Governor's Budget MAY REVISION 2012-13

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Introduction

A year ago, the state faced an immediate $26.6 billion budget shortfall and future estimated annual gaps of $20 billion. The state's fiscal challenges were exacerbated by an unprecedented level of debts, deferrals, and budgetary obligations accumulated over the prior decade.

The 2011 Budget Act made substantial progress in returning the state to fiscal stability, but more work remains. The Governor's Budget estimated that the state faced a $9.2 billion budget problem for 2012-13. The May Revision, however, estimates that the problem has increased to $15.7 billion as a result of a reduced revenue outlook, higher costs to fund schools, and decisions by the federal government and courts to block budget cuts.

The May Revision builds upon the key principles underlying the enacted 2011-12 Budget and the Governor's Budget protecting education and public safety programs, making government more efficient and less costly, moving government closer to the people, and paying down debt. While requiring more difficult cuts than originally anticipated, the May Revision will restore fiscal balance and make California more attractive for business, investment, and the creation of jobs.

Substantial Progress Has Been Made

The enacted 2011-12 Budget substantially shrank the state's ongoing deficit and rejected the past approach of over-relying on one-time solutions.

The 2011-12 Budget reflected the following:

- Passing an on-time budget that avoided the gimmicks of prior budgets.
- Closing more than half of the state's ongoing budget shortfall. A year ago, the gap stood at about $20 billion; it is now estimated to have shrunk to about $8 billion.
- Realigning public safety programs to bring government closer to the people.
- Eliminating redevelopment agencies to increase funding for schools, police, fire, and other core local services.
- Making tough cuts across state government to reduce General Fund spending as a share of the economy to its lowest level since 1972-73. State Supplementary Payment grants were reduced to 1983 levels. CalWORKs grants were reduced to below 1987 levels. General Fund support for the state's universities was cut by nearly 25 percent. General Fund support for the state's courts was cut by about 20 percent. The Williamson Act subventions were eliminated, and the child care and dependent tax credit was eliminated.
- Protecting education, public safety, and other core state services to the extent possible.
- Reducing the state's cash-flow borrowing, and saving hundreds of millions of dollars in short and long-term borrowing costs.
- Improving management of the state's infrastructure projects by committing available cash to shovel-ready projects and avoiding unnecessary debt.

Through the budget and executive action, the Administration has focused on shrinking state government and making it more efficient. These changes will help the state keep its budget balanced for the long term. Progress includes:

- Reducing the state workforce by more than 30,000 positions on a permanent basis. The state workforce is at its lowest level as a share of the state's population in almost a decade. California already had the nation's fifth lowest level of government employment in 2010.

- Launching a downsizing plan for the California Department of Corrections and Rehabilitation. The plan is a long-term strategy to save billions of dollars, conform the prison system to post-realignment population changes, satisfy the U.S. Supreme Court's order requiring reduced crowding, end federal court oversight in health care and other areas, and improve rehabilitation programs to reduce recidivism. It will reverse the trend of prison spending consuming a growing percentage of the General Fund budget—from 11 percent to 7.5 percent.

- Eliminating 20 boards, commissions, task forces, offices, and departments. The Governor's Budget and the May Revision combined propose to eliminate more than 60 additional entities and programs.

- Reorganizing state government to improve the management and coordination of government activities, facilitate further efficiencies and reduce costs. The Administration submitted its reorganization plan to the Legislature on May 3. The plan cuts the number of state agencies from 12 to 10 and consolidates and aligns related programs and departments.

The 2012-13 Budget Shortfall

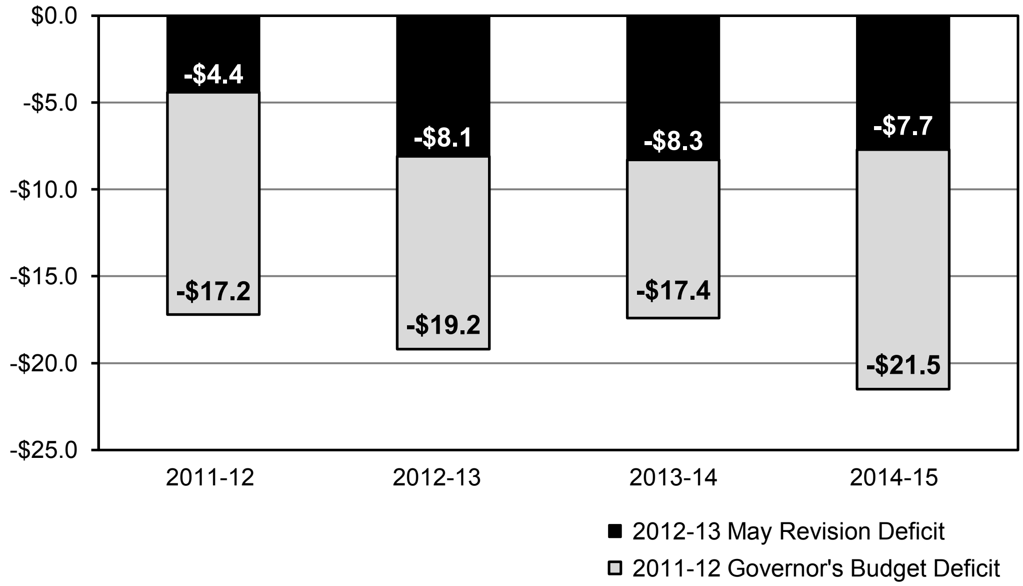
In January, the budget shortfall was estimated to be $9.2 billion. The May Revision estimates that the gap has increased to $15.7 billion. Absent actions to eliminate the structural gap between revenues and expenditures, the state would face about an $8 billion budget shortfall each year. As shown in Figure INT-01, the ongoing budget problem is much smaller than what the state faced just over a year ago. The May Revision proposes to close the remaining gap.

The $6.5 billion increase in the size of the 2012-13 budget problem is largely attributable to three factors:

- *Prior Revenue Forecast Was Too High ($4.3 billion)*—Finance's January forecast was too reliant on strong April and June 2011 receipts, which have now been wiped out by weak final payments received in April 2012. The May Revision continues to project a modest economic recovery.

- *Proposition 98 Spending Increases ($2.4 billion)*—Proposition 98 funding for K-14 education relies on year-to-year changes in revenues. Under the revenue forecast, 2011-12 revenues have decreased ($3.1 billion), and 2012-13 revenues, while lower than in January, are increasing by 5.9 percent. The resulting year-over-year increase

Figure INT-01
Annual Budget Shortfall Reduced by More than Half from $20 Billion to $8 Billion
(Dollars in Billions)



in revenues means the state must pay an additional $1.2 billion for K-14 education. In addition, lower property tax estimates have increased General Fund costs.

- *Federal Government and Courts Blocked Budget Cuts ($1.7 Billion)*—The federal government and courts continue to block reasonable measures to reduce the state's spending. These measures include requiring co-payments for Medi-Cal services, an In-Home Supportive Services (IHSS) provider fee, and cuts to Medi-Cal providers. By blocking these measures, the federal government and courts are forcing the state to pursue even deeper reductions elsewhere. Similarly, further cuts will be required because the federal Receiver for prison medical services overspent his budget by $428 million.

The cost increases are somewhat offset by a net reduction of $1.9 billion from a variety of other factors, such as lower-than-expected caseloads.

Additional Difficult Spending Cuts Are Necessary

As described above, the 2011 Budget Act made deep cuts in state spending, bringing General Fund spending as a share of the economy down to its lowest level since 1972-73. The Governor is seeking additional tax revenues to mitigate the need for deeper cuts to education and public safety. These revenues, however, will not be sufficient to close the entire budget gap. In January, the Governor's Budget proposed difficult spending reductions across state government. These reductions were proposed to permanently reduce spending to a sustainable level and to:

- Protect education and public safety to the greatest extent possible.
- Provide a basic safety net for the most vulnerable.
- Restructure programs to improve outcomes and reduce spending.
- Use alternative funding sources where available.

For instance, the Governor's Budget proposed refocusing CalWORKs and subsidized child care by increasing income support to working families and reducing assistance to families who are not meeting work requirements. The Governor's Budget also proposed to merge the delivery of services for those who are eligible for both Medi-Cal and Medicare to reduce costs and improve the coordination of services.

With the larger budget gap, the May Revision proposes $4.1 billion in additional spending reductions, for a total of $8.3 billion of reductions as summarized in Figure INT-02.

These reductions include:

- Using local reserves to offset General Fund costs for local trial courts on a one-time basis and pausing the court construction program for another year. Commensurate with the offset, the May Revision proposes to evaluate the progress achieved in meeting the goals of trial court reform enacted in 1997. While the state has reduced its General Fund support for courts in recent years, alternative funding from increased fees and transfers have kept overall court funding relatively stable. (Savings of $544 million with ongoing reductions of $125 million)
- Implementing various reductions to hospital and nursing home funding to lower Medi-Cal costs.(Savings of $396 million)
- Reducing IHSS hours by 7 percent. (Savings of $99 million)

Figure INT-02
Budget Balancing Proposals
(Dollars in Millions)

Expenditure Reductions		
Health and Human Services		
Medi-Cal	$1,219.2	
CalWORKs	879.9	
In-Home Supportive Services	224.5	
Other Health and Human Services Programs	161.0	
Education		
Proposition 98	1,497.9	
Child Care	452.5	
Cal Grant Program	291.7	
Other Education	64.4	
All Other Reductions		
Redevelopment Assets	1,405.0	
State Mandates	828.3	
Judiciary	544.0	
Employee Compensation	401.7	
Other Reductions	333.4	
Expenditure Reductions	**$8,303.5**	**50%**
Revenues		
Temporary Taxes	$5,579.8	
Other Revenues	339.1	
Revenues	**$5,918.9**	**35%**
Other		
Loan Repayment Extensions	$1,158.3	
Transfers and Loans from Special Funds	612.2	
Additional Weight Fee Revenues	385.2	
Unemployment Insurance Interest Payment	312.6	
All Other	49.6	
Other	**$2,517.9**	**15%**
Total	**$16,740.3**	

- Prohibiting colleges and universities that are unable to meet minimum performance standards from participating in the Cal Grant Program, as well as aligning future student awards to federal financial-need standards. (Savings of $38 million)
- Reducing the cost of state employee compensation by 5 percent through a reduced workweek or a commensurate reduction in work hours and pay. (Savings of $402 million)

- Using proceeds from the recent National Mortgage Settlement to offset existing General Fund costs for assisting homeowners and protecting consumers, rather than creating new programs. (Savings of $292 million)
- Creating a framework to transfer cash assets previously held by redevelopment agencies to cities, counties, and special districts to fund core public services. Assets transferred to schools will offset General Fund costs. (Savings of $1.4 billion)
- Making various adjustments, including using a 2011-12 overappropriation of the minimum guarantee to pre-pay Proposition 98 funding required by a court settlement. (Savings of $1.5 billion)

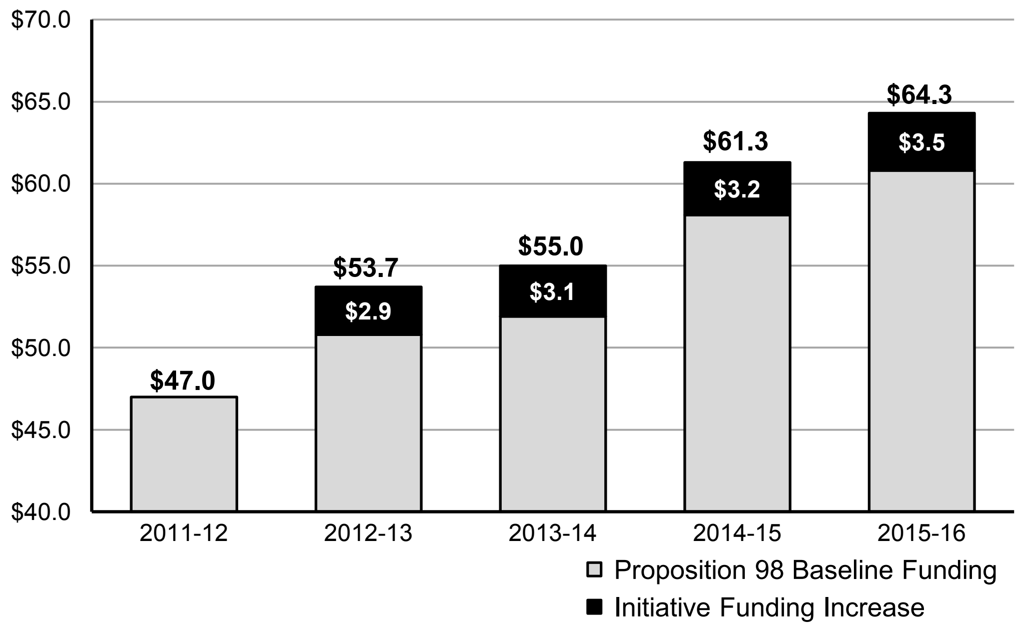
Under the May Revision, General Fund spending for K-14 schools would increase by 16 percent—providing $5.2 billion in additional funding. General Fund spending outside of Proposition 98 would decline by $2.4 billion, or 4.5 percent, excluding a required repayment of $2.1 billion the state borrowed from local government in 2009.

Temporary Taxes to Protect Education and Public Safety

The May Revision assumes the passage of the Governor's proposed initiative at the November election. This measure temporarily increases the personal income tax on the state's wealthiest taxpayers for seven years and increases the sales tax by one-quarter percent for four years. The measure guarantees these new revenues to schools. The measure will generate an estimated $8.5 billion through the budget year. These revenues will enable the state to meet its existing Proposition 98 obligation and to increase funding for schools and community colleges by an additional $2.9 billion. The measure will provide a net benefit to the General Fund of $5.6 billion. In addition, the measure constitutionally guarantees the 2011 Realignment funds for local public safety. The measure will prevent deeper cuts to schools, protect local public safety funding, and assist in balancing the budget.

The May Revision reverses years of cuts in funding for schools and community colleges. As shown in Figure INT-03, K-14 education funding would increase by $17.3 billion, or 37 percent, and per pupil funding would increase by over $2,500 in the next four years. The May Revision dedicates these increased funds to restore cuts, to increase flexible funding for schools, to better meet the needs of low-income students and English language learners, and to pay off deferrals. The proposed weighted student formula,

Figure INT-03
K-14 Funding Increases by $17 Billion Over 4 Years
(Dollars in billions)



as modified, would make school funding more transparent and would give local decision makers greater flexibility.

Alternative to Revenues Is Deeper Cuts

The California Constitution requires that the annual state budget be balanced. To pay the state's bills on time, the budget must be credible and financeable. After more than a decade of putting off dealing with its budget problems, the state must restore a long-term balance between its revenues and spending. Consequently, the May Revision proposes a backup plan if the ballot measure is not approved.

To balance the budget in an ongoing manner, the deep reductions enacted last year and proposed this year must be made and maintained. Without additional revenues, deeper cuts will be required. As education spending accounts for 53 percent of General Fund spending and the May Revision substantially increases K-14 spending and protects the University of California and California State University from deeper cuts, schools and universities would be most affected without the additional revenues.

The ballot trigger cuts totaling $6.1 billion, as summarized in Figure INT-04, would go into effect on January 1, 2013:

Figure INT-04

Ballot Trigger Reductions

(Dollars in Millions)

Expenditure Reductions	2012-13
Proposition 98	$5,493.6
University of California[1/]	250.0
California State University[1/]	250.0
Developmental Services	50.0
Local Water Safety Patrol	10.6
Department of Forestry and Fire Protection	10.0
Flood Control	6.6
Fish and Game: Non-Warden Programs	2.5
Park Lifeguards	1.4
Fish and Game: Wardens	1.0
Department of Justice	1.0
Park Rangers	0.1
Total	**$6,076.8**

1/ This level of savings may be offset by Cal Grant increases if the universities raise tuition.

- Funding for schools and community colleges would be reduced by $5.5 billion. A reduction of this magnitude would result in a funding decrease equivalent to the cost of three weeks of instruction. It would also continue to provide 20 percent of program funds a year in arrears.
- The University of California and California State University would each be reduced by $250 million.
- The state would reduce funding for a variety of public safety programs. The number of the state's public safety officers in the departments of Parks and Recreation (park rangers) and Fish and Game (wardens) would be reduced, and the state would no longer staff its beaches with lifeguards. Grants to local law enforcement for water safety patrol would be eliminated. The Department of Forestry and Fire Protection's firefighting capabilities would be reduced. Flood control programs in the Department of Water Resources would be cut, which would reduce channel and levee maintenance and floodplain mapping. The Department of Justice's law enforcement programs would be reduced.

Restoring and Maintaining Fiscal Stability

The May Revision proposes $16.7 billion in budget-balancing measures to address the state's immediate budget problem and build a prudent $1 billion reserve. Equally important, under current projections, the budget would be balanced on an ongoing basis. In future years, the state would have the capacity to pay down the $33 billion in outstanding budgetary borrowing that was accumulated over the past decade. With diligent fiscal management, the May Revision would reduce this outstanding debt to $6.6 billion by the end of 2015-16.

Even with the balanced budget plan proposed by the May Revision, risks to the budget remain. Potential cost increases associated with actions to reduce the federal deficit, federal government and court decisions, the pace of the economic recovery, an aging population, and rising health care costs all threaten the ability of the state to achieve and maintain a balanced budget over the long term. In addition, the exact level of capital gains and income growth for top earners remains uncertain. The scope of these risks and uncertainties underscores the need to take actions now that improve the state's finances on an ongoing basis.