



Mac Taylor
Legislative Analyst

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The 2012-13 Budget:

Overview of the Governor's Budget



2012-13 BUDGET

EXECUTIVE SUMMARY

Governor's Proposal

Proposed Tax Initiative Is Cornerstone of Governor's Budget Proposal. The administration estimates that the Legislature and the Governor must address a budget problem of \$9.2 billion between now and the start of the 2012-13 fiscal year. The cornerstone of the Governor's 2012-13 budget plan is its assumption that voters will approve a temporary increase in income and sales taxes through an initiative that the Governor has proposed be on the November 2012 ballot. The administration estimates the initiative would increase state revenues by \$6.9 billion by the end of 2012-13, and generate billions of dollars per year until its taxes expire at the end of 2016. The taxes would be deposited to the General Fund to pay for the state's Proposition 98 school funding obligations, as increased by the initiative, and to help balance the budget by paying for other state programs. The Governor also proposes significant reductions to social services and child care programs and additional state borrowing.

Administration Estimates Plan Would Return State Budget to Balance. The administration estimates the Governor's plan would leave the state with a \$1.1 billion reserve at the end of 2012-13 and balanced annual budgets for the next few years. The Governor also proposes that the state take steps to reduce outstanding state budgetary obligations (which he calls a "wall of debt") during the next several years.

Proposed Trigger Cuts if Voters Reject Governor's Tax Initiative. The Governor's proposal requests that the Legislature approve \$5.4 billion of "trigger cuts" to take effect on January 1, 2013, if voters do not approve the Governor's tax initiative. Proposition 98 funding for schools and community colleges would bear the brunt of these trigger cuts: \$4.8 billion (90 percent) of the total.

LAO Comments

Governor's Plan Would Continue State's Efforts to Restore Budgetary Balance. In 2011, the Legislature and the Governor took significant steps—through ongoing budgetary actions—to begin to restore the state budget to balance. To finish this job, the Legislature still faces a very difficult task for 2012, as the Governor's proposal shows. The Governor's plan envisions multiyear tax increases and significant reductions in social services and subsidized child care programs. As an alternative, if his tax plan is rejected he proposes much larger cuts, aimed largely at schools. If the state chooses either of the Governor's two paths, the state budget would be moved much closer to balance over the next several years.

Revenue Estimates Bigger Question Mark Than Usual. Our revenue estimates—including estimates of state revenue gains from the Governor's proposed initiative—currently are lower than the administration's. Already, California's budget is dependent on volatile income tax payments by the state's wealthiest individuals, and the Governor proposes that these Californians pay more for the next few years. As has become evident in recent years, differing fortunes for these upper-income taxpayers can create or eliminate billions of dollars of projected state revenues. If our current

revenue estimates are closer to the target than the administration's, the Legislature will have to pursue billions of dollars more in budget-balancing solutions.

Restructuring Proposals in Education Merit Serious Consideration. The Governor's plan contains major restructuring of the school finance system, community college categorical funding, and education mandates. We think the Governor's restructuring proposals in all these areas would overcome most widely recognized shortcomings of these current systems and institute lasting improvements.

Social Services and Child Care Proposals Have Merit, But Involve Drawbacks. The Governor proposes to reduce General Fund support for California Work Opportunity and Responsibility to Kids (CalWORKs) and subsidized child care—the state's primary sources of cash assistance and work support for low-income families—by a total of about \$1.4 billion. His proposal would focus reforms in the CalWORKs program on achieving the goal of emphasizing work. The Legislature may wish to consider whether the proposed reductions to families most in need of support to achieve self-sufficiency are too severe, as well as the Governor's proposal to restrict eligibility criteria and time lines for subsidized child care. Focusing these programs on a different set of objectives and priorities than the Governor would not necessarily eliminate opportunities for budgetary savings, but the savings potential under such alternatives could be less.

Trigger Cut Framework Needs to Be Considered Carefully. Though the Governor's tax initiative would improve the financial outlook of public education over the next several years, his trigger plan would create significant uncertainty for schools, community colleges, and universities in 2012-13. This uncertainty is likely to be particularly problematic for schools, as most will feel compelled to build their 2012-13 budgets assuming the trigger cuts will be implemented. This means schools in 2012-13 likely will implement most, if not all, of the reductions that many hope to avoid. Given this possibility, the Legislature needs to be very deliberate in structuring a workable trigger package. In particular, the Legislature will need to be careful in setting the size of the trigger reduction; determining the specific education reductions to impose; and designing tools to help schools, community colleges, and universities respond to the trigger cuts.

OVERVIEW

THE GOVERNOR'S BUDGET PROPOSAL

On January 5, 2012, the Governor proposed a 2012-13 state spending plan with \$92.6 billion of General Fund expenditures, \$39.8 billion of spending from state special funds, and \$5.0 billion of bond fund expenditures. In addition, the budget assumes that \$73 billion of federal funds flow through state accounts in 2012-13.

The cornerstone of the plan is its assumption that voters will approve the Governor's proposed tax initiative in November 2012. These taxes would be deposited to the General Fund to pay for the state's Proposition 98 school funding obligations, as increased by the initiative, and to help balance the budget by paying for other state programs. Under the administration's estimates, as shown in Figure 1, the state would end 2012-13 with a \$1.1 billion General Fund reserve. The budget plan also contains trigger cuts that would take effect if voters reject the Governor's tax proposal.

\$9.2 Billion Budget Problem Projected for 2012-13

Consists of \$4 Billion 2011-12 Deficit, Plus \$5 Billion Shortfall for 2012-13.

Each year, in assembling the Governor's proposed budget, the administration estimates what revenues and expenditures would be under current tax and expenditure policies. This is

called the baseline, or workload, budget forecast. For 2012-13, the administration projects that baseline General Fund revenues are \$89.2 billion, while baseline General Fund spending is \$94.3 billion. In addition to this prospective annual budget shortfall of over \$5 billion for 2012-13, the administration estimates that 2011-12 will end with a General Fund deficit of over \$4.1 billion. Combined, the state faces an estimated budget problem of \$9.2 billion to address between now and the start of the new fiscal year.

Several Major Differences From LAO's November 2011 Forecast. In our November 2011 publication, *California's Fiscal Outlook*, our office estimated that the baseline budget problem for the state's General Fund would total \$12.8 billion for 2012-13. This is about \$3.6 billion more than the estimated budget problem reflected in the *2012-13 Governor's Budget*. The administration's definition of the 2012-13 budget problem differs from ours in several ways:

Figure 1
Governor's Budget
General Fund Condition

(Dollars in Millions)

	Actual 2010-11	Proposed 2011-12	Proposed for 2012-13	
			Amount	Percent Change
Prior-year fund balance	-\$5,019	-\$3,079	-\$986	
Revenues and transfers	93,489	88,606	95,389	7.7%
Total resources available	\$88,470	\$85,527	\$94,404	
Expenditures	\$91,549	\$86,513	\$92,553	7.0%
Ending fund balance	-\$3,079	-\$986	\$1,850	
Encumbrances	\$719	\$719	\$719	
Reserve^a	-\$3,797	-\$1,704	\$1,132	

^a Reflects the administration's projection of the balance in the special fund for economic uncertainties. (The *2012-13 Governor's Budget* proposes to continue suspending transfers to the Budget Stabilization Account.)

- **Administration's Revenue Forecast.** The administration forecasts that baseline General Fund revenues and transfers will be \$4.7 billion higher over 2011-12 and 2012-13 combined than indicated in our November 2011 forecast. This is partially offset by the administration's estimate of \$803 million less in revenues and transfers than we estimated for the prior year, 2010-11. For the three fiscal years combined, therefore, the Governor's budget forecasts baseline revenues that are over \$3.9 billion higher than those forecast by our office in November. The vast majority of our differences during this period are related to our respective forecasts of personal income tax (PIT) revenues.
- **Proposition 98 Estimates.** The administration's baseline figures are different from those in our November forecast for state General Fund spending for Proposition 98. Specifically, for the 2011-12 and 2012-13 fiscal years combined, the administration's baseline General Fund Proposition 98 estimates are about \$1.1 billion lower than our estimates. A number of reasons account for these differences, including the treatment of the realignment revenues, redevelopment revenues, the gas tax swap, and 2011-12 trigger cuts.
- **Non-Proposition 98 Spending.** Compared to our November forecast, the administration's workload budget estimates for 2011-12 and 2012-13 include a net amount of about \$1.4 billion more in non-Proposition 98 General Fund spending. There appear to be a variety of reasons for these differences, such as the administration's estimates of several hundred million dollars of higher General Fund expenses

for some health and social services programs and debt service. Contrary to our past practices in developing workload budgets, the administration also includes over \$700 million of General Fund expenses to reimburse local governments for the prior-year costs of currently inactive mandates. In addition, we understand that budget proposals to augment some programs are included in the administration's workload budget estimates, such as a proposed \$90 million increase to the University of California (UC) budget. Finally, the administration also assumes in its workload budget \$500 million of savings from using revenues from the Air Resources Board's (ARB's) auction of "cap-and-trade" greenhouse gas emission allowances to offset unspecified General Fund costs. The Legislature, however, has never explicitly adopted such a policy for the use of cap-and-trade auction revenues, and accordingly, we regard the revenues as a budgetary solution (not as a change in the definition of the problem).

Governor's Budget Proposals

Proposes Over \$10 Billion of Budget-Balancing Actions. The Governor proposes over \$10 billion of budget-balancing actions to address the administration's estimated \$9.2 billion budget problem—leaving the state with a reserve of \$1.1 billion at the end of 2012-13. Figure 2 summarizes the administration's estimates of savings or revenue related to the Governor's major proposals. (We list the administration's estimates in every case but two—the cap-and-trade and mandate issues noted above.)

Key Proposals. The budget plan rests predominantly on proposals in three areas, all of which are discussed in greater detail in the sections that follow:

- **Plan Assumes Voters Approve Governor’s Tax Initiative.** The centerpiece of the Governor’s budget plan is its assumption that voters approve his initiative proposal to temporarily increase PIT on upper-income filers and sales and use taxes (SUT) for the next several years. The administration estimates that this plan would generate \$6.9 billion of revenues to benefit the 2012-13 General Fund budget plan.
- **Proposition 98 Proposals.** As always, Proposition 98 funding for schools and

community colleges is the single largest spending priority in the proposed budget. For 2012-13, the Governor proposes state and local Proposition 98 funding of \$52.5 billion—the administration’s estimate of the Proposition 98 minimum guarantee. The guarantee reflects the additional revenue assumed to be raised by the Governor’s tax initiative. The year-to-year funding increase under the Governor’s budget proposal is dedicated largely to reducing the size of existing K-14 payment deferrals. The budget also

Figure 2
Budget-Balancing Actions Proposed by the Governor

2011-12 and 2012-13 General Fund Benefit (In Millions)

Revenue Actions	
Increase personal income and sales and use taxes through voter initiative	\$6,935
Make permanent the existing tax on Medi-Cal managed care plans	162
Implement changes to unclaimed property program	70
Implement other revenue actions (net)	19
Subtotal	<u>(\$7,186)</u>
Increased Proposition 98 Costs Due to Proposed Tax Increases	
	-\$2,534
Expenditure Actions	
Restructure and reduce CalWORKs and subsidized child care program costs	\$1,393
Defer payments to Medi-Cal providers and other related actions	682
Make various Proposition 98 adjustments	544
Use part of cap-and-trade program auction revenues to offset unspecified General Fund costs ^a	500
Change Cal Grant awards and eligibility requirements	302
Eliminate domestic and related services for certain In-Home Supportive Services recipients	164
Reduce Medi-Cal costs through program efficiencies and other changes	160
Defer payment on pre-2004 local mandate obligations ^b	100
Reduce Healthy Families Program managed care rates	64
Reduce various other program costs	49
Implement other fund shifts	28
Subtotal ^c	<u>(\$3,987)</u>
Other Actions	
Delay loan payments to special funds	\$631
Borrow from disability insurance fund to pay costs of federal unemployment insurance loans	417
Use weight fee revenues to offset General Fund costs	350
Suspend county share of child support collections on one-time basis	35
Subtotal	<u>(\$1,432)</u>
Total	\$10,070

^a Although the administration’s workload budget includes those funds, we characterize those funds as a budget-balancing proposal.

^b Contrary to the Governor’s approach, does not include as a solution \$729 million related to past-year costs of suspended mandates.

^c The administration characterizes the Governor’s proposed expenditure actions as totaling \$4.2 billion. Our estimate is \$229 million lower due to the differences described in footnotes a and b above.

includes proposals that would dramatically change how the state provides general purpose, categorical, and mandate funding to schools.

- Significant Changes for CalWORKs and Child Care Funding.** The Governor proposes to reduce General Fund support for the CalWORKs program and subsidized child care, the state’s primary sources of cash assistance and work support for low-income families, for total savings of about \$1.4 billion. The savings would be achieved primarily by reducing cash grants to a significant portion of current CalWORKs recipients, further limiting eligibility for subsidized child care and CalWORKs employment services, and reducing payments to child care providers.

Borrowing From State Special Funds. Typical of budgets in recent years, the administration proposes further delays to specified General Fund loan repayments to state special funds. Many special funds are fee-driven accounts eligible to be used for specific public programs. The budget plan assumes \$631 million of such loan repayment delays. Examples of these delays include deferrals of General Fund repayments to the Off-Highway Vehicle Trust Fund (\$90 million) and the Electronic Waste Recovery and Recycling Fund (\$80 million). The budget also proposes to borrow again from the disability insurance fund (\$417 million) to pay the state’s interest costs to the federal government on its unemployment insurance loan.

Trigger Cuts

Over \$5 Billion of Additional Cuts if Voters Reject Tax Measure. The Governor proposes \$5.4 billion of trigger cuts to take effect in January 2013 if voters reject his proposed tax measure this November. These trigger cut proposals are summarized in Figure 3. Proposition 98 funding for schools and community colleges would bear the brunt of such reductions: \$4.8 billion (90 percent) of the \$5.4 billion in total trigger cuts. University and judicial branch appropriations, among others, would see significant reductions in this scenario under the Governor’s plan.

Impact on Future Years

Smaller Shortfalls Projected. Using its estimates of workload revenues and expenditures, the administration estimates that the state currently faces a future annual budget shortfall of \$4.7 billion in 2013-14, \$2.9 billion in 2014-15, and \$1.9 billion in 2015-16—much reduced from the outyear budget shortfalls projected one year ago. Higher revenue collections and the results of last year’s ongoing budgetary actions are responsible for this improvement in the state’s fiscal health.

Shortfalls Estimated to Be Eliminated. The administration estimates that the Governor’s

**Figure 3
Proposed “Trigger” Reductions
If Voters Reject Proposed Tax Initiative**

<i>2012-13 General Fund Benefit (In Millions)</i>	
Proposition 98 funding for schools and community colleges	\$4,837
University of California	200
California State University	200
Judicial branch	125
CalFire	15
Department of Water Resources flood control programs	7
Department of Fish and Game	4
Department of Parks and Recreation	2
Department of Justice law enforcement programs	1
Total	\$5,390

2012-13 budget plan would continue last year's progress in returning the state budget to balance. Specifically, the administration's calculations indicate the Governor's plan would "eliminate future budget problems throughout the forecast period under current projections." (The administration's forecast period runs through 2015-16.)

Reducing State Budgetary Obligations. In addition to providing funding for support of existing General Fund program commitments, the Governor proposes to use tax revenues over the next several years to pay down what the administration characterizes as a \$33 billion wall of debt. This consists of budgetary obligations such as deferred payments to schools and community colleges, the Economic Recovery Bonds that were used to refinance the state's early-2000s deficit, unpaid local government mandate reimbursements, and loans from state special funds. The *2012-13 Governor's Budget Summary* states the Governor's plan would "pay off" this \$33 billion by 2015-16.

LAO COMMENTS

Governor's Plan Would Continue State's Efforts to Restore Budgetary Balance. In 2011, the Legislature and the Governor took significant steps—through ongoing budgetary actions—to begin to restore California's state budget to balance. To finish this job, the Legislature still faces a very difficult task in 2012, as the Governor's proposal shows. The administration's major proposed budgetary actions this year are significant—multiyear income and sales tax increases coupled with significant reductions in social services and subsidized child care. As an alternative, if the voters choose not to approve the proposed tax increases, the Governor proposes much larger cuts, aimed largely at schools. If the state chooses either of the Governor's two paths, the state budget would be moved much closer to balance over the next several years.

Revenue Estimates Are a Bigger Question Mark Than Usual. As we discuss later in this report, our revenue estimates for 2011-12, 2012-13, and subsequent years currently are lower than the administration's, and we estimate the revenue gain from the Governor's proposed tax initiative would also be significantly lower. The administration has made a good-faith effort in its revenue and economic forecasting despite the huge uncertainties involved in projecting the state's recovery from an unprecedented economic downturn. Nevertheless, our differences with the administration's estimates for high-income tax filers mean we now project billions of dollars less in state revenues. We will continue to review incoming revenue and economic data and update the Legislature during the next few months.

Already, California's budget is dependent on volatile income tax payments by the state's wealthiest individuals. The top 1 percent of PIT filers pay around 40 percent of state income taxes, the General Fund's dominant funding source. Because the Governor's budget proposal is centered on his idea for these wealthy tax filers to pay more, the state would become more dependent on this uncertain revenue source. For this reason, revenue estimates are an even bigger question mark than usual for the Legislature this year. As we have learned in past years, differing fortunes for upper-income taxpayers can quickly create or eliminate billions of dollars of projected state revenues. If our current revenue estimates are closer to the target than the administration's, the Legislature will have to pursue billions of dollars more in budget-balancing solutions.

Restructuring Proposals in Education Merit Serious Consideration. The Governor's package also contains major restructuring of the K-12 finance system, community college categorical funding model, and education mandate system. In all three cases, the state's existing systems

are widely recognized as having longstanding, fundamental shortcomings. We think the Governor's restructuring proposals in all three areas would overcome most of these shortcomings and institute lasting improvements. As such, we recommend the Legislature adopt the Governor's basic restructuring approaches. The Legislature, however, might want to make some modifications to specific proposals. For example, the Legislature might want to change the amount of mandate block grant funding provided or the specific mix of mandated programs that are eliminated versus made discretionary.

Now Not the Time for Major New Programs or Program Expansions. We agree with the Governor's assessment that now is not the time to initiate major new programs or authorizing program expansions. The Governor's plan contains associated proposals that together would help lower costs by \$300 million. Of greatest magnitude, we recommend the Legislature adopt the Governor's proposal not to initiate the transitional kindergarten program set to go into effect beginning in 2012-13. Not initiating this program yields \$224 million in associated revenue limit savings. We also recommend the Legislature adopt the Governor's proposals to halt the Cal Grant expansions that would otherwise come about through loosened transfer entitlement rules and cohort default rate limits beginning in 2012-13. These two proposals would result in state savings of more than \$70 million.

Social Services and Child Care Proposals Have Merit, But Involve Trade-Offs. The Governor's budget proposes to reduce General Fund support for CalWORKs and subsidized child care—the state's primary sources of cash assistance and work support for California's low-income families—by a total of about \$1.4 billion. The Governor's proposal recognizes that, given current funding constraints, it is difficult to fully achieve existing goals of the CalWORKs program. Accordingly, his proposal

would focus reforms in the CalWORKs program on achieving the goal of emphasizing work.

Although we find the Governor's CalWORKs and child care proposals have some advantages, they also involve potential trade-offs. Most clearly, the reductions proposed by the Governor would have significant negative impacts on many of California's low-income families. Regarding CalWORKs, the Legislature may wish to consider whether reductions made to families most in need of support to achieve self-sufficiency would be too severe. Similarly, the Legislature may want to consider whether the Governor's proposal too severely restricts eligibility criteria and time lines for subsidized child care. More generally, the Legislature should consider whether focusing CalWORKs and subsidized child care primarily on supporting efforts of low-income families to obtain employment is consistent with its priorities or whether other objectives are also important. Focusing these programs on a different set of objectives and priorities than the Governor would not necessarily eliminate opportunities for budgetary savings; however, the potential for savings could be less and there could be trade-offs in other areas of the budget.

Legislature Needs to Carefully Consider Any Trigger Framework. Though the Governor's tax initiative would improve the financial outlook of public education over the next several years, his trigger plan would create significant uncertainty for schools, community colleges, and universities in 2012-13. This uncertainty is likely to be particularly problematic for schools, with most schools feeling compelled to build their 2012-13 budgets assuming the trigger cuts are implemented (that is, assuming only the state revenue that they are assured of receiving). This means schools in 2012-13 out of necessity likely will be implementing most, if not all, of the reductions that many would be hoping to avoid. Given this is the case, the Legislature

needs to be very deliberate in structuring a trigger package. In particular, the Legislature should be careful in setting the size of the trigger reduction; determining the specific education reductions to impose; and designing tools to help schools, community colleges, and universities respond to

the triggers. The Legislature also needs to assess whether specific trigger plans are workable. One major consideration, for example, is how the state treats realignment sales tax revenues in calculating the Proposition 98 minimum guarantee.

ECONOMICS AND REVENUES

Economic Forecast

Summer's Economic Slowdown Apparently Temporary. The administration's 2012 forecast reflects an economy that has rebounded from its generally disappointing performance this past summer. Economic weakness during the summer months was primarily due to the reaction of financial markets to the European debt crisis and congressional deadlock over the federal debt ceiling. Employment and other economic news improved during the fall and early winter months. We agree with the administration that a return of the U.S. economy to recession is unlikely now. The U.S. and California economies are poised to continue slow recoveries.

Administration's Forecast for 2012. As shown in Figure 4 (see next page), the administration's new economic forecast is similar to, but slightly more pessimistic than, our November 2011 economic forecast. Both forecasts are based on the assumption that Congress extends the partial employee payroll tax holiday and emergency unemployment insurance benefits beyond their current expiration dates next month. Absent these extensions, economic performance in the immediate future probably would be weaker than shown in Figure 4.

Modest Strengthening in 2013 Expected. The administration's economic forecast projects cautious, but steadily expanding, growth in 2013. More robust growth is being held back by lingering

foreclosure activity and continued price declines in the California housing market, as well as relatively weak growth in real incomes. The administration, however, expects the economy to begin expanding more rapidly in 2013, which is consistent with our recent forecast.

The administration observes that the California economy is being pulled along, in part, by healthy wage and salary growth in high-income labor markets—most notably the technology sector in the Silicon Valley and other areas of the state. Consumer spending also has picked up in California, as individuals and firms return to more normal consumption behavior fueled, in part, by pent-up demand. The Governor's forecast of taxable sales aligns closely with our November forecast. Although we do not project consumption to weaken, there is some risk to the administration's and our office's taxable sales forecasts because consumers and businesses are contending with low credit availability and weak, albeit improving, consumer confidence.

Uncertainty About Federal Policies in 2012 and Beyond. A number of federal policy changes scheduled—or assumed—to take place in 2012 and 2013 could alter the trajectory of economic growth projected by the administration and our office. As noted above, the administration's forecast assumes Congress will extend the payroll tax holiday and unemployment benefits through 2012. In addition, various tax reductions enacted under the prior federal administration (and extended under the

current administration) are scheduled to expire at the end of 2012, and both of our economic forecasts now anticipate these tax cuts will be extended. Automatic congressional spending cuts, known as sequestration, also are set to occur in early 2013, and the President recently announced a broad proposal to shrink the size of the Army, the Marine Corps, and other parts of the U.S. military, which could ripple through the national economy. The U.S. Postal Service—a major governmental employer—also must implement large spending reductions in the coming years.

Most economic forecasts—including our own and the administration’s—assume that Congress and the executive branch agree to compromises in the coming months to mitigate some of the near-term negative economic effects of these changes. Failure of Congress and the President to agree to such policies could, therefore, negatively affect the economy during the next few years. Over the longer term, the federal government’s deep fiscal imbalances will require significant changes to federal programs and taxation that could affect large segments of both the U.S. and California economies.

Economic and Fiscal Forecasting Especially Challenging Now. There is considerable uncertainty in the administration’s forecast—as well as our November 2011 forecast—regarding the short- and medium-term path for the economy. In addition to the difficulty in predicting federal policies, there is also significant uncertainty due to the nature of the historically deep recession from which California and the nation are recovering. There is limited precedent with which to make sound judgments about how the economy will proceed in the coming years. Particularly significant in the context of California budgetary forecasting is the difficulty in projecting the income prospects of high-income tax filers, who experienced a disproportionately large drop in income—relative to other groups of taxpayers—during the recession. These Californians are in the state’s top marginal income tax brackets and pay a very large share of state tax revenues. Largely because their income—dominated by sales of stocks, bond, and other assets—is volatile, state income tax collections are volatile too.

Figure 4
Comparing the Administration’s Economic Projections With LAO’s November 2011 Forecast

	2012		2013	
	LAO Forecast— November 2011	Governor’s Budget Forecast— January 2012	LAO Forecast— November 2011	Governor’s Budget Forecast— January 2012
United States				
Percent change in:				
Real gross domestic product	2.1%	1.7%	2.8%	2.5%
Wage and salary employment	1.0	0.9	1.7	1.4
California				
Percent change in:				
Personal income	4.1%	3.8%	4.5%	4.1%
Wage and salary employment	1.3	1.3	2.1	1.8
Housing permits (thousands)	61	52	77	80
Taxable sales (billions)	\$537	\$538	\$579	\$573

Revenue Forecast

As shown in Figure 5, the administration’s new revenue forecast projects that the General Fund will record \$88.6 billion of revenues in 2011-12 and \$95.4 billion in 2012-13, including revenue from the Governor’s tax initiative proposal. The administration expects that the Governor’s tax proposal, if approved by voters, would generate \$2.2 billion of revenues attributable to 2011-12 and \$4.7 billion in 2012-13. Most of those revenues result from the PIT part of the Governor’s tax proposal.

Administration Forecasts Higher Revenues Than Our Office Did in November. Figure 6 compares the administration’s *baseline* revenue forecast (that is, the current-law revenue forecast excluding revenue from the Governor’s tax and other revenue proposals) with our November 2011 current-law forecast. For 2010-11, the administration’s more up-to-date information on revenue accruals and transfers and loans shows that the General Fund received \$803 million less than we assumed in November. For 2011-12 and 2012-13, however, the administration forecasts significantly

higher baseline revenues than we did two months ago. In 2011-12, the administration’s baseline forecast is higher than ours by \$1.5 billion, and in 2012-13, its forecast is higher than ours by \$3.2 billion. Over the three fiscal years combined, the administration forecasts \$3.9 billion more in baseline General Fund revenues than we did.

Sizable PIT Forecasting Differences, Particularly for High-Income Taxpayers. Of the \$3.9 billion difference in our baseline revenue

Figure 5
Governor’s Budget
General Fund Revenue Forecast
(Including Revenue Proposals)

(In Billions)

	2011-12	2012-13
Personal income tax	\$54,186	\$59,552
Sales and use tax	18,777	20,769
Corporation tax	9,479	9,342
Subtotals, “Big Three” Taxes	(\$82,442)	(\$89,663)
Other revenues	\$4,751	\$4,885
Net transfers and loans	1,413	841
Total Revenues and Transfers	\$88,606	\$95,389

Figure 6
Administration’s Baseline Revenue Forecasts Differ From LAO’s^a

General Fund (In Billions)

	2010-11		2011-12		2012-13	
	LAO November Forecast	Governor’s Budget Forecast	LAO November Forecast	Governor’s Budget Forecast	LAO November Forecast	Governor’s Budget Forecast
Personal income tax ^b	\$49,779	\$49,491	\$50,812	\$51,937	\$53,134	\$56,025
Sales and use tax	26,983	26,983	18,531	18,777	19,980	19,595
Corporation tax	9,838	9,614	9,483	9,479	9,432	9,342
Subtotals, “Big Three” Taxes	(\$86,600)	(\$86,088)	(\$78,826)	(\$80,193)	(\$82,546)	(\$84,962)
Other revenues	\$5,795	\$5,913	\$4,486	\$4,730	\$4,540	\$4,788
Net transfers and loans	1,897	1,488	1,451	1,386	-1,048	-529
Total Revenues and Transfers	\$94,292	\$93,489	\$84,764	\$86,309	\$86,038	\$89,221
Difference—Governor’s Budget Minus LAO November Forecast		-\$803		\$1,545		\$3,183

^a Baseline revenues are revenues excluding the effect of any proposed law or policy changes. For example, revenues that would result from the Governor’s proposed November 2012 tax initiative are excluded from these figures.

^b Differences in federal tax policy assumptions explain a portion of the administration’s higher personal income tax estimates.

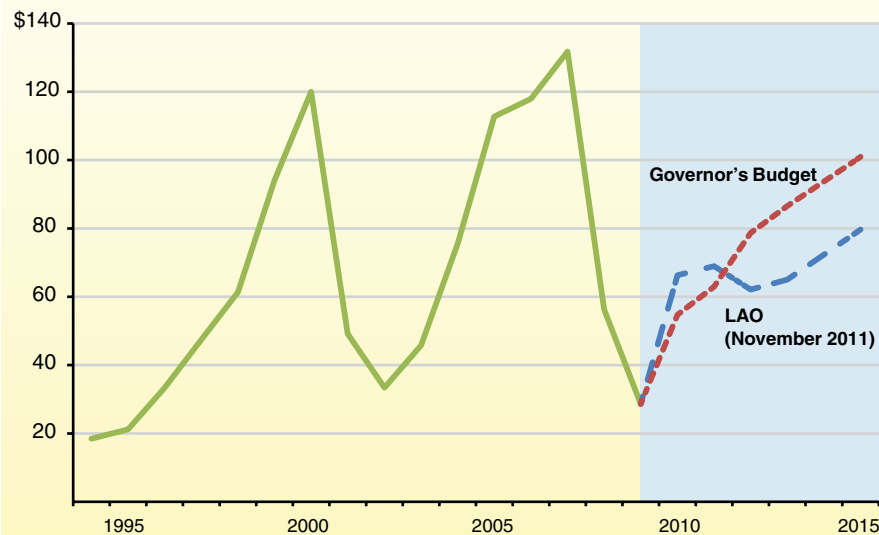
projections, \$3.7 billion can be attributed to our different PIT forecasts. In recent weeks, since the Department of Finance (DOF) announced its updated 2011-12 “trigger” forecast, we have devoted significant time to analyzing these differences. While our respective forecasting models differ—making it difficult to assess the reasons for all of our differences—it seems clear that our office’s forecasting models currently assume that high-income tax filers will receive significantly less income than that assumed in DOF’s models. Our differences seem particularly significant beginning in tax year 2012, which affects General Fund PIT revenue forecasts for both 2011-12 and 2012-13. It appears that our differences most likely include those in various categories of income for wealthier filers, including wages and salaries, business-related income, retirement income, and the exceptionally volatile income category of capital gains.

Concerns About the Administration’s Capital Gains Forecast. In its new forecast, DOF projects capital gains realized by California tax filers to rise to \$96 billion in 2012. By contrast, our office’s November forecast assumed \$62 billion of 2012 capital gains. This \$34 billion difference accounts for about \$3 billion of our organizations’ differing PIT baseline forecasts in 2011-12 and 2012-13 combined. A part of this \$3 billion revenue difference results from our differing assumptions concerning federal tax policy. In contrast to our forecast, DOF’s revenue

forecast assumes that the 2001 cuts in federal tax rates will be allowed to expire as scheduled at the end of 2012. This expiration then is assumed to cause investors to accelerate realization of capital gains that they otherwise would take in 2013, thereby “shifting” a portion of capital gains income forward from 2013 to 2012. In this forecast, for the first time, DOF also has shifted an additional part of 2013 capital gains to 2012 based on assumed investor behavior to shield income from higher Medicare taxes scheduled to take effect next year. These various shifts tend to reduce projected state revenues for 2013-14 and increase them in earlier years.

We are concerned that the administration’s current method of forecasting high-income filers’ income—especially capital gains—tends to overestimate state revenue growth from the PIT over the next few years, including revenue growth that would result from the Governor’s tax initiative. Figure 7 shows historical net capital gains

Figure 7
Administration Forecasts Much Higher Capital Gains
Net Capital Gains (In Billions)



Note: Figures are adjusted to eliminate assumed accelerations of capital gains realizations due to changes in federal tax policy. The figures are not adjusted for inflation.

of California resident tax filers, as well as both our office's November 2011 estimates and DOF's current estimates. In this figure, we have adjusted both sets of estimates to eliminate the federal tax-related shifts described above in order to show our underlying forecasting differences. With these adjustments, DOF forecasts roughly \$20 billion more of capital gains than our office in each year beginning in 2012. This results in DOF forecasting roughly \$2 billion more in annual baseline revenues than we do going forward. Over time, DOF assumes capital gains begin to approach levels only experienced during previous stock market and real estate "bubbles." We advise the Legislature to regard these estimates with some caution.

As we discussed in our November report, *California's Fiscal Outlook*, Franchise Tax Board (FTB) data on the state income tax base lags by one to two years, such that preliminary data on 2010 income tax returns only recently has emerged. Since publication of our report, FTB preliminary data for 2010 suggests that our November 2011 forecast of capital gains for that tax year was too high. This, in turn, may have resulted in our forecast of capital gains for subsequent years being somewhat too high. We expect to adjust for these differences—as well as other differences that may offset the downwardly revised capital gains estimates—in our next revenue forecast (slated for release in late February).

Forecasting capital gains and other income of wealthier Californians is extremely difficult. These forecasts can change rapidly during the course of any given year due to abrupt changes in asset markets and the overall economy, which, as we have seen in recent years, are not all that rare. Yet, both DOF and our office utilize similar assumptions for future stock market and home price growth in our models, and our office has found that movements in these asset prices, combined with simple time trends, have explained more than 80 percent of the

annual variation in the major categories of capital gains over the last two decades. We will continue to examine economic and tax collection data in the coming months to try to reconcile our forecasting differences with DOF.

December 2011 Income Taxes Lagged Estimates. Using data from FTB and the Employment Development Department (EDD), which administers PIT withholding, our office and DOF track PIT and corporation tax (CT) agency cash receipts daily. December and January are significant months for collections of PIT estimated payments, which are paid largely by high-income filers. December 2011 was a disappointing month for PIT collections (as well as CT collections). Preliminary FTB data show that estimated PIT payments and PIT withholding lagged prior-year collections for the same month. They also lagged the amount of expected revenues for December 2011 assumed in DOF's June 2011 budget forecast of monthly receipts. (The DOF's new revenue forecast has the effect of *increasing* the average projected PIT and CT receipts for the rest of 2011-12 above the levels in the June 2011 forecast. This makes it all the more notable that December PIT and CT revenues were over \$900 million *lower* than the June forecast.)

It is too early to make definitive judgments about what these most recent PIT collection trends mean. In particular, receipts over the next two weeks will be an important early indication as to whether our office's or DOF's high-income taxpayer forecast is closer to target. Additional data will emerge in the coming months, particularly during the all-important revenue collection month of April. Negative trends like those we have seen recently can reverse themselves quickly.

The Facebook Effect. Facebook Inc., a privately held company headquartered in Palo Alto, may proceed with an initial public offering (IPO) of its stock in 2012. Facebook reportedly is considering

issuing \$10 billion of stock in an IPO that would value the company at over \$100 billion. Other companies also are considering IPOs in the coming years.

In the coming months, the state's revenue forecasts will need to be adjusted somewhat to account for the possibility of hundreds of millions of dollars of additional revenues related to the Facebook IPO. These revenues could affect the budgetary outlook beginning in 2012-13. We caution that it will be impossible to forecast IPO-related state revenues with any precision, and it is likely that little information about the state revenue gain from the Facebook IPO will be available before investors file tax returns in April 2013. (Even then, due to the confidentiality of individual taxpayer information, we are unlikely to know precisely how much state revenues increased due to Facebook's IPO.)

In considering the size of the Facebook IPO effect in the coming months, revenue forecasters will have a difficult task. Our office's income models are based on historical trends and, therefore, already assume that some level of IPO activity occurs for California companies each year. Moreover, in our recent forecasts, our office has deliberately built in "extra" capital gains (above those generated by our model) in 2010, 2011, and 2012 to try to account for a variety of factors, including the surprisingly strong PIT receipts in some recent months. Finally, Facebook-related capital gains likely will prove to be a relatively small percentage of California's overall capital gains in 2012. If the stock market as a whole has an unusually strong or weak year, that fact could change forecasted capital gains up or down by much more than the positive Facebook effect.

Revenue Proposals

Governor's Tax Initiative Proposal. The Governor's 2012-13 budget plan assumes passage of

his initiative proposal for temporary PIT and SUT increases. Specifically, the Governor proposes to increase PIT rates for upper-income Californians for five years (2012 through 2016) and a 0.5 percent increase in the statewide SUT for four years (2013 through 2016). The administration forecasts that this measure would generate \$6.9 billion that would be available for the Legislature's consideration during the 2012-13 budget process—\$2.2 billion in 2011-12 revenues and \$4.7 billion of 2012-13 revenues. All of the 2011-12 revenue and \$3.5 billion of the 2012-13 revenue would result from the higher PIT rates.

As we discussed in our recent analysis of the Governor's initiative proposal, our current estimates of the revenue impact of his initiative proposal are lower than the administration's. Currently, we forecast that the proposal would generate \$4.8 billion for the 2012-13 budget process, or \$2.1 billion less than the administration's estimate. Our estimates of the initiative's revenue increases in later years also are lower than the administration's. The reasons for our lower estimates are essentially the same as the reasons for our differences in baseline revenues described above.

Both our office and the administration agree that the initiative revenues will likely prove to be volatile, given that a large portion of them will relate to upper-income tax filers' capital gains and other nonwage income.

Accrual Proposal. The administration proposes that the budget include a control section authorizing a new method of accruing revenues for tax policy changes enacted in 2012. This proposed change, similar to the administration's rejected accrual change proposal from last year, would apply to the Governor's tax initiative proposals but not other tax revenues.

We discussed last year's proposal in our January 2011 publication, *The 2011-12 Budget: The Administration's Revenue Accrual Approach*. Similar to what we described in that report,

the accrual of a portion of the initiative tax revenues to 2011-12 would tend to decrease the state's 2012-13 Proposition 98 minimum school funding guarantee. While we find some merit in the administration's proposed accrual approach, we continue to have concerns that it is not being applied uniformly across all revenues. We recommend that the Legislature pass a law requiring DOF to develop and regularly update a clear, transparent summary of the state's accrual methodologies, and we recommend that the state move toward consistent application of accepted accrual techniques across all tax revenues and spending.

Tax Administration

Proposed Department of Revenue. The 2012-13 Governor's Budget Summary mentions that the Governor will propose merging FTB and the tax administration components of EDD into a new Department of Revenue (DOR). Based on the potential benefits for the state and taxpayers from

having a single tax administration entity, our office has long advocated some sort of tax agency merger. In our view, a successful merger would require detailed preparatory work by the tax agencies involved and a significant amount of time to implement merger-related efficiencies gradually.

In addition to merging FTB and the tax administration sections of EDD, we urge the Legislature to consider merging the bulk of the State Board of Equalization's (BOE) tax administration efforts into the proposed DOR. The State Constitution mandates that certain limited tax administration functions remain with the elected BOE, but legislative action could allow most of BOE's functions to be transferred to the proposed DOR. We believe that long-term efficiencies are possible from a carefully planned merger of this type. In addition, taxpayers could benefit from having one, coordinated tax agency with which to interact. Other departments with revenue collection functions also could be considered for inclusion in DOR in the future.

PROPOSITION 98

Proposition 98 funds K-12 education, the California Community Colleges (CCC), preschool, and various other state education programs. The Governor's budget increases total Proposition 98 funding by \$4.9 billion, or 10 percent between the current year and the budget year. As shown in Figure 8 (see next page), the year-over-year increases in Proposition 98 General Fund for schools and community colleges are larger—15 percent and 14 percent, respectively, with local property tax revenues estimated to be virtually flat. The funding levels reflected in Figure 8 assume voters approve the Governor's November 2012 ballot measure to raise sales and income tax rates temporarily, with a portion of the associated revenue increase benefiting K-14 education.

Makes Various Adjustments to Minimum Guarantee. For 2012-13, the Governor funds at the minimum guarantee (\$52.5 billion) assuming approval of his tax measure (which accounts for more than \$2 billion of the increase in the guarantee). To arrive at this guarantee, the Governor adjusts or "rebenches" the guarantee in three notable ways. Of greatest magnitude, the Governor permanently rebenches the minimum guarantee to account for a shift in property tax revenues (of approximately \$1 billion annually) from redevelopment agencies to school districts and community colleges. By rebenching the guarantee for this shift, the state achieves associated General Fund savings. In addition, the Governor proposes to eliminate existing provisions that require the

state to rebench for the “gas tax swap” adopted by the Legislature in 2011. The gas tax swap eliminated the sales tax on gasoline (previously included in the Proposition 98 calculation) and replaced it with an increase in the excise tax on gasoline (excluded from the Proposition 98 calculation). With the rebenching, the minimum guarantee was unaffected by the gas tax swap. Without the rebenching, the minimum guarantee drops by \$544 million. Thirdly, the Governor proposes to recalculate last year’s rebenchings using the “1986-87 methodology.” This change (which applies to child care, student mental health, and redevelopment revenues) increases the 2012-13 guarantee by \$217 million.

Makes Two Additional Adjustments to Minimum Guarantee Under Back-Up Plan. If the Governor’s tax measure is not adopted, the Governor has a back-up plan that contains \$4.8 billion in spending reductions to schools and community colleges, including \$2.4 billion in programmatic reductions. These programmatic reductions are linked with the Governor’s proposal to include K-14 general obligation bond debt-service payments

within the Proposition 98 minimum guarantee. To account for this shift, the Governor proposes a rebenching of the minimum guarantee, resulting in an increase of \$200 million. Since the cost of debt-service payments (\$2.6 billion) far exceeds the increase in the minimum guarantee from the rebenching, the Governor proposes \$2.4 billion in programmatic Proposition 98 reductions to maintain spending at the guarantee. His estimate of the guarantee also excludes the realignment-related sales tax revenue. How the state should treat these revenues is currently being litigated.

Major Proposals

As shown in Figure 9, the year-to-year funding increase under the Governor’s basic plan would be dedicated primarily to backfilling one-time solutions from last year, covering a slight increase in the K-12 student population (estimated to be 0.35 percent) for a few select K-12 programs, and paying down existing K-14 deferrals. The plan provides no cost-of-living adjustment for any K-14 education program. (Providing the projected 3.17 percent COLA for K-14 programs would cost

Figure 8
Proposition 98 Funding

(Dollars in Millions)

	2011-12 Revised	2012-13 Proposed	Change From 2011-12	
			Amount	Percent
K-12 Education				
General Fund	\$29,329	\$33,755	\$4,426	15%
Local property tax revenue	12,891	12,908	17	—
Subtotals	(\$42,220)	(\$46,663)	(\$4,443)	(11%)
California Community Colleges				
General Fund	\$3,217	\$3,683	\$465	14%
Local property tax revenue	2,107	2,101	-6	—
Subtotals	(\$5,324)	(\$5,784)	(\$459)	(9%)
Other Agencies	\$83	\$80	-\$2	-3%
Totals, Proposition 98	\$47,627	\$52,527	\$4,900	10%
General Fund	\$32,629	\$37,518	\$4,889	15%
Local property tax revenue	14,998	15,009	11	—

\$1.8 billion.) It also provides no enrollment growth funding for CCC. Moreover, it contains essentially no programmatic augmentations while containing a few notable programmatic reductions. The Governor’s plan also contains a set of proposals to restructure the state’s K-12 and CCC funding models. Below, we highlight the Governor’s major Proposition 98 spending proposals as well as his major restructuring proposals. (The Governor also proposes significant reductions for the California Department of Education [CDE]-administered child care programs, described in the next section of this report.)

Dedicates Funding Increase to Paying Down Deferrals. The largest component of the Governor’s plan is to pay down \$2.4 billion in existing K-14 deferrals (\$2.2 billion for school districts and \$218 million for CCC apportionments). This funding would reduce the need for school districts and community colleges to borrow to support operations while awaiting the state’s late payments. From both a state and a local perspective, paying down deferrals helps to realign funding with expenses. The proposal would reduce the state’s outstanding deferrals from \$10.4 billion to \$8 billion. Because this funding would not be intended to increase programmatic activities, K-12 per-pupil programmatic funding under the Governor’s basic plan is roughly flat year over year.

Suspends K-12 Categorical Program Requirements, Phases

In Weighted Student Formula Over Five Years.

To assist with local budget constraints, the state has temporarily suspended requirements for about 40 categorical programs. The Governor proposes to suspend requirements for up to ten additional programs—essentially phasing out most existing categorical programs beginning in 2012-13. (A few categorical programs—including special education, child nutrition, and the After School Education and Safety program—would remain.) In lieu of the current revenue limit and categorical program model, the Governor proposes that all districts and charter schools receive an equal base per-pupil amount, plus additional general purpose funding intended to serve their disadvantaged students. Specifically, for every dollar districts/charter schools receive for a student, they would get an additional 37 cents if the student were poor and/or an English Learner. Districts/charter schools with large proportions of these disadvantaged student populations also would receive supplemental

Figure 9
2012-13 Proposition 98 Spending Changes

(In Millions)

Technical	
Backfill one-time actions	\$2,440
Make revenue limit technical adjustments	162
Fund revenue limit growth	158
Backfill Proposition 63 mental health funding	99
Backfill CCC fee revenue decline	97
Make other technical adjustments	-182
Subtotal	(\$2,775)
Policy	
Pay down K-12 deferrals	\$2,151
Pay down CCC deferrals	218
Create K-12 mandate block grant	98
Create CCC mandate block grant	12
Do not initiate Transitional Kindergarten program	-224
Reduce preschool funding	-58
Swap one-time funds	-57
Eliminate Early Mental Health Initiative	-15
Subtotal	(\$2,125)
Total	\$4,900

“concentration” funding. Perhaps as soon as 2013-14, the administration plans to add a performance component to the weighted student formula, which would provide fiscal incentives for districts to improve or sustain high academic performance. Districts would have local discretion as to how to spend weighted student formula funding. The Governor proposes to transition to the new formula over a five year period, with implementation beginning in 2012-13.

Proposes More Flexibility for CCC Categorical Programs. Under current law, 11 of community colleges’ 21 categorical programs are included in a “flex item.” Through 2014-15, districts are permitted to transfer funds from categorical programs in the flex item to any other categorical purpose. As part of his emphasis on flexibility, the Governor adds seven currently protected categorical programs to the flex item. Under the Governor’s proposal, funding for the remaining three CCC categorical programs (Disabled Students Program, Foster Care Education Program, and Telecommunications and Technology Services) would remain restricted.

Replaces Existing K-14 Mandate System With New Block Grant. The Governor proposes a number of K-14 mandate-related changes. Under the Governor’s package of changes, the existing mandate system essentially would be replaced with a discretionary block grant.

- ***Eliminates More Than Half of Existing Mandates.*** The Governor proposes to eliminate 31 of 57 existing education mandates. The mandates proposed for elimination include two of the costliest mandates—one relating to high school science graduation requirements and one relating to behavioral intervention plans for special education students.

- ***Suspends Remaining Mandates.*** The remaining 26 education mandates would be suspended. (Though suspended, school districts and community colleges still would need to undertake these activities if they wanted to access the block grant funding described below.)
- ***Creates Block Grant.*** The Governor proposes to create a new, discretionary “mandate block grant.” His budget provides \$200 million (\$178 million for school districts, \$22 million for community colleges) for the block grant. School districts and community colleges that choose to receive block grant funding would receive a per-student allocation. As a condition of receiving block grant funding, recipients would be required to complete the 26 sets of activities still deemed to be high priorities. The administration indicates it will establish some auditing and/or compliance monitoring process to ensure grant recipients undertake the required activities.

Does Not Initiate Transitional Kindergarten Program. In response to concerns that California was encouraging children to start attending school before they were developmentally ready, the Legislature recently passed legislation prohibiting children under five years of age from enrolling in kindergarten (unless a parental waiver was obtained). The change is phased in, moving the birthday cutoff back from December 1 to September 1, by one month at a time over three years, beginning with the shift to November 1 in 2012-13. This change reduces the kindergarten population by about 125,000 students and yields estimated revenue limit savings of \$224 million in

2012-13. The Legislature, however, redirected these savings to fund a new Transitional Kindergarten program, which is to offer an additional year of public school to the children who will just miss the new kindergarten cutoff. This program also is phased in over three years, beginning 2012-13 for those children turning age five between November 1 and December 1. By proposing not to initiate this new program, the Governor achieves \$224 million in 2012-13 savings, growing to roughly \$675 million in annual savings (by 2014-15, when the program otherwise would have been fully implemented).

Includes 2012-13 Midyear Trigger Reductions.

The Governor's back-up plan includes \$4.8 billion in trigger reductions if his ballot measure is rejected by voters. The Governor proposes to implement these reductions by rescinding the \$2.4 billion K-14 deferral pay-down and reducing general purpose funding for schools and community colleges by \$2.4 billion. Paying down existing deferrals is intended to have no associated programmatic effect but the reduction in general purpose funding would reflect a base cut. Under this scenario, K-12 per-pupil programmatic funding would decline 6 percent from the current-year level.

Several Components Merit Serious Consideration

The Governor's plan addresses several of the longstanding, fundamental, widely recognized problems with the state's K-12 and community college funding systems. Though the Legislature might find ways to improve upon the Governor's specific restructuring plans, we recommend the Legislature adopt the Governor's basic restructuring approaches (regardless of the state's revenue situation). In this fiscal climate, particularly with so many existing outstanding

Proposition 98 obligations, we also recommend the Legislature adopt the Governor's proposal to avoid initiating a major new program beginning in 2012-13. We discuss these particular aspects of the Governor's plan in more detail below.

More K-12 Categorical Flexibility, New Funding Model Moving in Right Direction. Most experts and advocates at both the state and local levels agree that the state's current school funding system is overly complex, inequitable, inefficient, and highly centralized. Consequently, the Governor's proposal to simplify and streamline the existing methods for allocating funding deserves both credit and serious consideration. We believe several components of the proposal are particularly sound, including immediate increases in categorical flexibility, a moderate phase-in period for the new formula, and additional funding "weights" for disadvantaged students. The Legislature could use this basic structure but make some modifications to ensure its important policy priorities are preserved. For example, the state could maintain some general requirements to ensure additional funds actually are spent on disadvantaged students. Alternatively, rather than one general purpose weighted formula, the Legislature could consolidate all K-12 funding into a few thematic block grants.

Proposal to Expand CCC Categorical Program Flexibility Has Promise, But More Detail Is Needed. The Governor's plan to expand the number of categorical programs in the CCC flex item also appears to be consistent with recommendations we have made in the past. By placing additional programs in the flex item, districts likely would have more freedom to decide for themselves how best to allocate funds to targeted purposes. This could help districts operate their services more efficiently and effectively, such as by consolidating various separately administered student counseling

programs into one comprehensive program. The Governor's full proposal, however, is not yet clear. Specifically, the administration has indicated that it intends to introduce provisional language that will attach certain conditions to how districts spend such funds. The Legislature will need to have this language before deciding on the merits of the Governor's proposal.

Mandate Approach Has Several Strong Points. As with the state's existing K-12 categorical funding system, the state's existing K-14 mandate system also is widely recognized as having fundamental problems. A broadly representative mandate work group that the Legislature asked our office to convene last year identified nine serious flaws with the state's existing system, including significant administrative burden for districts, wide variation in reimbursement rates for completing the same sets of activities, reimbursement regardless of outcomes, and very high disallowance rates of audited claims. The Governor's restructuring approach addresses many of these problems. It provides upfront, standardized per-student funding for all districts using a relatively simple allocation process that does not involve extensive paperwork. Also, by first eliminating all nonessential activities, the state is able to reduce associated costs, thereby freeing up resources that can be used to fund districts that do not participate in the existing process (one of the main factors that drives up the cost of most restructuring proposals). Though the Legislature might want to make some changes to the Governor's proposal (for example, eliminating/suspending a different set of mandates and/or adjusting the amount of block grant funding provided), we recommend the Legislature adopt the Governor's restructuring approach.

Adopt Kindergarten Proposal, Prioritize Access to Preschool for Low-Income Children. Given the major funding and programmatic

reductions districts have experienced in recent years—and the potential for additional reductions if the November election does not result in new state revenue—we agree with the Governor's assessment that now is not the time to initiate major new programs. As such, we recommend the Legislature adopt the proposal to not initiate the Transitional Kindergarten program, for the associated revenue limit savings of \$224 million. The Legislature could consider prioritizing state preschool slots for low-income children specifically affected by the change in kindergarten start date. Moreover, in the context of this change—and the significant reductions proposed for the state's child care programs—the Legislature may want to modify or reject the Governor's proposed \$58 million cut to the state preschool program.

Concerns With Governor's Overarching Proposition 98 Approach

The Governor's Proposition 98 proposal builds one budget plan that is based upon revenues that would not materialize until midyear and then has a relatively severe back-up plan in case the revenues ultimately do not materialize. Such an approach generates significant uncertainty for school districts, as discussed below.

Governor Proposes Relatively Severe Back-Up Plan for Schools. Given his back-up plan would cut schools and community colleges by \$4.8 billion (including \$2.4 billion in programmatic reductions), schools and community colleges would bear most of the midyear trigger reductions. Schools have difficulty, however, in downsizing operations midyear given students already have been assigned to classes, teachers are working on year-long contracts, and the number of instructional days already has been decided.

Most Districts Likely to Build 2012-13 Budgets Based Upon Governor's Back-Up Plan. Because

the Governor's basic plan relies on revenues that have not yet materialized and ultimately might not materialize, and because large midyear reductions are so disruptive, most districts likely would feel compelled to adopt budgets assuming the Governor's back-up plan. Under this scenario, districts would adopt 2012-13 budgets that already contain \$2.4 billion in programmatic reductions statewide. That is, they already would make the reductions some would be hoping to avoid. If revenues ultimately did materialize, these districts likely would restore reserve levels immediately but not make major programmatic adjustments until the following school year (2013-14). While districts could make relatively minor programmatic adjustments midyear (such as hiring additional instructional aides), more significant programmatic changes (such as reducing class size and hiring additional teachers) likely would not be undertaken. This is because even these enhancements can be disruptive if implemented midyear, resulting in the shuffling of students among classes and corresponding changes in students' teachers.

Districts That Budget More Optimistically Could Face Very Difficult Midyear Situations. By contrast, districts that feel compelled to be more optimistic and build their budgets assuming the tax measure is adopted could face very difficult midyear fiscal situations. Under this scenario, districts would have few options for making \$2.4 billion in programmatic reductions midyear. Given current statutory restrictions, districts cannot lay off teachers midyear. They also typically negotiate changes in the length of the work year with affected unions, with districts needing to follow certain typically lengthy legal procedures if they wish to declare impasse and impose changes to the teacher contract. Moreover, districts with reserve levels at the state-allowed minimums would not have sufficient reserves to cover a reduction as large as the one proposed under the Governor's

back-up plan. As a result of all these factors, some of these districts could run out of cash the last part of the school year, be unable to make payroll, and require an emergency state loan (for which the district pays all associated costs and loses local control for a period up to 20 years). Though the administration indicates it is willing to work with districts to ameliorate some of these issues, reaching agreement is likely to be difficult and most of the modifications likely to be considered (such as a new layoff window after the election) still would be disruptive.

Consider Unintended Consequences of Trigger Approach. Though the 2012-13 budget situation under the Governor's plan is awkward for school districts, his plan would improve notably the outlook for schools over the subsequent four years. Nonetheless, the Governor's trigger approach has significant consequences for school districts in 2012-13. As detailed above, for 2012-13, most school districts will feel compelled to make the programmatic reductions imposed by the triggers. Given this is the case, the Legislature needs to be very deliberate in structuring a trigger package, as it in essence would determine the size and quality of California's 2012-13 K-14 education program. The Legislature should be especially careful in setting the size of the trigger reduction, determining the specific K-14 reductions to impose, and designing tools to help districts respond given all the constraints they face in making midyear adjustments. Alternatively, given the potentially unintended consequences of the trigger as well as the major disruptions caused by midyear reductions, the Legislature could consider building a budget without midyear cuts. In this case, the Legislature could focus on a funding level it could afford despite the revenue uncertainties and then use any ballot-measure revenue as one-time investments in 2012-13 to pay down existing Proposition 98 obligations.

HEALTH AND HUMAN SERVICES

CALWORKS AND SUBSIDIZED CHILD CARE

The Governor's budget proposes to reduce General Fund support for CalWORKs and subsidized child care—the state's primary sources of cash assistance and work support for California's low-income families—by a total of about \$1.4 billion. These savings would be achieved primarily by: (1) reducing cash grants received by a significant portion of current CalWORKs recipients, (2) further limiting eligibility for subsidized child care and CalWORKs employment services, and (3) reducing the maximum amount the state pays child care providers. To manage these significant reductions, the Governor proposes to prioritize funding in these programs on efforts to increase work participation and support for families that are most likely to achieve self-sufficiency through employment.

Major Proposals

Restructuring the CalWORKs Program.

Currently, the CalWORKs program provides 48 months of cash assistance, employment services, and child care to support efforts of low-income families to achieve self-sufficiency through a variety of welfare-to-work activities (such as employment, education, training, and other activities to remove barriers to work). In addition, the current program provides non-time-limited cash assistance—on behalf of children—to families not participating in welfare-to-work activities. In 2011-12, a combined total of \$5.4 billion in federal, state, and local funds support these activities.

Under the Governor's proposal, the current CalWORKs program would be replaced by a three-part system, consisting of two CalWORKs subprograms—CalWORKs Basic and CalWORKs Plus—and a new Child Maintenance program.

The CalWORKs Basic program would effectively continue the current CalWORKs program, including current cash assistance levels and employment services, for eligible adults for up to 24 months. After 24 months in CalWORKs Basic, families working a sufficient amount of hours (30 hours for single-parent families, 35 hours for two-parent families, and 20 hours for single-parent families with a child under the age of six) in unsubsidized employment would be eligible for an additional 24 months (48 months total) of cash assistance, employment services, and child care through the CalWORKs Plus program. Families who fail to meet these work participation requirements—for various reasons—would be transferred to the Child Maintenance program. In addition, all families with parents who are not work-eligible (such as those with undocumented immigrant parents) would be placed in the new Child Maintenance program rather than the CalWORKs program. Families in the Child Maintenance program would receive reduced cash assistance (27 percent below current CalWORKs levels) and no employment services or child care. Participation in the Child Maintenance program would not be time limited. Time limits in both the CalWORKs Basic (24 months) and the CalWORKs Plus (an additional 24 months) would be applied retroactively to all CalWORKs recipients, including those exempted from work participation requirements or in sanction status.

Although these three programs would continue to serve the same population as the current CalWORKs program, a majority of current recipients would face a reduced cash grant and all recipients would face more restrictive limitation on receipt of employment services and child care. Altogether, the Governor's proposed restructuring would reduce General Fund expenditures for

CalWORKs by an estimated \$942 million. The Governor's budget also proposes to transfer \$736 million in federal Temporary Assistance for Needy Families (TANF) block grant funds (the primary source of federal funding for the CalWORKs program), made available by the CalWORKs restructure, to the Student Aid Commission to fund Cal Grants. This transfer is necessary to fully realize the General Fund savings from the reduced CalWORKs expenditures described above, while continuing to satisfy requirements for state maintenance-of-effort in programs which fulfill the goals of the TANF program.

Tightening Work Participation Requirements.

The Governor's proposal would narrow the scope of work activities which allow a family to meet its CalWORKs work participation requirement. The first way the proposal would do this is by limiting countable activities to a more restrictive list of federal requirements. More specifically, the Governor's proposal would eliminate the opportunity for CalWORKs recipients to pursue higher education beyond 12 months of vocational training or receive mental health or substance abuse treatment as part of welfare-to-work activities. Additionally, the proposal would allow recipients to participate only in *unsubsidized* employment (as opposed to subsidized employment or education) after 24 months of cash assistance. This narrowed employment eligibility definition would also apply to all subsidized child care programs, limiting eligibility for subsidized child care to those families who meet the work requirements described above for the CalWORKs Plus program.

Reducing Funding for Subsidized Child Care.

The 2011-12 budget provides about \$1.6 billion in state and federal funds to CDE to administer subsidized child care programs. These include specific programs targeted at three populations:

(1) current CalWORKs recipients, (2) former CalWORKs recipients, and (3) other low-income working families not receiving CalWORKs cash assistance. The Governor proposes to reduce funding for these programs by roughly \$450 million, or almost 30 percent. The bulk of this reduction (about \$300 million) results from limiting eligibility for receiving child care services to families that meet the work participation requirements described above. Additionally, the proposal would reduce the maximum amount the state pays child care providers (saving about \$80 million) and reduce family income eligibility thresholds from 70 percent of state median income (SMI) to 200 percent of the federal poverty level, which equates to 62 percent of SMI (saving about \$45 million). These policy changes would also apply to and result in some savings for the CalWORKs Stage 1 child care program, reflected in the CalWORKs budget item. The administration estimates that its package of child care-related reductions would eliminate about 62,000 slots from a current total of about 293,000 slots.

Restructuring the State's Subsidized Child Care System. Additionally, the Governor's proposal would begin consolidating funding and administration for several child care programs in 2012-13 with a goal of shifting administration from CDE and local contractors to the Department of Social Services and county welfare departments in 2013-14. This consolidation means that there would no longer be a dedicated funding stream for low-income working families that have never received CalWORKs cash assistance. Depending on local priorities and funding availability, county welfare departments could choose to continue offering services to these families. By eliminating subsidized child care for all families who are not working sufficient hours in unsubsidized employment, as well as ultimately transferring the responsibility for the state's subsidized child care

system to DSS and county welfare departments, the Governor's proposal would focus the intent of these programs on supporting low-income families' ability to find and retain unsubsidized employment.

LAO Comments

Governor's Proposal Has Some Strengths.

Currently, the CalWORKs program is focused on two primary goals: (1) supporting the efforts of low-income families to find work and become self-sufficient and (2) ensuring a basic level of subsistence for all families in the state. In an environment of limited resources, these goals often compete with one another for funding support. The Governor's proposal recognizes that, given current funding constraints, it is difficult to fully achieve both goals of the CalWORKs program. Accordingly, the proposal would focus reforms in the CalWORKs program on achieving the goal of emphasizing work.

In general, we find that the reforms proposed by the Governor are consistent with his stated priorities for the program. Evaluating the merit of supporting work over providing subsistence is largely a matter of legislative priorities; however, this approach does have budgetary advantages. First, by targeting resources to a specific, smaller portion of low-income families, the Governor is more likely to achieve his objective with limited resources. Second, the Governor's focus on work would improve the state's ability to meet overall program work participation requirements established by the TANF program—which the state is currently failing to do. Failing to meet these requirements could result in significant federal sanctions and reductions to the state's federal TANF block grant. We similarly find that the Governor's attempt to consolidate, streamline, and prioritize the state's overly complicated child care

delivery system has some merit. Specifically, the proposal would replace multiple state programs—and multiple reimbursement rates, contract administrators, and eligibility criteria—with one uniform approach.

Potential Trade-Offs of the Governor's Proposal. Although we find the Governor's proposal has some advantages, it also has potential drawbacks. Most clearly, the reductions proposed by the Governor would have significant negative impacts on many of California's low-income families. Regarding CalWORKs, the Legislature may wish to consider whether reductions made to families most in need of support to achieve self-sufficiency would be too severe. Similarly, the Legislature may want to consider whether the Governor's proposal too significantly restricts eligibility criteria and time lines for subsidized child care. More generally, the Legislature should consider whether focusing CalWORKs and subsidized child care primarily on supporting efforts of low-income families to obtain employment is consistent with its priorities or whether other objectives are also important. Focusing these programs on a different set of objectives and priorities than the Governor would not necessarily eliminate opportunities for budgetary savings; however, the potential for savings could be less.

The direction in which the Legislature elects to focus these programs will likely dictate specific reforms and help to determine such matters as which state and local entities would be best positioned to administer a streamlined child care system. We therefore encourage the Legislature, before evaluating or taking action on any specific reform proposals, to carefully consider its primary goals for these programs, with recognition that pursuit of specific goals likely involves trade-offs.

MEDI-CAL

Governor's Dual Eligibles Proposal

The Governor's budget proposes to shift certain Medi-Cal beneficiaries who are also eligible for Medicare, known as "dual eligibles," from fee-for-service to managed care plans. (Under managed care, a health plan is responsible for providing certain medical services to enrollees who prepay a fixed amount.) Dual eligibles tend to be low-income senior and persons with disabilities with multiple chronic conditions. They represent some of the state's most expensive and medically complicated health cases and are among the state's highest users of long-term care services, including costly nursing home care. Under the Governor's proposal, managed care plans would cover long-term services for dual eligible beneficiaries, including In-Home Supportive Services (IHSS), Community-Based Adult Services, and nursing home care. The shift of dual eligibles to managed care would begin on January 1, 2013 in eight to ten counties that would be most likely to have capacity to coordinate care for these beneficiaries. The enrollment of dual eligibles into managed care throughout the rest of the state would be completed over the following few years. The administration projects the proposal will achieve ongoing savings of \$1 billion General Fund beginning in 2013-14, mainly due to: (1) the Medicare program sharing its savings with the state and (2) lower utilization of high-cost Medi-Cal long-term care services such as nursing home care.

The Governor's budget assumes net savings of \$679 million General Fund in 2012-13, mainly due to a payment deferral to all Medi-Cal providers. Payments would be delayed by one or two weeks, thereby shifting them into the next fiscal year. The Governor's proposal links the payment delay with the shift of dual eligibles into managed care. However, it is unclear whether it is necessary to implement the shift of dual eligibles in order to implement the payment deferral.

LAO Comments

Proposal Has Merit, but More Information Needed. The Governor's proposal has merit because it could reduce costs and improve the coordination of care for dual eligibles. However, more information is needed to assess how the proposal would affect the medical care provided to these beneficiaries and the proposal's fiscal impact to the state. The proposed shift of dual eligibles to managed care is an expansion of a four-county demonstration program that was authorized by the Legislature in 2010-11 but has not yet been implemented. Since the results of the pilot will not be available for the Legislature to evaluate before the budget is due to be enacted, useful data that could assist the Legislature in assessing the merits of this proposal and whether the proposed savings are achievable will not be available. Before considering the Governor's proposal, the Legislature will need more information, including details on the proposed design and financing of managed care benefits for dual eligibles, as well as on the assumptions underlying the savings estimates associated with the Governor's proposal. For example, it is uncertain how the provision of non-medical services, such as IHSS, would be authorized and financed in the new managed care arrangement.

HEALTHY FAMILIES PROGRAM Proposal

The Healthy Families Program (HFP)—currently administered by the Managed Risk Medical Insurance Board (MRMIB)—provides health, dental, and vision benefits through participating managed care health plans for children who are not eligible for Medi-Cal.

The Governor's budget proposes to achieve \$64 million in net General Fund savings in 2012-13 by taking a number of actions related to HFP. This estimate reflects the savings generated by the proposal to reduce the rates paid to HFP managed

care providers by 25.7 percent, on average, effective October 1, 2012—bringing these rates to Medi-Cal levels. In addition, the Governor proposes to gradually transition HFP enrollees—approximately 878,000 children—to the Medi-Cal Program administered by the Department of Health Care Services (DHCS) by June 30, 2013. General Fund support would shift from MRMIB to DHCS. The transition of HFP enrollees would happen in three phases over a nine month period, as follows:

- **Phase 1 (October Through December 2012).** Beginning October 1, 2012, about 411,000 HFP enrollees who are enrolled in a managed care plan that directly contracts with Medi-Cal would stay in the same plan and transition to Medi-Cal.
- **Phase 2 (January Through March 2013).** Beginning January 1, 2013, the remaining 424,000 HFP enrollees who live in a county with an existing Medi-Cal managed care plan would transition into those plans. For example, HFP enrollees would shift from one commercial managed care plan to another commercial managed care plan operated by a different corporation.
- **Phase 3 (January Through June 2013).** Beginning January 1, 2013, the remaining

43,000 HFP enrollees who live in a county without an existing Medi-Cal managed care plan would be transitioned into fee-for-service Medi-Cal. (Under a fee-for-service arrangement, providers are paid for each good or service they provide.)

The Governor's budget also proposes to eliminate MRMIB by July 1, 2013. The other four programs that MRMIB administers would be transferred to DHCS at that time.

LAO Comments

Proposal Has Merit, but Key Details Are Lacking. The Governor's proposal has merit because it could reduce state costs while continuing to provide managed care to most HFP enrollees. The administration, however, has not provided details on several key issues related to the shift of HFP enrollees into Medi-Cal that would enable legislative evaluation of this proposal. For example, the administration should provide more information about how continuity of care would be maintained for enrollees who move from managed care into fee-for-service Medi-Cal. The administration should also provide more information about how eligibility determinations and enrollment functions would work under the new arrangement.

OTHER EXPENDITURE ISSUES

CAL GRANTS

Proposal

Citing dramatic increases in Cal Grant costs since adoption of the entitlement programs in 2001, the Governor's budget proposes several new restrictions in Cal Grant eligibility and award amounts. The Governor estimates these new restrictions would result in \$302 million of General Funds savings. The major proposals are to:

- Increase the minimum required grade point average (GPA) for students to qualify for Cal Grants. The GPA requirements for high school entitlement awards would increase from 3.0 to 3.25 for Cal Grant A and from 2.0 to 2.75 for Cal Grant B (which serves lower-income students). The Community College transfer entitlement requirement would increase from 2.4 to 2.75.

- Reverse the California Student Aid Commission's (CSAC's) recent decision to expand access to transfer entitlement awards. Currently students must begin university studies in the academic term immediately following community college enrollment to qualify for the transfer award. The CSAC decision would allow an interruption in studies prior to transferring. By reversing this decision, the administration estimates it will avoid \$70 million in new General Fund costs.
- Halt the planned increase in allowable student loan default rates at Cal Grant-eligible institutions. The default limit is currently 24.6 percent but is scheduled to increase to 30 percent for 2012-13. The Governor's proposal would retain the current limit, which prevents institutions with higher rates (primarily private for-profit colleges) from participating in the Cal Grant program.
- Lower the current annual grant cap of \$9,708 for students attending private colleges and universities. The new cap would be \$5,472 for students attending private *non-profit* institutions and \$4,000 for those attending private *for-profit* institutions.

Major Financial Aid Fund Shifts. The Governor's proposal would shift \$736 million in Cal Grant costs from the General Fund to federal TANF funds. This fund swap would have no net effect on total funding for Cal Grants. As discussed earlier in this report, the Governor's proposal would cut CalWORKs services in order to free up TANF funding for Cal Grants.

LAO Comments

Of the Governor's financial aid proposals, we believe two merit serious consideration, one should be modified, and one is problematic given its potential to increase state costs. We also are concerned that the Governor's plan does not take into account potential increases in Cal Grant costs that the state would incur if the universities raised their tuition/fee levels.

Governor's Proposals to Avoid Two Program Expansions Make Sense in This Environment. We believe the Legislature should seriously consider the Governor's proposals to reverse CSAC's decision to expand access to transfer entitlement awards and maintain the current default limit at 25 percent. In the current fiscal environment, we think foregoing program expansions that could necessitate further program reductions in other areas makes sense. In the future when the state fiscal condition has improved the Legislature could consider whether these are areas it would prioritize for new investments.

Some Increases in GPA Requirements Appear Warranted but Legislature Should Deliberate on Where to Draw the Line. Students with very low GPAs are unlikely to be prepared for postsecondary education. Awarding Cal Grants to these students, who have very low academic persistence and completion rates, provides little long-term benefit to the students or the state. Raising the GPA requirement at the low end of the scale (such as the 2.0 requirement for Cal Grant B) would better target state resources to students who can benefit from postsecondary education. In contrast, the Governor's proposal to raise the Cal Grant A minimum GPA above 3.0 could affect a large number of academically well-qualified students with financial need. Where to draw the line in each case is a policy decision that will require balancing concerns about cost effectiveness and college access.

Proposal to Reduce Grant Amounts Could Result in Higher State Costs. The Governor's proposal recognizes the need to constrain costs in the fast-growing Cal Grant programs. We are concerned that the proposal to reduce awards for students at private colleges could reduce access for needy students while actually *increasing* state costs after the first year. The state subsidy for financially needy students at private institutions (from Cal Grants) is substantially lower than the total subsidy provided to similar students at UC and the California State University (CSU). The state could incur greater costs if enrollment shifts from private to public institutions. If the Legislature wishes to limit maximum award amounts, it will be important to consider longer-term impacts on state costs and student choices. If, on the other hand, the Legislature's goal is to limit the use of state resources at colleges with poor outcomes, we would recommend an approach based more directly on institutional outcomes instead of institution type.

Does Not Take Into Account Potential Increases in Cal Grant Costs. By statute, Cal Grant award amounts keep pace with tuition at UC and CSU. As a result, the university governing boards can unilaterally increase state Cal Grant costs by raising tuition. (For example, the universities' most recent tuition increases resulted in additional Cal Grant costs of about \$90 million above the budgeted level.) Thus, if the universities raise tuition for 2012-13, Cal Grant costs would increase beyond the level anticipated in the Governor's budget.

UNEMPLOYMENT INSURANCE FUND INSOLVENCY

In 2008, historically high demand for unemployment insurance (UI) benefits began to push the cost of providing UI benefits beyond the state's available resources. As a result, in 2009 the state's UI fund (the Unemployment Fund) became insolvent. Since that time, California has borrowed

from the federal government to continue payment of UI benefits. Currently, California's outstanding federal loan is about \$10 billion. California is required to make annual interest payments on this loan. The first payment (\$303 million) was made in September 2011 and the second (an estimated \$417 million) is due September 2012. As interest payments must be made from state funds, the cost of future payments is likely to fall on the General Fund. Below, we discuss the Governor's approach to addressing the UI insolvency issue in 2012-13.

Proposal

Funding Source for Interest Payments on the Loan to the UI Fund. Similar to 2011-12, the Governor proposes to avoid General Fund interest costs in 2012-13 by: (1) making an interest payment of \$417 million from the General Fund and (2) immediately covering the cost to the General Fund with a loan from the state's disability insurance (DI) fund. In addition, the Governor is proposing to institute a new employer surcharge, payable to the Employment Training Fund, which would be used to pay the state's federal interest payment in 2013-14 and subsequent years, as well as General Fund payments over the next few years to repay the DI fund loans made in 2011-12 and 2012-13. The surcharge would not be used to pay down the principal on the state's federal loan. The amount of the surcharge in each year would be based on EDD's projections of interest costs in the following year. The EDD estimates that the annual increased cost to employers will be between \$40 and \$61 dollars per employee over the next few years, gradually declining as the federal loan is paid off.

Increase the Minimum Monetary Eligibility Requirement. The Governor's budget also proposes to increase the earnings threshold an unemployed worker must satisfy to receive UI benefits. Presently, to qualify for UI benefits, an

unemployed worker must have earned at least \$900 in the highest quarter or \$1,300 in any one quarter of his/her 12-month base period. These thresholds have not been adjusted for changes in wage levels since 1992. Under the Governor's proposal, these limits would be increased to \$1,920 and \$3,200 respectively. The EDD estimates that this change would reduce annual UI benefit payments by \$30 million (less than one percent of total annual benefit payments).

LAO Comments

Governor's Proposal Does Little to Address UI Fund's Long-Term Insolvency. As the funds raised by the Governor's proposed employer surcharge would be limited to repayment of interest on loans to keep the UI fund solvent, the proposal does little to address either the insolvency of the UI fund or the long-term structural imbalance between UI fund revenues and expenditures. Continuing to carry a balance on the loan to the UI fund poses several problems for California that necessitate corrective action. We provide an in-depth discussion of the UI fund insolvency issue in a number of recent policy reports, including *California's Other Budget Deficit: The Unemployment Fund Insolvency* and *Managing California's Insolvency: The Impact of Federal Proposals on Unemployment Insurance*.

It is important to note that inaction with regard to the insolvency will result in automatic and gradually increasing federal employer UI-related tax increases which pay down the principal on the federal loan to the state's UI fund. The first increment of this tax increase will be implemented in 2012, and will result in increased employer taxes of around \$300 million annually. Altogether, the potential drawbacks of the Governor's proposal are that it: (1) would take longer to repay the federal loan (resulting in higher interest costs) than otherwise would be the case, (2) concentrates the

impact of repaying the federal loan almost entirely on employer costs, and (3) does not address the structural imbalance in the UI fund. To address these issues, as discussed in our policy reports mentioned above, the Legislature could consider a more comprehensive plan—one which makes more significant increases to employer taxes and/or decreases to benefit payments—to address the structural imbalance in the UI program and allow for more timely repayment of the federal loan.

CAP-AND-TRADE REVENUES Proposal

As part of its plan to address climate change, the state will begin implementing a cap-and-trade program in 2012-13. The program places a "cap" or limit on the sources of greenhouse gases responsible for 85 percent of the state's emissions. The ARB will issue carbon allowances that these sources will, in turn, be able to "trade" (buy and sell) in a newly created carbon market. The Governor's budget assumes that cap-and-trade auctions will generate \$1 billion in state revenues in 2012-13. Under the administration's plan, these revenues would be invested in (1) clean and efficient energy, (2) low-carbon transportation, (3) natural resource protection, and (4) sustainable infrastructure development. The budget also assumes that \$500 million of the revenues will be used to offset General Fund costs of existing programs. According to the administration, since actual cap-and-trade revenues will not be known until late in 2012-13, the planned expenditures are not specified by program in the proposed budget. Rather, the administration plans to submit an expenditure plan to the Legislature after the first cap-and-trade auction—which would be after the 2012-13 budget is enacted—and allocate funds to specific programs not sooner than 30 days after submitting this plan.

LAO Comments

The Governor's proposal raises several issues for legislative consideration. For example, since there are legal constraints associated with the use of cap-and-trade revenues, it will be important for the Legislature to consider any potential legal risks with the proposal. Moreover, the administration's approach provides the Legislature with no opportunity to develop a detailed plan on the use of the revenues as part of the budget process in order to ensure that the plan is aligned with legislative priorities. We would also note that because the auction rules developed by ARB include both floor and ceiling prices for allowances, actual cap-and-trade revenues for 2012-13 could range from roughly \$1 billion to almost \$3 billion.

JUVENILE JUSTICE REALIGNMENT

Proposal

Currently, counties initially oversee all juveniles entering the criminal justice system and are responsible for almost all juveniles determined to be offenders. The state, on the other hand, houses the most serious offenders in facilities run by the Division of Juvenile Facilities (DJF). The Governor proposes to shift full responsibility for all juvenile offenders to counties. Specifically, DJF would stop receiving new juvenile wards on January 1, 2013. However, DJF would continue to house individuals admitted to state facilities prior to this date until the completion of their terms. According to the

administration, the state would provide counties with an unspecified amount of ongoing funding beginning in 2013-14 for costs incurred during the prior fiscal year. As a result of the proposed changes, the budget reflects (1) a one-time \$10 million General Fund augmentation in 2011-12 to help counties prepare for the transition and (2) \$11.2 million in General Fund savings in DJF operations in 2012-13. In addition, the Governor's budget delays implementation of the current-year trigger reduction related to charging counties for wards in DJF.

LAO Comments

We have recommended in the past that counties be given full responsibility for juvenile wards to encourage the development of efficient and effective local policies to reduce delinquency. While the administration's proposal merits consideration, there are a number of issues the Legislature should examine in reviewing this proposal. These include (1) creating a funding formula for the payments to counties, (2) identifying whether counties have or could develop sufficient capacity to house additional serious juvenile offenders, (3) developing incentives for increased efficiency and improved outcomes (such as reduced recidivism of these juvenile offenders), and (4) assessing potential unintended consequences of this proposal (such as a possible increase in the number of juveniles tried as adults and sentenced to state prison).

2012-13 BUDGET

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