Reasonable Revenue Estimates for the 2011-12 Budget Process. As described above, our revenue estimates end up virtually identical to the administration's for 2010-11 and 2011-12, despite some differences in methodology. Accordingly, we conclude that the overall revenue numbers in the Governor's revised budget plan are reasonable. Revenue prospects clearly have improved substantially since January based on robust PIT collections trends.

PROPOSITION 98—K–14 EDUCATION

Governor's May Revision Proposal

Figure 12 shows the Governor's May Revision Proposition 98 funding levels for K-12 education and the California Community Colleges (CCC). Relative to the budget approved by the Legislature in March, the May Revision contains only minor funding increases in the current year but a $3 billion increase in the budget year.

2010-11 Funding Up Slightly. For 2010-11, the Governor's May Revision continues to assume the Proposition 98 minimum guarantee is suspended. The May Revision, however, includes an increase of $129 million in Proposition 98 funding to recognize higher-than-expected K-12 costs ($72 million) and higher-than-expected community college property tax revenues ($57 million). Despite the small increase in total Proposition 98 funding, General Fund costs are notably reduced ($517 million). This is because higher-than-expected K-12 local property tax revenues ($646 million) reduce the General Fund share of revenue limit costs. (For CCC, higher-than-expected local property taxes do not result in an automatic reduction in state General Fund spending. The additional revenues instead provide an increase to community college apportionments.)

2011-12 Funding Up $3 Billion. The Governor continues to fund at the Proposition 98 minimum guarantee in 2011-12. Due to a number of factors, however, the minimum guarantee is $3 billion

Figure 12

Governor's Proposition 98 Funding Proposal

(In Millions)

	2010-11			2011-12		
	Conference	May Revision	Change	Conference	May Revision	Change
K-12 Education						
General Fund	$32,239	$31,722	-$517	$32,494	$34,430	$1,936
Local property tax revenue	11,557	12,147	589	11,406	12,123	717
Subtotals	($43,796)	($43,868)	($72)	($43,900)	($46,553)	($2,653)
California Community Colleges						
General Fund	$3,885	$3,885	—	$3,542	$3,807	$265
Local property tax revenue	1,892	1,949	$57	1,873	1,949	75
Subtotals	($5,777)	($5,834)	($57)	($5,415)	($5,756)	($340)
Other Agencies	$85	$85	—	$87	$85	-$2
Totals, Proposition 98	**$49,658**	**$49,787**	**$129**	**$49,402**	**$52,394**	**$2,992**
General Fund	$36,209	$35,691	-$517	$36,123	$38,322	$2,199
Local property tax revenue	13,449	14,096	646	13,279	14,072	793

above the March level. Figure 13 shows the changes from the March to the May estimates of the minimum guarantee. As the figure shows, the minimum guarantee increases by $2 billion due to improvements in the state's baseline General Fund revenues and changes in the way the state accrues certain General Fund revenues. These increases are offset slightly by the Governor's revised tax proposals, which reduce the minimum guarantee by $375 million. The guarantee also increases by $793 million due to higher estimates of local property tax revenues in the budget year. Finally, the Governor makes various adjustments so that the minimum guarantee is "held harmless" for specific changes in tax policy and shifts in programmatic responsibilities. These adjustments—commonly called rebenching—increase the minimum guarantee by a net of $656 million. (Rebenching is discussed in more detail in the box on page 20.)

Additional Funding Designated for Paying Down Deferrals. Whereas the March package contained a new $2.2 billion deferral of K-14 payments in 2011-12 (bringing total K-14 deferrals up to $10.4 billion), the May Revision provides $2.8 billion to eliminate the new 2011-12 deferrals and begin paying down prior-year deferrals. Specifically, the May Revision provides $2.5 billion to reduce K-12 deferrals and $350 million to reduce CCC deferrals. These payments would reduce the state's outstanding Proposition 98 deferrals to $7.6 billion.

Other Notable Proposals. The May Revision also contains three major policy proposals:

- ***Shifts Student Mental Health Services to School Districts.*** In contrast to his January proposal, the Governor's May Revision proposes to make school districts (rather than counties) responsible for providing students with educationally necessary mental health and residential support services. The May Revision contains a total of $389 million to support these services in 2011-12.

- ***Undertakes Education Mandate Reform.*** The May Revision contains an education mandate reform package that would eliminate 27 K-14 mandates and reduce the costs of 13 K-14 mandates—achieving $41 million in associated savings.

Figure 13

Summary of Changes in 2011-12 Proposition 98 Minimum Guarantee

(In Millions)

General Fund Adjustments:	
Baseline General Fund increase	$1,451
Accrual/policy changes	573
Tax proposal changes	-375
Other minor revenue changes	-106
Subtotal—Revenues	($1,543)
Property Tax Increase	$793[a]
Rebenching:	
Gas tax shift	$630
AB 3632 mental health shift	222
Change in value of existing LPT shifts/other	-196
Subtotal—Rebenching	($656)
Total Changes	**$2,992**

[a] In 2011-12, the Proposition 98 minimum guarantee is determined by Test 1, in which a fixed percentage (roughly 41 percent) of state General Fund revenues must be provided to K-14 education. When Test 1 is applicable, any increases in local property tax revenues do not offset state General Fund spending and instead result in additional funding for school districts and community colleges.

LPT = local property tax.

- ***Proposes Task Force to Reform State's Testing and Data Systems.*** In the May Revision, the administration raises several concerns with the state's existing accountability system, including excessive testing requirements and cumbersome data requirements. The administration proposes to address these issues by bringing together a group of teachers, scholars, administrators, and parents to identify ways to reduce testing time and eliminate unnecessary data collections. The May Revision also eliminates funding for the state's longitudinal student and teacher data systems.

Budget Outlook Improved but Districts Still Face Uncertainty and Timing Issues

Despite the proposed $3 billion increase in Proposition 98 funding, the May Revision does not reflect a major program expansion from the budget plan adopted in March. This is because the bulk of the additional Proposition 98 funding is associated with paying down deferrals (that is, making existing school payments on time) rather than increasing the level of programmatic

Rebenching Raises Many Dicey Issues

The May Revision contains two rebenching proposals that result in increases in the Proposition 98 minimum guarantee. Specifically, the administration proposes to rebench for: (1) the recent policy change that eliminated the sales tax on gasoline and increased the excise tax and (2) the proposed shift of responsibility for student mental health services from county mental health departments to school districts. As discussed in more detail below, rebenching raises serious legal, policy, and implementation issues.

Constitution Makes No Provision for Rebenching. The California Constitution is silent on whether the Proposition 98 minimum guarantee can be adjusted to account for policy changes. Over time, the state has adopted various statutory provisions relating to rebenching, but these provisions tend either to implement only one specific shift or are so general as to raise questions of legal interpretation. In the case of program shifts, statute also addresses only shifts *to* not *away* from schools. That is, if implemented, rebenching for programmatic shifts would result only in more, never less, funding for schools.

Rebenching Can Make Policy Sense but Opens Up Pandora's Box…To date, rebenching largely has been used to account for shifts in local property tax revenues to or away from schools. In these cases, rebenching can make policy sense because local property tax and General Fund revenues are considered fungible. For example, when the state has redirected local property tax revenues away from schools to other local governments, then General Fund support for schools has been increased to backfill for the loss of local revenue. Though these types of changes seem reasonable, the administration's rebenching proposals open up a Pandora's box of other rebenching possibilities. For example, if the state rebenches for the gas tax change (in an effort to hold schools harmless for the loss of sales tax revenue), should it also rebench for the administration's realignment proposals (in a similar effort to hold schools harmless for the loss of sales tax and vehicle license fee revenue)? Moreover, if the state rebenches for policy decisions that result in the loss of certain General Fund spending. Under the May Revision, per-pupil programmatic spending goes up only $40—from $7,693 to $7,733—with virtually all of the increase attributable to including mental health funding within Proposition 98. Because of the improvement in the state's fiscal condition and the propect of reduced deferrals, school districts face less budget uncertainty today than in March. While uncertainty has been reduced, it has not been eliminated entirely. As a result, school districts continue to face timing issues that likely will result in some of them planning for programmatic cuts.

Increase in Baseline Revenues Significantly Improves Districts' Budget Outlook. School districts must have their 2011-12 budgets finalized by July 1. As a result, without a complete, adopted state budget, school districts often build their budgets and make their related staffing decisions assuming a "worst-case" scenario. Under these scenarios, school districts prior to the May Revision were planning for potential Proposition 98 reductions of up to $4.5 billion. School districts now face an improved budget outlook. As noted above, improvement in state General Fund and

Rebenching Raises Many Dicey Issues *(Continued)*

revenues, then should it also rebench for policy decisions that result in increases in General Fund revenues (such as personal income tax rate increases)?

...The Swarm of Questions Continues. Rebenching due to shifts of program responsibility can be almost as problematic as revenue-related rebenchings. For example, given school districts have responsibility for all other special education services, does assuming responsibility for student mental health services reflect a shift of program responsibility? Moreover, should the state rebench only when program responsibilities are shifted between schools and other agencies or should rebenching apply more generally when schools are required to perform any new service? Conversely, should rebenching occur when schools are no longer required to perform existing services (for example, if home-to-school services or after-school programs were eliminated)? Along these lines of thinking, should the state rebench every time a major categorical program is created or eliminated, as most categorical programs are linked to the provision of specific services?

Rebenching Fraught With Implementation Issues. Even if one were to set aside these fundamental legal and policy issues, other implementation issues would remain. One major implementation issue is how exactly to adjust the minimum guarantee. For example, the administration's May Revision plan uses a different rebenching method than the rebenching method used for previous local property tax shifts. Had the administration used the traditional rebenching method, the effect on the Proposition 98 minimum guarantee would have been significantly smaller. Moreover, for the mental health shift, the administration is rebenching based upon an extremely high estimate of existing program costs. If one of the major reasons these services are being shifted to school districts is because the existing program structure lacks incentives to contain costs, then the Legislature likely would want to reevaluate the amount that should be used for rebenching purposes. Furthermore, depending on the overall state budget situation, the Legislature might want to revisit more generally whether it can afford either of the administration's rebenching proposals.

local property tax revenues result in substantial additional Proposition 98 funding. As a result of this improvement, cuts as deep as $4.5 billion are much less likely.

Risk of Tax Proposals Not Passing and Having a Deferral Means Some Districts Still Likely to Make Cuts. Unless the state adopts tax proposals prior to July 1, many school districts likely will feel compelled to continue making budget and staffing decisions assuming no such tax proposals. Nonetheless, a lower level of Proposition 98 funding likely would not result in major programmatic reductions, particularly if the state maintained the already adopted payment deferrals. Though districts likely will budget based on this same set of assumptions, the effect will vary partly depending on a district's ability to borrow. If a district believes it will be able to access short-term cash to cover a large deferral, then it will support a higher programmatic level. In contrast, if a district believes it will be unable to access short-term cash to cover such a deferral, then it very likely will make corresponding cuts rather than budget at the May Revision programmatic level. In a survey we conducted earlier this year, approximately 40 percent of districts reported that they would not access cash to cover an additional deferral. In short, though no longer planning for the worst-case scenario considered in March, some districts will continue to consider some programmatic cuts due to remaining concerns over timing and borrowing capacity.

Administration's Proposition 98 Priorities Generally Reasonable and Responsible

We believe the administration's May Proposition 98 plan is generally reasonable and responsible and recommend the Legislature adopt most of its major components. Specifically, if the final state budget package were to contain revenues able to support the May Revision level of spending, we recommend the Legislature adopt the administration's plan to rescind previously adopted deferrals. In addition, regardless of the revenue situation, we recommend the Legislature adopt the Governor's proposal to shift mental health responsibilities to school districts as well as his proposal to undertake mandate reform. (We recommend the Legislature reject the administration's proposal to defund the state's student and teacher data systems.

Paying Down Deferrals Improves Fiscal Health. By not creating new programs and instead paying down deferrals, the May Revision provides benefits to both the state and school districts. From the state's perspective, outstanding state obligations as well as out-year state budget shortfalls are reduced. From districts' perspective, less borrowing is needed, thereby reducing associated transaction and interest costs and potentially allowing districts to build back some programmatic support and/or replenish their reserves. From both perspectives, using additional funds for deferrals is fiscally responsible.

OVERALL ASSESSMENT OF THE GOVERNOR'S PLAN

As described above, the Governor's May Revision proposal generally maintains the same framework as his January proposal. As such, it has many of the same positive features and concerns as his original plan.

Positive Aspects of the Proposal

Uses Reasonable Estimates. In putting together its revised proposal, the administration had to make a variety of estimates: the problem definition, caseload and other spending requirements, revenues, and the value of proposed solutions.

Generally speaking, we find their 2010-11 and 2011-12 numbers to be reasonable. As noted earlier, with regard to the most important variable—updated revenues—our near-term estimates are very similar to those of the administration. We expect to complete a more thorough multiyear budget forecast in the coming days.

Achieves Operating Balance for Next Several Years. As in January, the proposal not only balances in the budget year, but, according to the administration's estimates, would tend to stay in the black over the forecast period. While the temporary nature of the major tax proposals raises longer-term issues, the plan would achieve the important goal of bringing annual spending and resources much closer in line over the forecast period.

Recognizes the "Overhang" of Other Budgetary Obligations. In addressing past budgetary shortfalls, the state has taken actions that have worsened its future fiscal situation. These actions—primarily spending deferrals of various types and borrowing—have resulted in an overhang of debt and obligations that will weigh on the Legislature's budget deliberations for years to come. Under current law, billions of dollars of these obligations are scheduled to be retired in the next few years. The administration, however, has proposed using a portion of the growth in General Fund revenues to retire more of these obligations, as well as committing to further "buy-downs" in the future. While the exact nature of those commitments—particularly with regard to school-related payments—is unclear, the administration's attention to these longer-term obligations is commendable.

Offers Some State Operational Efficiencies. Through various executive orders and decisions in recent months and numerous proposals in the May Revision, the administration has provided means of achieving some savings and changes in state governmental operations.

Concerns With the May Revision Proposal

Uncertainties Caused by the Election Contingency. The Governor continues to propose that his major tax proposals and linked realignment plan be approved by the voters. While the May Revision document does not specify a date, the Governor appears to prefer a time earlier in the fiscal year rather than later. The problem with this plan is that it creates enormous uncertainty for both the state and local governments. For example, school districts, which need to make budget-year staffing and other decisions in the near future, will not know whether to budget based on the higher Proposition 98 funding level in the May Revision, the minimum guarantee should no tax proposals be adopted, or some level below that (should rejection of the tax measures require even more significant reductions).

Counties will face the same types of uncertainties. Since the administration's realignment proposal is linked to the tax measures, they will be up in the air as to their new responsibilities until the voters have decided. If the voters reject the measures, they could also face additional state reductions in programs they administer in order to bring the budget back into balance.

Finally, the state also faces uncertainty in the case of a midyear election. As the Treasurer has already noted, the risk associated with such an election would make it difficult to obtain the external intrayear borrowing that is needed to address the state's cash needs. In addition, if the voters rejected the tax measures, the state would have to reconsider various reductions to state programs in order to bring the budget back into balance.

Issues With the Governor's Tax Proposals. Despite the noted improvement in state revenues, the Governor has chosen not to change his proposals to extend the higher tax rates on the state's two major taxes (with the exception of a one-year delay in the PIT surcharge). The state's sales and PIT rates are currently among the highest in the country. Keeping these rates as competitive as possible can contribute to the state's longer-run economic health. With regard to his other tax proposals, we would rather have seen the administration stick with its original proposal to eliminate enterprise zones, and we continue to have concerns about the cost-effectiveness and other features of the hiring credit. As to his proposal to exempt some manufacturing equipment from sales taxes, we think the Governor has raised legitimate concerns about the taxation of business intermediate goods. His specific proposal to treat start-ups more generously than existing businesses, however, creates unnecessary and distorting distinctions among businesses.

How Should the Legislature Address the Remaining Problem?

After accounting for actions taken to date and growth in baseline revenues, the Legislature still needs to address a remaining budget-year shortfall of about $10 billion. Below, we offer our advice to the Legislature on how to approach this problem.

Evaluate the Spectrum of Options. The May Revision document states that, "Absent the balanced approach proposed by the Governor, the options are either an 'all cuts' budget or a combination of gimmicks and cuts." Clearly, this is not the case. The Legislature has many options to address the remaining shortfall, including: (1) adoption of some of the administration's revenue proposals, (2) consideration of other revenue proposals, (3) additional program reductions, and (4) selected fund transfers and internal borrowing.

Maximize Ongoing Solutions. Through its actions and improved revenues, the Legislature has already addressed about half of its ongoing structural shortfall. Last November, we suggested in our *Fiscal Outlook* that such a target would be a productive first step in chipping away at the state's persistent operating shortfall. The state, however, is now in a position to make more significant inroads into the problem. Whether through revenue or expenditure solutions, we strongly urge the Legislature to maximize the amount of ongoing solutions in addressing the remaining problem.

Prioritize Revenue Increases. In considering proposals that increase revenues, the Legislature must always struggle with the trade-off between avoiding undesired program reductions and the impact of increased taxes on individuals and businesses. As such, we think the Legislature should carefully prioritize such tax proposals. In our view, the Legislature should give highest priority to tax provisions which eliminate distortions among taxpayers or for which the evidence is not persuasive regarding their effectiveness. It is on these bases that we have recommended approval of the Governor's proposals to eliminate enterprise zones and require single sales apportionment for corporations. We would give next priority to proposals which achieve a desired tax policy objective. For example, we think the administration's VLF proposal accomplishes the goal of the state taxing property at a similar rate.

Provide as Much Certainty as Possible. As discussed above, a budget that is based on the approval of voters for key provisions can create huge uncertainty at the state and local government levels. At this point, the outcome providing the most certainty would be the Legislature and Governor reaching a budget agreement without going to the voters. If, however, the tax measures are to go before the voters, it might be preferable to have the election at the end of the fiscal year. In this case, parties affected by the budget would at least have certainty as to funding levels for the entire fiscal year.

Incorporate the Governor's Emphasis on Budgetary Obligations. Regardless of the components of a final budget package, we think the Legislature should incorporate the Governor's focus on the state's large fiscal obligations in its budgetary deliberations. This could be done in many ways. For example, the Legislature could adopt the Governor's approach of scheduling the repayment of various Proposition 98-related obligations. With regard to infrastructure spending, the Legislature could improve its oversight and prioritization of bond fund expenditures in order to minimize the impact of growing debt-service payments. Furthermore, as the economy and revenues improve, it could specify its priorities for (1) paying off other obligations (such as special fund loans), (2) improving funding of long-term commitments (such as retiree health benefits), and (3) reversing the numerous revenue acceleration and accrual policies adopted in recent years in order to enhance investor and public confidence in the state's accounting practices.

CONCLUSION

In recent budgets, the state has not been able to make significant inroads into its underlying operating shortfall. The reliance on one-time and short-term solutions has meant that the Legislature and Governor have had to address each year a large budget problem. This year is different. An improved economic and revenue situation, along with significant budgetary solutions already adopted, mean that the state is in a position to dramatically shrink its budget problem. The Governor has offered a serious proposal worthy of legislative consideration. The Legislature, however, has a variety of other tax and spending actions it could take to more closely align state revenues and expenditures now and in the future.

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