reduce the state's prison population to 137.5 percent of design capacity, 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. SB 105, which received nearly unanimous support from both Democrats and Republicans, appropriated $315 million General Fund to 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 be released.

According to the provisions of SB 105, if the 3JP grants a time extension or if a portion of the $315 million is not needed, then the first $75 million of savings, plus 50 percent of any savings above $75 million, is required to be transferred to the Recidivism Reduction Fund (RRF), while the remainder is to revert to the General Fund. The Governor's Budget estimated that there would be $87.2 million in SB 105 savings, so it proposed to spend $81.1 million from the RRF on measures intended to reduce recidivism, including community reentry programs ($40 million), substance abuse treatment programs ($21.5 million), integrated services for mentally ill offenders ($11.3 million), and the design phase of a capital outlay project to renovate the Northern California Women's Facility, converting it into a male reentry facility ($8.3 million).

In February 2014, the 3JP granted CDCR's request for a two-year extension and ordered the Administration to implement a list of measures to reduce the prison population. These were largely the same measures the Governor proposed in January. As a result, the May Revision reflects approximately $20 million in additional SB 105 savings, resulting in $9.9 million more for the RRF and an equal amount to be reverted to the General Fund.

The Governor proposes spending the additional $9.9 million to enhance the $40 million proposal he introduced in January to contract with local jails and community-based providers for residential reentry services. Specifically, the Governor's proposal would target the population of mentally ill offenders who are within six months to a year of release. By shifting prison inmates with six months to a year left of their sentences to jails and community-based residential programs, this proposal would have an immediate effect on reducing the prison population. Furthermore, assuming that local providers deliver evidence-based programs that actually reduce recidivism, this proposal would also indirectly reduce the prison population when fewer offenders reoffend. **However, given the relatively small investment and the Administration's inability to establish successful reentry programs in the past, it is unlikely this proposal will result in any significant success.**

Early Release for Second Strikers. In its February 2014 order, the 3JP increased the credit earning cap on "non-serious," "non-violent" second strikers from 20 percent to 33.3 percent. As these offenders accumulate credits at the higher rate, they will eventually be released earlier than they otherwise would have. The original intent was to place them under parole supervision upon their early release until the time they would have otherwise been released under the 20 percent credit cap, then transfer them to post-release community supervision (PRCS). The Governor now proposes releasing them directly to PRCS, indicating that "law enforcement concurs that it is in the best interest of public safety for these offenders to be under the supervision of one jurisdiction for the length of their supervision term." The May Revision includes $11.3 million General Fund for county probation departments to manage this new population of PRCS offenders. While the Governor wants to characterize these offenders as being "non-serious" and "non-violent," **the fact is that these offenders have a demonstrated propensity for committing serious or violent crimes by virtue of their first strike, which by definition must be a serious or violent offense.** These are dangerous felons who should be treated as such, not simply handed off to counties in the same way the state offloaded other non-serious, non-violent felons.

Realignment Funding for City Police

The May Revision includes $12.5 million General Fund to increase the total funding provided to cities to mitigate the impacts of Realignment. The additional $12.5 million would bring total Realignment funding for city police departments to $40 million in 2014-15. This funding is allocated by the Board of State and Community Corrections to a single city in each county that receives funding. That city acts as the fiduciary agent for all other cities in the county. **While $40 million is clearly inadequate to address the numerous problems caused by Realignment, at least the Administration is beginning to recognize that more needs to be done.**

Judiciary

More Money for Trial Courts. Between 2008-09 and 2012-13, annual General Fund support for the trial courts was reduced by about $724 million. These reductions have been largely mitigated by increasing court user fees, shifting court construction funds to operational purposes, and requiring courts to spend down their reserves. Despite these measures, the reductions have been challenging for the trial courts, leading to widespread furloughs and layoffs of court employees, reductions in court services, and court closures. 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. Beginning in 2014-15, the trial courts will no longer have reserve balances to offset the ongoing reductions.

The January Governor's Budget proposed a $100 million General Fund augmentation for the trial courts. The May Revision includes another $60 million increase, bringing total additional funding for 2014-15 to $160 million. Unlike the January proposal, which did not specify how the additional funding should be spent, the May Revision would allocate the additional funding in a way that is intended to encourage the courts to comply with standards set forth in the Public Employees' Pension Reform Act (PEPRA) that require state employees to share in their retirement costs. According to the Department of Finance, the trial courts currently spend about $22 million per year covering their employees' share of retirement costs. Rather than providing a 2014-15 budget augmentation to fund the entire $64.8 million the courts say they need for increased retirement and employee health care costs, the Administration proposes to fund $42.8 million ($64.8 million total costs, less $22 million currently spent covering employee contributions). To the extent the courts make satisfactory progress (by the Administration’s standards) toward complying with PEPRA, funding of future employee health care and retirement cost increases related to existing health and retirement benefits would be supported by the Administration <u>one year in arrears</u>

Senate Republicans pointed out in January that the courts still have room for improvement, fiscally speaking, and that their employees still do not contribute to their own pensions. It is encouraging that the Governor heard this message and is taking steps to address the issue. The carrot-and-stick approach reflected in the May Revision could be an effective way to ensure that court employees begin to contribute to their own retirement costs like virtually all other state employees.

While the additional $160 million would certainly help the trial courts, information provided by the Administrative Office of the Courts suggests that another $100 million would be necessary for the trial courts to maintain the level of service they are currently providing. **The Governor's May Revision proposal is a definite improvement, but it could still fall short of preventing further court closures and other reductions in court services.** As the Legislature determines the appropriate level of funding for the trial courts, it will be important to ensure that scarce resources are allocated in a manner that promotes efficiency without overburdening the taxpayers.

Realigning Court Security Put the State on the Hook for Cost Increases. The May Revision includes $1 million General Fund for the state to pay increased trial court security staffing costs for counties with new court facilities constructed or opened after October 9, 2011. As part of the 2011 Public Safety Realignment (Realignment), responsibility for the costs of trial court security, along with a dedicated source of funding, was shifted to the counties. Proposition 30, which was placed on the ballot by the Governor and approved by the voters in 2012 (a year after Realignment took effect), sought, in part, to provide counties with certain fiscal protections they demanded in exchange for their cooperation with the Governor's plan that shifted tens of thousands of dangerous felons from state to county responsibility. One of those protections includes a provision that requires the state to provide funding for administratively required activities that increase county costs of realigned programs.

According to the Administration, new court facilities built by the state and opened after October 9, 2011, may require a different level of court security than the facilities they replaced. Any additional costs of the new security requirements imposed by these recently-constructed trial court facilities may fall into the category of "new administratively required programs" for which the state must provide funding. The proposed funding would be available to affected counties upon approval by the Department of Finance.

Realignment came with many unintended consequences. In reality, when the ruling Democrats forced the policy down the throats of Californians, it was probably never contemplated that the state's construction of new court facilities would cause increased county court security costs that the state would have to pay. The Proposition 30 provision requiring the state to fund increased county costs of realigned programs is untested. Furthermore, it is not clear that it was ever intended to cover trial court security cost increases or that it would apply in this particular situation. That said, the costs for the state to litigate the question could easily rival the costs of simply paying for the increased security personnel, at least in the short term. **One thing is certain: The costs of Realignment continue to increase, despite promises from the Governor and legislative Democrats that it would reduce the costs of criminal justice in California.** Even the ruling party has begun to publicly lament the lack of Realignment savings and the accompanying lack of improved public safety outcomes. When major policy changes are made hastily for the sake of saving money, unintended consequences often follow.

General Government

State Controller's Office

Woes of the 21st Century Project. The May Revision proposes $2.5 million General Fund on a one-time basis for the Controller to contract with the Department of Technology to oversee an independent assessment of the 21st Century Project. As proposed, this assessment would determine (a) whether the incomplete system-to-date aligns with current business and legal requirements, (b) what portion of the incomplete design and system may be usable, and (c) what it would cost to move forward with the existing plan.

Figuring out how best to move forward with building a statewide payroll system that taxpayers can rely on must start with a comprehensive review of the state's business model, how to incorporate best practices to improve and streamline the state's management of payroll, and how the state can avoid mistakes made in the past. The assessment proposed in the May Revision, which may be considered a good first step, does nothing to help the state improve its business practices or create a new system, but arguably could be considered duplicative of activities that would likely be performed as part of the Controller's due diligence in building its legal case against SAP. Additionally, serious concerns have been raised about how this issue and project is progressing, including:

- The state has already spent more than $260 million on the project, with virtually nothing to show for it after firing two system integrators.
- In addition to this money for an independent assessment, the Controller's Office continues to charge forward to spend $6.5 million of taxpayer money, including $5 million for attorney fees, to pursue litigation against SAP in 2014-15. This is on top of more than $7 million that the Controller's Office has already spent for mediation and litigation efforts in 2012-13 and 2013-14.
- There is no guarantee that the Controller's Office will win it's case, and now faces a counter suit. On April 14, 2014, SAP filed a cross-complaint against the Controller's Office for breach of contract and breach of the implied covenant of good faith and fair dealing. This could result in increased costs in the tens of millions of dollars to pay SAP for work on the project that has already completed (and allegedly accepted), damages to be determined at trial, and potential costs to reimburse SAP for its legal costs.

Labor & Workforce Development

Employment Development Department

Unemployment Insurance (UI). The May Revision proposes an additional $67.6 million ($46.6 million General Fund) to administer the UI Program. For the most part, this funding would provide additional staff to process all claims for unemployment benefits within three days of receipt, respond to online inquiries within five days of receipt, schedule 95 percent of eligibility determinations in a timely manner, and respond to 50,000 calls per week.

This proposal is in addition to:

- A $64 million package of “efficiencies and supplemental funding” that was included in the Governor’s January budget for 2014-15, which included increased withholding penalties on employers,
- $4.8 million of additional federal funds in the current year to fund increased contract costs associated with proceeding with the UI Modernization project,
- $35.4 million of additional federal funds in the current year to retain staff, hire new staff, and fund overtime to provide a higher level of service to unemployed individuals.

Ensuring that the unemployed receive benefits that they are entitled to within an acceptable timeframe has merit, but it’s unfortunate that the state has to pay for a federal responsibility. The federal government continues to underfund the UI Administration Grant, providing only about 73 percent of what its own Resource Justification Model calculates California should receive.

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 as of the 2014-15 May Revision, the remaining balance "budgetary borrowing" has been reduced to about $26.7 billion.

Wall of Debt as of 2014-15 May Revision							
	Outstanding at May Revision	Additional Payments 2013-14	2014-15 Pay Down	2015-16 Pay Down	2016-17 Pay Down	2017-18 Pay Down	Remaining after 2017-18
Totals	**$26,745**	**$5,108**	**$6,022**	**$5,385**	**$5,194**	**$4,235**	**$0**

Source: Department of Finance Wall-of-Debt Table

A more detailed table, which includes the individual components of the Wall of Debt can be found on Appendix A on page 41 of this document. Notable changes to the Wall of Debt repayment schedule since the Governor's Budget include:

- Approximately $700 million of school deferrals accelerated from 2014-15 to 2013-14.
- Approximately $650 million of loan repayments to special funds delayed from 2015-16 to 2016-17 and 2017-18.
- A decision to pay about $1.2 billion of deferred Medi-Cal costs in 2015-16 and 2016-17, instead of 2017-18.
- Approximately $783 million of deferred state payroll costs from 2017-18 to 2016-17.
- $100 million appropriation in 2014-15 to begin paying down the $900 million owed to cities, counties, and special districts for mandate reimbursement costs that were incurred prior to 2004. Each local agency will receive a portion of this payment based on the proportion of total pre-2004 mandate debt owed to that agency.

Statewide Debt. Combined with the "Wall of Debt," the Governor estimates $337.5 billion of long-term liabilities (down from $354.5 billion estimated in January), which will constrain the state's finances in the future. The following table reflects the Administration's estimates of long-term liabilities.

California's Long-Term Liabilities (dollars in billions)	
Unfunded Retirement Liabilities	
(State Retiree Health, State Employee Pensions, Teacher Pensions, UC Employee Pensions, and Judges' Pensions)	$217.3
Wall of Debt	$14.8
Proposition 98 Maintenance Factor	$4.0
Unemployment Insurance Debt	$6.8
Deferred Maintenance	$64.6
Unissued Bonds	$30.0
Total	**$337.5**

Again, while he has identified $337.5 billion of long-term liabilities, the Governor has neglected to include $75.1 billion of General Obligation debt and $10.2 billion of Lease Revenue debt (recently identified by the Legislative Analyst's Office). This debt has already been issued to investors, and the Department of Finance estimates that the General Obligation debt alone will cost the state about $4.8 billion in 2013-14 and $5.2 billion in 2014-15 (4.9 percent and 5.0 percent of estimated General Fund revenues, respectively).

Debt Service. As noted above, the state has already issued $85.3 billion of combined General Obligation (GO) and Lease Revenue (LR) Bond debt, for which taxpayers are already responsible for paying. According to the Department of Finance:

- Current year debt service expenditures are estimated to decrease by a net of $112.7 million as compared to the Governor's Budget, for a total of $5.4 billion, including reduced General Fund GO debt service costs ($4.8 billion total) and no change for LR bond debt service costs ($575.8 million total).
- Budget year debt service expenditures are estimated to decrease $81.6 million as compared to the Governor's Budget, to a total of $5.8 billion, which reflects General Fund GO debt service costs ($5.2 billion total) and no change for lease revenue bond debt service costs ($609.9 million total).

Reduced costs in both fiscal years are the result of (1) increased savings in the form of investor premiums received from the spring 2014 bond sales, (2) savings related to bond refinancing, (3) reduced variable interest rates, (4) a smaller spring 2014 bond sale than projected, and (5) lower fees.

California Safety Net Facts

California has a very generous safety net relative to other states. The following statistics, which include the source of information, provides a remarkable picture of just how robust California's government safety net programs really are.

Welfare

- California has the 5th highest CalWORKs grant in the nation, 2nd highest amongst the ten largest states. (Per Legislative Analyst Office)
- California is only one of three states that provide a grant for the family after the adult has timed out of the CalWORKs program. (Per Legislative Analyst Office)
- About one in five CalWORKs families has received welfare assistance for over six years. (Public Policy Institute of California). (Per Legislative Analyst Office)
- Approximately 46 percent of welfare caseload has less than 12 years of education and the state has no requirement for completion. (Per Legislative Analyst Office)
- California is one of only five states that provide state-funded food assistant to immigrants ineligible for the federal food stamp program. (Per Legislative Analyst Office)
- California is one of only six states that provide a 100 percent state-funded monthly cash benefit to aged, blind and disabled non-citizens who are ineligible for Supplemental Security Income/State Supplementary Payment (SSI/SSP). (Per Legislative Analyst Office)
- California has 12 percent of the nation's population but 33 percent of the welfare caseload (U.S. Department of Health and Human Services, Administration for Children and Families).
- About 70 percent of In-Home Supportive Service recipients receive care from a family member (per the Department of Social Services).

Health

- CA is 3rd highest for Medicaid eligibility for childless adults following implementation of health reform. (Per Legislative Analyst Office)
- CA is 4th highest for Medicaid eligibility for parents following implementation of health reform. (Per Legislative Analyst Office)
- CA is one of 15 total states that provides full Medicaid coverage at state-only cost to legal resident immigrants (those here for less than five years, who are not eligible for federal funds for full-scope coverage). Of the 10 largest states, CA is one of four that provides this coverage (Data per 2011 Urban Institute report).
- CA ranks 21st overall, and **4th among the 10 most populous states**, in terms of most generous Medicaid/CHIP eligibility at 266 percent of the federal poverty level. (Data per Kaiser Family Foundation, effective Jan. 2014 KFF table here).

Child Care

California provides some of the most generous child care funding in the nation (most recent data per federal Child Care & Development Fund Policies Database 2011 Book of Tables):

- Our family income eligibility limits are higher than most other states (6^{th} highest).

- Our provider rates are among the highest in the nation (6^{th} highest pre-school and 5^{th} highest for infants).

Student Financial Aid

California provides some of the most generous student financial aid in the nation (most recent data per 2011-12 survey by Nat'l Association of State Student Grant & Aid Programs):

- We spend far more *money* on need-based grants than any other state ($1.5 billion – the next highest is New York at $933 million).

- We make the second highest *number* of need-based grants (about 250,000 grants, after New York's 310,000).

- Our *average expenditure per recipient* is the highest in the country by far ($5,982 – New York is $2,967).

Appendix A - Wall of Debt

Wall of Debt
2014-15 May Revision
(Dollars in Millions)

	Outstanding (as of end of 2010-11)	Outstanding based on 2014-15 May Revision	Proposed Supplemental Payments to 2013-14 and Earlier	2014-15 impact	2015-16 impact	2016-17 impact	2017-18 impact	Remaining Amount
Deferred Payments to Schools and Community Colleges	$10,430	$6,164	$4,510	$1,654	$0	$0	$0	$0
Economic Recovery Bonds	7,100	3,943	0	3,142	0	0	0	0
Loans from Special Funds	5,100	3,879	0	946	1,362	1,071	500	0
Unpaid Costs to Local Governments, Schools and Community Colleges for State Mandates	4,300	6,682	0	100	1,993	2,302	2,287	0
Underfunding of Proposition 98	3,000	2,391	598	0	1,793	0	0	0
Borrowing from Local Governments (Proposition 1A)	1,900	0	0	0	0	0	0	0
Deferred Medi-Cal Costs	1,200	2,324	0	97	152	1,038	1,037	0
Deferral of State Payroll Costs from June to July	759	783	0	0	0	783	0	0
Deferred Payments to CalPERS	524	411	0	0	0	0	411	0
Borrowing from Transportation Funds (Proposition 42)	417	168	0	83	85	0	0	0
Total	**$34,730**	**$26,745**	**$5,108**	**$6,022**	**$5,385**	**$5,194**	**$4,235**	**$0**

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