

options for accommodating midyear reductions, as most decisions affecting workload for the remainder of the academic year (admissions and course scheduling for example) were made months earlier. Unless the universities find sources of replacement revenue (such as through a midyear tuition increase), they will have to accommodate the reductions with some combination of drawing down reserves, borrowing, and reducing per-student costs.

Overall University Costs Projected to Be Flat Throughout Forecast. Our forecast assumes the universities' annual General Fund operating costs will be roughly \$4 billion over the course of the forecast period. This reflects our overall forecast approach of not providing automatic COLAs, as well as an absence of college-age population growth.

Enrollment Projected to Be Flat. Enrollment at the universities is affected by demographic changes in the student population as well as demand among eligible individuals. We project that demographic growth in the student population will slow and then become negative by the end of the forecast period. Though enrollment demand at the universities is difficult to project, as it depends on many different economic and social forces, we assume a modest increase in demand would generally be canceled out by the projected demographic declines. We therefore assume no increase in university enrollment during the forecast period.

UC Retirement Program Costs Not Included in Forecast. Because no statutory formula or plan has been adopted governing state support for the UC Retirement Program (UCRP), we did not include General Fund costs for UCRP in our forecast. Based on discussions with UC, however, we estimate that UC could request state General Fund contributions exceeding \$400 million annually by the end of the forecast period. Beginning in the early 1990s, neither the state nor UC employees made contributions to UCRP. This was because UCRP investments were sufficient to cover retirement

cost obligations. This is no longer the case, with UC recently reinstating employee payroll contributions and UC employer contributions toward UCRP. These contributions, however, are insufficient to cover all of UC's projected retirement costs. Though UC recently has begun requesting increased state General Fund support to help close this gap, the state has yet to appropriate funds for this purpose.

California Student Aid Commission

Cal Grant Programs. Most of the state's direct General Fund support for student financial aid is provided through the CSAC's Cal Grant programs, which offer tuition coverage and subsistence grants to eligible students. These costs are affected both by the number of students participating in the programs and the universities' tuition charges. As discussed above, we do not anticipate significant changes in enrollment levels. However, recent trends in tuition increases, coupled with statements by the universities, suggest that UC and CSU tuition will continue to increase. As a result, we project that Cal Grant costs will increase from \$1.4 billion in 2011-12 to \$2.3 billion at the end of the forecast period. Our forecast also takes into account costs associated with passage of the California Dream Act of 2010. Among other provisions in the act, Chapter 604, Statutes of 2010 (AB 131, Cedillo), makes some nonresident students eligible to receive state financial aid beginning in 2013.

Key Issues

Given that state General Fund resources are likely to continue to be severely constrained for the next several years, the Legislature faces several key questions with regard to the higher education budget.

- ***How Much Should Students Pay?*** As noted above, the universities have signaled that they could continue to increase tuition significantly for at least the next several years. The Legislature may wish to provide direction to the universities with regard to the share of education cost that non-needy students should be expected to pay.

- ***How Can Cal Grant Costs Be Managed?*** Because state law currently provides for a corresponding increase in Cal Grant payments when UC and CSU raise their tuition, state General Fund costs are driven in part by independent actions by the universities' governing boards. In some cases, the universities' decisions to increase tuition are made after passage of the state budget. The Legislature may wish to explore ways to better manage its own expectations for Cal Grant costs at the time of budget passage.
- ***How Should the Universities Reduce Operating Costs?*** Since the onset of the current recession, General Fund support for UC and CSU has declined by about a quarter. Much of this reduction has been backfilled with revenue from student tuition increases. Given the likelihood of continuing state budget constraints for the next several years, it may be necessary for the universities to further reduce their overall costs. The Legislature may wish to express expectations with regard to cost-saving opportunities related to factors such as faculty teaching and research expectations, student remediation rates, articulation of course sequences, student assessment and placement, and expansion of distance education and other alternative modes of instruction.
- ***How Should the State Address UCRP Costs?*** As noted above, UC's current efforts to restart UCRP contributions envision a corresponding increase in General Fund support, reaching several hundred million dollars per year by the end of the forecast period. Besides the magnitude of any augmentation, the Legislature also will have to consider how state support would be adjusted in future years, including potential increases or decreases in UCRP normal costs and unfunded liabilities.

HEALTH AND HUMAN SERVICES

Overview of Services Provided. California's major health programs provide health coverage and additional services for various groups of eligible persons—primarily poor families and children as well as seniors and persons with disabilities. The federal Medicaid program, known as Medi-Cal in California, is the largest state health program both in terms of the amount of funding and number of persons served. In addition, the state supports various public health programs, community services, state-operated facilities for the mentally ill and developmentally disabled, and health care insurance for children through the Healthy Families Program. Beyond these health programs, the state provides a variety of human services and benefits to its citizens. These include income maintenance for the aged, blind, or disabled; cash assistance and welfare-to-work services for low-income families with children; protection of children from abuse and neglect; and the provision of home-care workers who assist the aged and disabled in remaining in their own homes. Although various state departments oversee the management of these programs, the actual delivery of many services is carried out by county welfare and child support offices, and other local entities. Health programs are largely federally and state funded, while most human services programs have a mixture of federal, state, and county funding.

Overall Spending Trends. The 2011-12 budget provided \$25.2 billion in General Fund spending for health and human services (HHS) programs. These costs would have been significantly higher, but the realignment package discussed earlier shifted \$3.5 billion of state costs to counties. We now estimate that these General Fund costs will be about \$25.9 billion in 2011-12, primarily due to higher-than-anticipated costs in Medi-Cal and In-Home Supportive Services (IHSS). Based on current law requirements, we project that General Fund spending for HHS programs will increase

to about \$27.2 billion in 2012-13 and \$28.6 billion in 2013-14. Over the final three years of the forecast, we project that spending will increase by about \$1.6 billion each year, eventually reaching \$33.4 billion. All of our estimates include annual savings of about \$325 million pursuant to the trigger reductions for Medi-Cal programs operated by the Department of Developmental Services and IHSS.

Although the average annual increase in HHS spending is 5 percent during the forecast period, there is substantial variation in spending growth rates by program. General Fund spending for the state's largest HHS program, Medi-Cal, averages 6.8 percent per year during the forecast period. Conversely, the Supplemental Security Income/State Supplementary Program (SSI/SSP) and CalWORKs programs are both projected to have average annual growth of around 3 percent.

Anticipated Lower Caseload Growth Reduces Cost Pressures. The recent recession raised unemployment and reduced income, resulting in historically high numbers of Californians enrolling in state HHS programs. As a result, caseload growth for many HHS programs from 2008-09 through 2011-12 was well above historical trends. Our economic forecast assumes modest but sustained employment growth over the next five years. Accordingly, our caseload projections for many HHS programs reflect substantially lower growth rates compared to the experience of recent years. This in turn reduces cost pressures. Below, we discuss spending trends in the major HHS programs.

Impact of Federal Affordable Care Act (ACA). The ACA, also referred to as federal health care reform, is far-reaching legislation that will change how millions of Californians access health care coverage. Among many other provisions, the new federal law expands federal funding and eligibility for the Medi-Cal Program and mandates that individuals obtain private or public health coverage.

Some key provisions will not take effect until 2014. The scope of ACA is so broad that it will be years before all of its provisions will be fully implemented and its overall ramifications fully understood. Our fiscal forecast includes some significant budgetary adjustments to account for the implementation of ACA. Some of these adjustments result in cost increases for the state while others result in savings.

Medi-Cal

Overall Spending Trends. We estimate that in the current year General Fund spending for Medi-Cal local assistance administered by the Department of Health Care Services will amount to \$15.1 billion. This is about \$450 million, or 3.1 percent, more than appropriated in the *2011-12 Budget Act*. We project that General Fund support will grow to \$15.6 billion in 2012-13, a 3.2 percent increase from current-year expenditures. The largest factors contributing to this year-over-year spending growth are: (1) increases in caseload, utilization of services, and rising costs for those services; (2) costs for replacing one-time savings from a budget maneuver that accelerated provider payments and reduced expenditures in the 2011-12 budget; and (3) full-year savings in 2012-13 from various cost-containment measures implemented in part of 2011-12. After 2012-13, we project that General Fund spending will increase by about 8 percent each year, reaching a total of \$21 billion by 2016-17.

Key Program Cost-Drivers. We assume that the cost per person for Medi-Cal health services will grow at an average annual rate of 5.4 percent over the entire forecast period. We also project that the number of individuals enrolled in Medi-Cal under current eligibility rules will grow at an average rate of only 0.8 percent per year. However, the overall Medi-Cal caseload will grow more than 6 percent annually due to factors related to the ACA, most notably expanded eligibility beginning in January 2014. The impact of the ACA on our Medi-Cal spending forecast is discussed below.

Key Assumptions Related to Cost-Containment Measures. The 2011-12 budget assumed savings from a variety of cost-containment measures, such as copayments and utilization limits, for which the state is still awaiting federal approval. Our forecast assumes the implementation of these measures will be delayed several months, resulting in an erosion of 2011-12 budget savings. We assume, however, a full year of savings from the cost-containment measures in 2012-13. We also assume the state will implement provider rate reductions recently approved by the federal government, despite ongoing legal challenges.

ACA Impacts. Implementation of ACA will have a series of impacts on the Medi-Cal Program over the forecast period. For example, the federal government will initially cover the health service costs for individuals who become eligible for Medi-Cal in 2014 under the expanded eligibility categories required in the ACA. Our spending forecast captures a partial-year effect in 2017, when the state will pay for a small proportion of costs associated with the expanded eligibility categories. The state will also share costs for any increase in caseload in existing eligibility categories that results from persons enrolling in Medi-Cal in response to the individual coverage mandate created under ACA. We note that, due to ACA, our estimates related to caseload growth and other factors impacting program expenditures contain a significantly greater degree of uncertainty.

Mental Health

We estimate that General Fund spending for the Department of Mental Health (DMH) in 2011-12 will be about \$1.3 billion and will grow very slowly, approaching \$1.4 billion by 2016-17. General Fund spending would have remained virtually unchanged during the forecast but for an almost \$80 million increase in DMH staff costs to provide treatment services for mentally ill inmates at a new prison facility in Stockton.

Current-Year Impacts. As shown earlier in Figure 1, General Fund spending for DMH programs decreased from almost \$1.8 billion in 2010-11 to \$1.3 billion in 2011-12. This net decrease of \$540 million can be attributed to two main factors: (1) realignment-related state savings of \$762 million from replacing General Fund expenditures for the Early and Periodic Screening, Diagnosis, and Treatment Program and Mental Health Managed Care with Proposition 63 funds; and (2) partially offsetting cost increases (including additional General Fund expenditures to replace expiring enhanced federal matching funds that were available in the prior year).

Developmental Services

We estimate that the General Fund spending for developmental services in 2011-12 will total \$2.5 billion, assuming that the “revenue” trigger discussed earlier is pulled to achieve \$100 million in ongoing savings. We project that General Fund support will grow to more than \$2.7 billion in 2012-13, an increase of more than 8 percent from current-year expenditures. This year-over-year projected growth is largely due to increased caseload, utilization of services, and rising costs for community services provided by regional centers. It is also due to the expiration of temporary provider payment reductions that were implemented as a cost-cutting measure.

We project that General Fund support will grow to \$3.2 billion by the end of the forecast period in 2016-17. This projected growth is largely due to increased caseload, utilization of services, and rising costs for community services. Our forecast assumes that regional center caseloads will grow at an annual average rate of 3 percent, and that costs overall will grow at an average annual rate of about 5 percent.

CalWORKs

Overall Spending Trends. For 2011-12, the state budget provided \$1 billion from the General Fund for CalWORKs. This amount reflects the

impact of the 2011 realignment legislation, which shifted about \$1.1 billion in CalWORKs grant costs to the counties. We project that General Fund spending for CalWORKs will be about \$1.1 billion in 2011-12 or approximately \$75 million above the 2011-12 Budget Act appropriation, due to higher-than-projected caseload. From this current-year base, we project spending will increase by about \$400 million in 2012-13, stay fairly flat in 2013-14, and then decline in each of the next three years to around \$1.2 billion in 2016-17. The increase in CalWORKs costs over the next two years is primarily the result of (1) the restoration of short-term reductions, (2) caseload growth, and (3) the state's fixed federal Temporary Assistance for Needy Families (TANF) block grant, which does not adjust for caseload changes. Long-term cost declines are primarily driven by projected declines in caseload levels.

Cost of Restoring Short-Term Policy Changes.

For 2011-12, the Legislature achieved major ongoing CalWORKs savings through grant and eligibility reductions and additional short-term savings of over \$400 million. The short-term savings included (1) extending certain exemptions from work participation requirements with a corresponding \$375 million reduction in county block grants for employment services and child care and (2) suspending the case management portion of the Cal-Learn program for teen parents who remain in school, for a General Fund savings of \$44 million. Our forecast reflects the complete restoration of these reductions beginning in 2012-13. (We note that the state General Fund bears 100 percent of these costs because the federal TANF block grant and county realignment funds do not adjust for caseload or policy changes.)

Caseload Levels Driven Mainly by Economic Conditions. Historically, changes in employment levels have significantly affected CalWORKs caseload growth. During the recent economic downturn, the growth rate of the CalWORKs caseload increased significantly. Conversely,

during previous periods of employment growth, the CalWORKs caseload grew at a slower rate or declined. Our forecast of CalWORKs caseload reflects this empirical relationship between caseload and employment. The budget forecasts caseload growth of 1.2 percent in 2011-12. Based on recent caseload data, we estimate slightly higher caseload growth of 2.5 percent, resulting in additional costs of about \$75 million. In 2012-13, as employment growth begins to increase, we project caseload will grow by only 0.6 percent. Beginning in 2013-14, we expect the caseload to gradually decline over the remainder of the forecast period.

SSI/SSP

State expenditures for SSI/SSP are estimated to be \$2.8 billion in 2011-12 and 2012-13. Beginning in 2013-14, we project that General Fund support for SSI/SSP will increase by an average of \$80 million per year, reaching \$3.2 billion by 2016-17. The projected spending increases are primarily due to average annual caseload growth of about 2 percent with somewhat higher growth rates in the later years to reflect the aging of the population.

IHSS

For 2011-12, we estimate that General Fund spending for IHSS will exceed the budget act appropriation by roughly \$300 million, resulting in total costs of about \$1.5 billion. We then project that costs will decrease to around \$1.3 billion in 2012-13. These amounts reflect implementation of revenue triggers mentioned earlier and a specific IHSS trigger discussed below which will result in combined savings of \$110 million in 2011-12 and \$350 million annually thereafter. Finally, we project only modest growth in program cost in the out-years.

Budget Solutions and Unrealized Savings.

The 2011-12 budget reflects a package of solutions including (1) receipt of additional federal funds due to a provider tax and implementation of the Community First Choice option under the federal ACA, (2) elimination of services for recipients

whose need for services has not been certified by a medical professional, (3) a medication dispenser initiative, and (4) program integrity activities. Altogether, the budget assumed these initiatives would result in about \$600 million in program savings in 2011-12. However, we estimate that this package will only save about \$200 million in that year. Most of the unrealized savings in 2011-12 are related to delays in the implementation of the medication dispenser initiative and the Community First Choice option, along with overestimation of savings from other solutions.

Medication Dispenser Initiative and Budget Trigger. As part of the 2011-12 budget, the Legislature established a medication dispensing pilot program intended to improve medication compliance among Medicaid recipients, estimated to result in annual net cost avoidance of \$140 million from reduced nursing home placement and hospital admissions. Budget legislation requires the Department of Finance (DOF) to report to the Legislature by April 10, 2012 on how much savings the pilot is likely to achieve. At that time, the Legislature will have until July 1, 2012 to enact alternative legislation to achieve a total of \$140 million in ongoing savings from the medication pilot and/or new initiatives. If the DOF determines that these legislative actions are insufficient to achieve \$140 million in savings, an across-the-board reduction in IHSS hours sufficient to meet this savings target will be implemented in 2012-13. Our forecast assumes that no savings from the medication dispensing pilot will be achieved in 2011-12, but that the full \$140 million target will be achieved beginning in 2012-13.

Caseload Growth. Our forecast assumes that IHSS caseload will grow 3 percent per year throughout the forecast period. Our forecast is higher than the trend observed in 2009 and 2010, but below the rapid caseload growth that occurred prior to those years.

JUDICIARY AND CRIMINAL JUSTICE

The major state judiciary and criminal justice programs include support for two departments in the executive branch—the California Department of Corrections and Rehabilitation (CDCR) and the Department of Justice—as well as expenditures for the state court system.

CDCR

We estimate that General Fund spending for the support of CDCR operations in the current year will be about \$7.7 billion, which is \$1.5 billion, or 16 percent, less than the 2010-11 level of spending. This primarily reflects the estimated savings from (1) the realignment of certain lower-level offenders, parole violators, and parolees to counties beginning October 1, 2011 and (2) use of realignment revenues in the current year to reimburse CDCR for lower-level offenders in state prison who were sentenced prior to October 1. Our estimate of current-year spending is also lower because of assumed trigger reductions. Counties would be required to pay \$125,000 per year to the state for each juvenile offender committed to the Division of Juvenile Facilities, resulting in an estimated savings of \$79 million in the General Fund cost of operating state youth correctional facilities in 2011-12. In addition, there would be a \$20 million unallocated reduction to CDCR's budget.

Our forecast projects that General Fund spending on corrections will increase to about \$8.6 billion in 2016-17. As indicated above, the 2011-12 realignment package assumed that the Local Revenue Fund 2011 (realignment revenues) would reimburse CDCR about \$1.2 billion for costs incurred in 2011-12 for lower-level offenders in state prison who were sentenced prior to October 1, 2011. Our forecast assumes that the General Fund will replace the \$1.2 billion in 2012-13 and future years. In addition, as discussed in more detail below, our projections also reflect actions to reduce the state's inmate population as well as additional costs that

CDCR will incur to staff and operate new prison facilities expected to be constructed during the forecast period.

Projected Savings From Reduced Inmate Population... Our forecast assumes that the realignment of certain criminal offenders from the state to the counties will reduce CDCR expenditures by \$1.5 billion annually upon full implementation in 2014-15. Although this realignment of services would significantly reduce the state's inmate population, and go a long way towards complying with a federal court order to reduce prison overcrowding, it may fall short in meeting the requirements within the deadlines established by the court. (Please see nearby box for more detailed information about the federal court order.) Thus, our forecast assumes annual savings of over \$100 million beginning in 2012-13 from additional inmate population reduction measures that would likely need to be adopted to comply with the court order. However, the actual savings achieved would largely depend on the specific actions taken to further reduce prison overcrowding.

...But Increased Costs to Operate Planned AB 900 Facilities. In 2007, the Legislature enacted Chapter 7, Statutes of 2007 (AB 900, Solorio), in order to relieve the significant overcrowding problems facing state prisons and improve rehabilitation. Specifically, AB 900 authorizes the

construction of tens of thousands of additional prison beds. Our projections assume that about 15,300 additional beds will be constructed pursuant to AB 900 during the forecast period, resulting in an estimated \$800 million in additional General Fund expenditures annually to staff and operate the new facilities. As the new facilities are built, the Legislature will need to make policy and budgetary decisions regarding the level of programming and staffing to be provided at these facilities, which will determine the actual increase in operational costs. Given the likely magnitude of these eventual costs, as well as the significant reduction in the state's inmate population resulting from the federal court ruling to reduce prison overcrowding, the Legislature may want to hold off from moving forward with some of the projects authorized under AB 900.

Judicial Branch

We estimate that General Fund spending for the support of the judicial branch in the current year will be about \$1.2 billion, which is roughly \$500 million lower than the amount appropriated in the *2011-12 Budget Act*. This estimate primarily reflects the estimated General Fund savings from the realignment of court security to county sheriffs. Our forecast assumes that state spending on the judicial branch will remain roughly flat from 2011-12 through 2016-17.

Federal Court Order to Reduce Prison Overcrowding

On May 23, 2011, the U.S. Supreme Court issued a ruling in a lawsuit against the state involving prison overcrowding. Specifically, the court upheld the ruling of a federal three-judge panel requiring the state to reduce overcrowding in its prisons to 137.5 percent of the system's overall "design capacity" within two years. Currently, the state prison system is operating at roughly 180 percent of design capacity—or about 32,000 inmates more than the limit established by the three-judge panel. The ruling, however, did not specify the particular measures that the state must implement to comply. On June 7, 2011 and July 21, 2011 the administration submitted reports to the three-judge panel describing specific measures that were recently taken, as well as those in the process of being implemented, to reduce overcrowding in California prisons. For more detailed information, see our recent publication, *A Status Report: Reducing Prison Overcrowding in California* (August 2011).

OTHER PROGRAMS

Redevelopment

The 2011-12 budget package included two measures designed to generate (1) \$1.7 billion in state education savings in the current year and (2) about \$400 million in increased resources for school districts annually thereafter. Under these measures, each city or county with a redevelopment agency must choose whether to retain its redevelopment agency and make annual remittance payments to local school districts or allow its agency to be eliminated. Under either scenario, school districts receive additional local funding, either from remittance payments or property tax revenues redirected from the expired redevelopment agencies. In 2011-12, the remittance payments are intended to *offset* state funding obligations for schools. In 2012-13 and future years, the ongoing remittance payments (about \$400 million annually) are intended to *supplement* the resources the state provides to schools.

Our forecast estimates that state education savings in the current year will be about \$1.4 billion, about \$300 million less than the amount assumed in the budget because:

- As permitted by law, DOF reduced the remittance payment obligations for certain local governments that experienced increases in their redevelopment debt obligations.
- Some cities and counties are expected to allow their redevelopment agencies to expire and that the amount of property taxes redirected from the expired agencies will be less than the local governments' remittance payments.
- Some of the remittance payments and property tax revenues will be allocated to school districts that do not receive state funding for apportionments (so-called

“basic aid districts”). These funds, therefore, will not offset state school costs.

On November 10, 2011, the California Supreme Court heard a case challenging the constitutionality of the redevelopment bills. A decision is expected by January 15, 2012.

Employee Compensation

During 2010-11, the Legislature ratified new memoranda of understanding (MOUs) with each of the state's 21 collective bargaining units. These MOUs reduced state employee compensation costs through (1) the Personal Leave Program (PLP), which decreased most employees' pay by about 5 percent for the first 12 months of the new MOU's, and (2) increased employee pension contributions. The *2011-12 Budget Act* also directed the California Public Employees' Retirement System (CalPERS) to reduce employee health benefit costs by \$80 million (General Fund).

Net Costs Beginning in 2012-13. Our forecast assumes that the state will achieve all of the MOU-related employee compensation savings anticipated in the *2011-12 Budget Act* (\$135 million General Fund), but only \$47 million of the anticipated savings in health benefits costs. Beginning 2012-13, our forecast assumes that employee compensation costs grow because:

- The temporary salary reductions associated with the PLP end in 2011-12.
- Employees at the top step of the salary range will receive pay increases as provided by the MOUs.
- Employee health care costs increase at an average annual rate of 7.6 percent.

By 2016-17, we forecast employee compensation costs (nonretirement) will be more than \$550 million higher than in 2011-12, principally due to higher health care costs.

Public Employee Retirement Costs

Our forecast reflects current-law increases in the state's annual payments to (1) pension programs for state and CSU employees, (2) teachers' pensions, (3) state and CSU retiree health benefit programs, and (4) pension programs for judges. (The teachers' pension program is administered by the California State Teachers' Retirement System [CalSTRS], and the other three programs are administered by CalPERS.) Figure 4 shows the recent history and forecasted trend for General Fund budgetary costs related to these retirement programs.

CalPERS Contributions Driven by Pay Raises, Investments, and Actuarial Methods. Our forecast assumes that the state's required contribution to CalPERS for state and CSU pensions rises from \$3.6 billion (all funds) in 2011-12 to \$3.8 billion in 2016-17. (Of the \$3.6 billion to be contributed in 2011-12, about \$2.1 billion is expected to be paid from the General Fund. This General Fund contribution grows to \$2.2 billion in our forecast

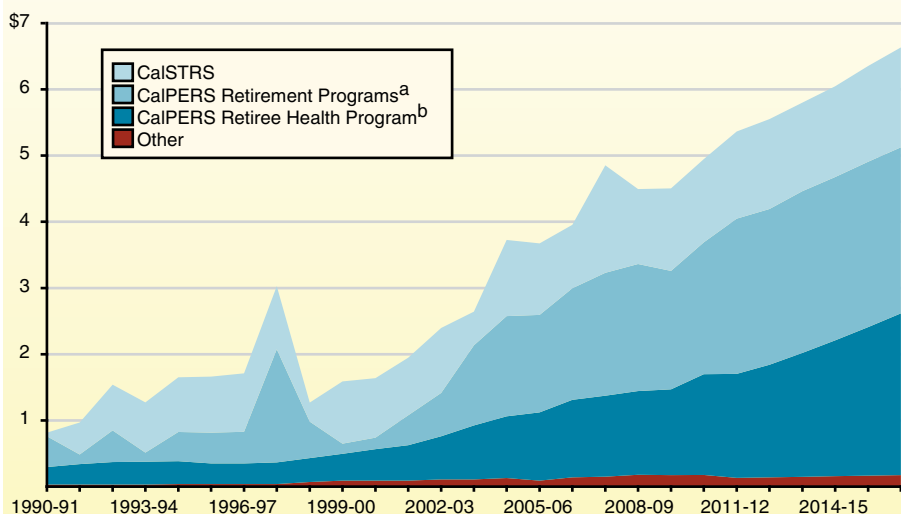
in 2016-17.) This assumes that CalPERS does not change its current actuarial rate-setting practices (including rate "smoothing") and that in 2012-13 and beyond, CalPERS investment returns hit the system's assumed investment target of 7.75 percent per year. Moreover, it assumes only the pay increases for state workers that are included in current MOUs—for most, a single 3 percent or 4 percent pay increase during the entire five-year forecast period. The forecast assumes that state workers continue to pay more in contributions to CalPERS throughout the forecast period, as agreed in collective bargaining agreements that were approved during the past year.

These various forecast assumptions limit the growth of the state's CalPERS contribution rates in our model. If, by contrast, pay raises were to rise faster than we assume, investment returns were to be significantly less, and/or actuarial methods of CalPERS were to change, the state's required payments to CalPERS could be hundreds of millions of dollars more than we forecast in 2016-17.

Figure 4

Current-Law State Retirement Costs to Keep Growing

General Fund (In Billions)



^a Amount for 1997-98 includes an over \$1 billion state payment related to a major court case involving CalPERS.

^b Includes the budget item for these costs and LAO estimate of the General Fund share of the implicit subsidy for annuitant benefits that is paid along with employees' health premiums.

CalSTRS Contribution Driven by Rates Set in Statute and Teacher Salary Growth.

The forecast assumes that the state's contributions to CalSTRS grow from \$1.3 billion in 2011-12 to \$1.5 billion in 2016-17. State contributions in 2011-12 are based on a 2009-10 payroll level for K-12 and community college teaching and administrative personnel of \$27.1 billion. The preliminary estimate for 2010-11 upon which the state's 2012-13 contributions will be based is \$26.2 billion (down 3.2 percent from

2009-10). We assume that statewide payroll remains fairly flat through the forecast period.

Typically, the state pays about 4.5 percent of prior-year teacher payroll to CalSTRS, as required in contractual commitments that are outlined in the Education Code. The system also receives payments from school districts and teachers to cover pension program costs, which also are fixed in the Education Code. Pursuant to its contractual obligations, the state must contribute additional funds each year when certain unfunded liabilities emerge, as they did after the decline of world financial markets in 2008. In our forecast, these added contributions total \$106 million in 2011-12 and grow to \$394 million by 2016-17. (These added contributions are very small compared to the billions of dollars of additional funding per year that CalSTRS will require to remain solvent and eliminate its unfunded liabilities over the next few decades.)

Retiree Health Costs to Continue Increasing.

The forecast assumes continued pay-as-you-go payments for the vast majority of state and CSU retiree health costs. These are forecast to grow from \$1.5 billion in 2011-12 to \$2.3 billion in 2016-17. This represents an average 9.4 percent annual growth rate during the forecast period. This growth is driven by two elements: (1) projected annual growth in state employee and retiree health plan premiums and (2) a rising population of state and CSU retirees.

Unfunded Liabilities Persist. The state's retirement programs are projected to have significant—and growing—unfunded liabilities through the forecast period. Because our forecast includes only current-law pension contribution requirements, it does not include funding sufficient to begin to reduce CalSTRS' unfunded liabilities (currently estimated to be around \$4 billion per year beginning immediately to eliminate the liabilities over the next 30 years, assuming that CalSTRS achieves its investment targets over the long term). Moreover, because the state is not

required under current law to contribute additional funds to UC to address its unfunded pension and retiree health liabilities, the forecast includes no General Fund resources to assist UC for these purposes. It also includes virtually no General Fund support to begin paying down large unfunded retiree health liabilities for current and past state and CSU employees. If the state does not take action concerning these liabilities soon, the extra costs needed to retire these unfunded liabilities over the next few decades will increase dramatically.

Debt Service on Infrastructure Bonds

The state uses General Fund revenues to pay debt-service costs for principal and interest payments on two types of bonds used primarily to fund infrastructure—voter-approved general obligation bonds and lease-revenue bonds approved by the Legislature. We estimate that General Fund costs for debt service on these bonds will be \$5.2 billion in 2012-13, which is roughly equal to the state's General Fund debt-service costs every year since 2009-10. General Fund debt-service costs have not increased significantly over this period for a few reasons. Most notably, the Legislature and Governor enacted legislation to offset some General Fund debt-service costs with transportation funds. Additionally, the administration slowed the pace of bond sales over the last 18 months, including the cancellation of state bond sales during the first half of 2011.

Over the forecast period, however, debt service is projected to grow 6.4 percent annually over the period, reaching \$7.3 billion by 2016-17. Projections of debt-service costs depend primarily on the volume of past and future bond sales, their interest rates, and their maturity structures. The exact timing of bond sales depends upon when various bond-related programs will be in need of funds and the accessibility of financial and credit markets. In general, our forecast assumes that the slower pace of bond sales continues for many programs because they currently have sufficient bond proceeds to cover their spending needs for

the initial portion of the forecast. Nonetheless, over the entire forecast period, we assume that a total of about \$36 billion of already authorized general obligation and lease-revenue bonds will be sold as currently approved projects move forward. A large share of this—about \$24 billion—is from the nearly \$54 billion in infrastructure bonds authorized by voters in 2006 and 2008. It also reflects the growing issuance of lease-revenue bonds for the prison system authorized by the Legislature in 2007. We also expect that transportation debt-service costs will exceed available transportation funds during the forecast period and the General Fund will resume paying a portion of these costs. Our forecast is based on the expected sale of bonds that have already been authorized, but does not include any proposed bonds (such as the water bond scheduled for the 2012 ballot).

Debt-Service Ratio (DSR) Expected to Rise.

The DSR for general obligation and lease-revenue bonds—that is, the ratio of annual General Fund debt-service costs to annual General Fund revenues and transfers—is often used as one indicator of the state's debt burden. There is no one "right" level for the DSR. The higher it is and more rapidly it rises, however, the more closely bond raters, financial analysts, and investors tend to look at the state's debt practices and the more debt-service expenses limit the use of revenues for other programs. Figure 5 shows what California's DSR has been in the recent past and our DSR projections for the forecast period.

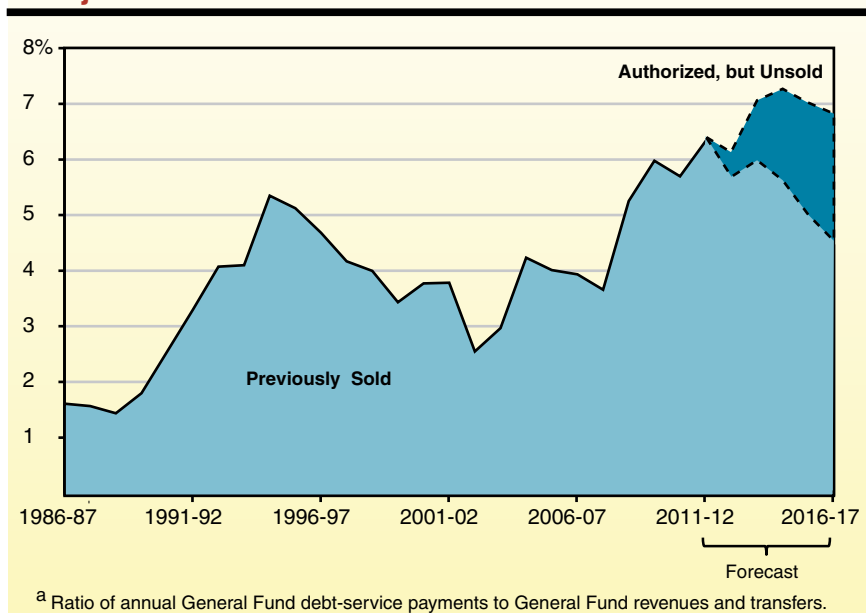
The DSR we are projecting—over 7 percent at its peak—is higher than it has been in the past. In part, this reflects declines in General

Fund revenues, as well as the continued sale of the large bonds approved since 2006. To the extent additional bonds are authorized and sold in future years beyond those already approved, the state's debt-service costs and DSR would be higher than projected in Figure 5.

State-Mandated Local Programs (Non-Education)

Over the last several years, the Legislature has taken various actions to reduce or defer costs for state mandates on local governments (cities, counties, and special districts). These actions include permanently repealing mandates, suspending statutory requirements to implement mandates, and deferring payments towards retiring the state's backlog of mandate claims (over \$1 billion). The 2011-12 budget shifted the responsibility and funding for providing certain mental health services to K-12 students from counties to schools (commonly referred to as "AB 3632" program). This action eliminates the need for ongoing mandate payments to counties for this program. Our forecast assumes that the Legislature

Figure 5
Projected Debt-Service Ratio^a



continues to suspend all mandates it suspended in 2011-12. Our forecast also assumes that the state makes annual payments to retire the backlog of mandate claims, as specified in current law. Under

these assumptions, state costs for mandates would increase from \$48 million in 2011-12 to roughly \$200 million annually throughout the forecast period.

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