CALIFORNIA BUDGET PROJECT

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Governor Releases May Revision: Signals Progress on Medi-Cal Expansion, Commitment to School Finance Proposal, and Weakened Fiscal Outlook

On May 14, Governor Jerry Brown released the May Revision to his 2013-14 budget proposal. This May Revision improves on the Governor's January budget proposal in some important ways, but also underscores key challenges still facing our state.

The May Revision moves California toward a state-led expansion of Medi-Cal and affirms the Governor's proposal to restructure school finance to provide additional dollars for districts with high concentrations of disadvantaged students. The May Revision revamps the Governor's January proposal to restructure adult education in California, while putting forth major reforms to the state's Enterprise Zone Program. The Governor's revised budget reflects a fiscal and economic outlook for the coming year that is worse than had been expected, due to recent federal actions and weak economic growth. The Governor's revised budget does not include any major restorations in funding for health and human services programs. This is at a time when poverty and long-term unemployment are still high in the wake of the Great Recession, and with the safety net and critical employment services severely weakened by recent years' spending cuts.

The following sections offer an overview of economic and revenue projections provided in the May Revision, highlight key changes and new policy proposals in the revised budget, and discuss the issues they raise for the state budget debate. The CBP will release additional commentary and analysis in the coming days.

May Revision Highlights Shifting Economic and Revenue Forecasts

The May Revision outlines changes in the state's economic outlook and revenue forecast. Through April of the current (2012-13) fiscal year, state revenue collections were running ahead of the Governor's January projections by $4.6 billion, prompting speculation that there might be increased revenue forecast for the upcoming 2013-14 fiscal year, which begins on July 1. However, the Administration cautions in the May Revision that the higher-than-anticipated revenue collections for 2012-13 are spread over several fiscal years and that "the influx is expected to be short-lived." The May Revision projects additional revenue collections in 2012-13, derived from taxpayers shifting income from 2013 to 2012 in response to federal tax changes, and from economic growth. But, the Administration projects a slight decrease in revenues for 2013-14 as a result of a weakening economic outlook.

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The May Revision:

- **Adjusts the short-term economic outlook downward due to weaker economic growth and recent federal actions.** The Administration points to weaker-than-expected global economic growth and to recent federal actions, including not extending the 2 percent payroll tax deduction in place in 2011 and 2012 and the sequester of billions of dollars in federal spending – actions not included in the Administration's January forecast.

- **Alters General Fund revenue forecasts and the state's Proposition 98 minimum funding guarantee.** General Fund revenues in the May Revision are forecast to be $2.8 billion higher than originally projected for 2012-13 (increasing from $95.4 billion to $98.2 billion), but $1.3 billion lower for 2013-14 (decreasing from $98.5 billion to $97.2 billion). Additional revenues are allocated to K-12 schools and community colleges based on the assumed 2012-13 Proposition 98 minimum funding level. Proposition 98 funding increases by $2.9 billion for 2012-13 and decreases by $941.4 million in 2013-14 in comparison to January projections.

- **Maintains projections for paying down budgetary debt and contributing to the state's reserves.** The May Revision maintains a plan for reducing the state's budgetary debt from $35 billion in 2010-11 to less than $5 billion by 2016-17 and includes a $1.1 billion contribution to the state's Special Fund for Economic Uncertainties.

Increased Revenues Boost the Minimum Funding Level for Schools

Approved by voters in 1988, Proposition 98 constitutionally guarantees a minimum level of funding for K-12 schools, community colleges, and the state preschool program. Because changes in state General Fund revenues tend to affect the Proposition 98 guarantee, the Proposition 98 funding levels included in the May Revision reflect changes in 2012-13 and 2013-14 projected revenue compared to January budget estimates. The May Revision assumes a 2012-13 Proposition 98 funding level of $56.5 billion for K-14 education programs, $2.9 billion more than the level assumed in the Governor's January proposal. However, the May Revision assumes a 2013-14 Proposition 98 funding level of $55.3 billion, $941.4 million *less than* the level assumed in the Governor's January proposal. Specifically, the May Revision:

- **Increases repayments to schools and community colleges by $758 million by the end of 2013-14 compared to the Governor's January budget proposal.** The May Revision provides an additional $1.8 billion in 2012-13 to partially restore previously deferred payments to schools and community colleges, but decreases 2013-14 repayments by more than $1 billion. At the end of 2013-14, payment deferrals to schools and community colleges – that is, the amount still owed by the state – would be $5.5 billion under the May Revision, compared to $6.3 billion under the Governor's January budget proposal.

- **Provides $1 billion in one-time 2012-13 funding to support implementation of the Common Core State Standards (CCSS).** In August 2010, the State Board of Education adopted CCSS for California's K-12 schools.

- **Increases funding for implementation of the Local Control Funding Formula (LCFF).** The LCFF would restructure the state's education finance system and provide all school districts a base grant per student, adjusted to reflect the number of students at various grade levels, as well as additional resources for the costs of educating English learners and students from low-income families. The May Revision increases 2013-14 funding by $240 million for K-12 school districts and County Offices of Education to implement the LCFF, providing a total of $1.9 billion toward first-year LCFF funding. Full implementation of the LCFF depends on sufficient funding for all districts to reach a target base grant. Additional LCFF dollars could potentially reduce the amount of time for full implementation of the LCFF, which the Governor's January budget estimated would take seven years.

May Revision Preserves Local Control Funding Formula Revenue for Disadvantaged Students

In January, the Governor proposed to restructure the state's K-12 education finance system through a Local Control Funding Formula (LCFF). The Governor's proposal would eliminate the majority of programs currently earmarked for specific purposes (so-called "categorical" programs), consolidate funding with state general purpose revenues, and establish a new education funding formula that would be phased in during a period of approximately seven years. The LCFF would provide school districts a base grant per student, adjusted to reflect the number of students at various grade levels; a supplemental grant per student, equal to 35 percent of the base grant for the unduplicated number of English learners (EL) and economically disadvantaged students in each school district; and a concentration grant per student, equal to 35 percent of the base funding grant, for school districts in which ELs and economically disadvantaged students exceed 50 percent of the total student population. The May Revision:

- **Preserves the LCFF's concentration grants.** Despite proposals by the Legislature to eliminate concentration grants, the May Revision preserves the formula proposed by the Governor in January to calculate LCFF concentration grants, as well as base and supplemental grants. The May Revision does make several adjustments to the LCFF proposal, which include:

    - Providing supplemental and concentration grant funding for ELs for up to seven years. The Governor's January budget proposal provided supplemental and concentration grants for ELs for no more than five years;

    - Using three-year rolling average percentages of ELs and economically disadvantaged students to calculate supplemental and concentration grants; and

    - Requiring County Offices of Education to review school district EL and economically disadvantaged student data as part of annual financial and compliance audits.

- **Strengthens LCFF accountability provisions** by requiring school districts to:

    - Spend supplemental and concentration grants "in a manner that benefits" the students for whom they are intended;

    - Spend no less than the amount that they spent for ELs and economically disadvantaged students in 2012-13 during the period of LCFF implementation, and upon full LCFF implementation at least as much as they receive from the base, supplemental, and concentration grants for ELs and economically disadvantaged students;

    - Demonstrate how they will comply with spending requirements and how they will increase expenditures in proportion to the additional funding they receive each year for LCFF implementation; and

    - Spend supplemental and concentration grants in proportion to the number of ELs and economically disadvantaged students at each school site.

Additionally, the May Revision strengthens funding accountability provisions by detailing enforcement provisions if school districts do not comply with revised LCFF spending requirements.

Governor Revamps Proposal to Restructure Adult Education

In January, the Governor proposed to provide $300 million to create a new adult education block grant program within the community colleges. The May Revision instead proposes to maintain for two years the existing funding structure and levels for community college adult education programs. During this time, the Governor proposes to transition to a new regional partnership system consisting of adult education providers. The May Revision:

- **Provides $30 million in 2013-14 for two-year planning and implementation grants.** The plans must demonstrate how the adult education providers would integrate existing programs with the new partnership program, including how they would serve adults in local correctional facilities.

- **Promises $500 million in 2015-16 to fund adult education schools jointly operated by regional partnerships of community college districts and school districts.** The Administration would require that at least $350 million of these funds be used to support existing adult education providers. Additionally, the districts comprising each partnership would need to maintain their 2012-13 level of spending on adult education in 2013-14, and in future years, to receive the new funding.

Governor Endorses a State-Led Expansion of Medi-Cal, But Maintains Proposal to Shift Costs for Certain Human Services Programs to Counties

Medi-Cal is California's version of Medicaid, a federal-state health coverage program for low-income children, parents, seniors, and people with disabilities. As part of federal health care reform, states may expand their Medicaid programs in 2014 to low-income adults who currently are not eligible, with the federal government paying 100 percent of the cost for the first three years and no less than 90 percent of the cost thereafter. In January, the Governor proposed two options for expanding Medi-Cal: directly enrolling newly eligible Californians in Medi-Cal (the "state-based" approach) or building on counties' current health care systems (the "county-based" approach).

In addition, the Governor in January proposed to link the Medi-Cal expansion to his proposal to "capture," for the state's benefit, some of the funding that counties now use to provide health care to low-income, uninsured ("medically indigent") Californians – many of whom would enroll in Medi-Cal under the expansion. Specifically, the Governor proposed to transfer – or "realign" – certain human services programs from the state to the counties. Under the Governor's January proposal, counties would fund their new responsibilities with a portion of the dollars that they *currently* receive to provide indigent health care – dollars that counties presumably would not need as more Californians enroll in Medi-Cal.

The May Revision:

- **Drops the Governor's county-based approach and commits to a state-led Medi-Cal expansion.** Newly eligible Californians would enroll in Medi-Cal and receive the same benefits available to other Medi-Cal enrollees. Health advocates, counties, and the nonpartisan Legislative Analyst's Office have strongly supported the state-based approach.

- **Maintains – and provides new details about – the Governor's proposal to link the Medi-Cal expansion to a major realignment of responsibilities for human services from the state to the counties.** The Governor proposes that counties "assume greater financial responsibility" for CalWORKs, CalWORKs child care, and operation of the CalFresh food assistance program, thereby generating substantial state savings. Under the Governor's proposal, these new county *costs* would be funded with county *savings* attributable to health care reform. The state would determine county savings by comparing counties' available health care revenues to their costs for providing health care to the remaining uninsured. Savings would be "redirected" to the human services programs, with this shift beginning in 2013-14 as the state implements the Medi-Cal expansion. The Administration suggests that the redirected dollars – that is, funding shifted from counties' health care infrastructure – could total $300 million in 2013-14, rising to $1.3 billion by 2015-16. On a May 14 briefing call, Administration officials indicated that the proposal would amount to a "fiscal transfer" for all programs during 2013-14, after which counties would have increased flexibility with respect to CalWORKs and related child care programs. County flexibility would be balanced with beneficiary protections, and "the state would continue to provide funding for above-average costs that result from economic downturns or policy changes outside counties' control," according to the Administration.

May Revision Leaves Many Previous Health and Human Services Cuts Unchanged, Proposes New CalWORKs Early Engagement Strategies

The May Revision leaves aspects of current Medi-Cal coverage in place, including some of the severe cuts of recent years. For example, the May Revision:

- **Does not restore adult dental care or other optional Medi-Cal benefits eliminated in 2009.** The 2009-10 budget agreement eliminated certain benefits that had previously been available under Medi-Cal, such as dental care for adults. Despite calls from some Legislators and advocates to restore these benefits, the May Revision does not include restorations.

- **Maintains the 10 percent Medi-Cal provider rate cut.** The 2011-12 budget agreement included a 10 percent cut to payments for doctors, dentists, pharmacists, and other providers who participate in Medi-Cal. The cut did not take effect due to several still-unresolved lawsuits by health provider associations. Medi-Cal's provider rates are already exceptionally low, and California ranked second-lowest in the nation in the percentage of doctors accepting new Medicaid patients in 2011. Despite recent Legislative proposals to prevent the reduction from taking effect, the May Revision does not call for the Legislature to repeal the cut.

The May Revision makes no significant funding restorations to human services programs that have experienced deep cuts in recent years, and makes few alterations to the Governor's January budget proposals concerning human services. For example, the May Revision:

- **Does not restore child care slots lost in recent years.** Since 2008-09, annual funding for child care has been reduced by nearly $1 billion, resulting in the elimination of 110,000 child care and development "slots" – about one-quarter of the total slots funded through the state budget in 2008-09. As with the Governor's January budget proposal, the May Revision generally maintains the prior year's funding levels for subsidized child care and preschool programs.

- **Leaves the CalWORKs grant unchanged, with no automatic cost-of-living adjustment (COLA).** The current CalWORKS maximum aid payment, at $638 for a family of three, leaves families well below poverty. At 39.2 percent of the federal poverty line, the grant is even significantly below "deep poverty." Since 2008, lawmakers have reduced the grant by a total of 12 percent, frozen the COLA in many years, and finally ended the COLA.

The May Revision does include new CalWORKs "early engagement" strategies to better address client needs during a shortened time window. The 2012-13 budget agreement imposed a 24-month limit on the amount of time CalWORKs parents can access the full array of welfare-to-work activities available under state law before being required to meet less flexible federal work participation requirements. The state convened a stakeholder workgroup to explore strategies for maximizing participants' limited time to participate in state-allowed welfare-to-work activities and make a successful transition into the workforce within the shortened window. The May Revision proposes $48.3 million for 2013-14 – and an unspecified level of resources in future years – to develop early engagement strategies including:

- An initial comprehensive assessment using a standardized assessment tool;
- Family stabilization plans to resolve barriers to employment that some families face; and
- Enhanced subsidized employment.

Because the 24-month time limit took effect January 1, 2013, steps would need to be taken soon in order for the proposed early engagement strategies to benefit CalWORKs participants whose 24-month "time clocks" have already started.

Governor Alters Proposal to Restructure California's Enterprise Zone Program

Established in 1984, California's Enterprise Zone (EZ) Program provides a variety of tax credits intended to encourage businesses to locate in economically distressed areas and to promote job creation. Research shows that, as currently structured, the program fails to achieve its goals. At the same time, the EZ Program places an increasing strain on the state budget – the program cost the state $720 million in 2010 and is projected to cost $1 billion by 2015-16. The May Revision includes a new, revenue-neutral set of proposals that would restructure the program and that represent a significant shift from the January proposal, which sought to improve EZs through a series of regulatory reforms. The May Revision:

- **Narrows the EZ hiring credit to specific areas with high unemployment and poverty rates, and limits availability to three targeted groups.** The high cost of the EZ Program is primarily attributable to the hiring tax credit, which comprises more than half of the total cost of the EZ tax breaks. In January, the Administration proposed additional controls on the use of the hiring tax credit. The May Revision restructures the EZ hiring credit to focus on areas with high levels of unemployment and poverty rates, eliminating existing zone eligibility criteria that are not indicative of economic distress. The credit would be targeted to three groups: long-term unemployed, unemployed veterans, and individuals receiving public assistance – in comparison to current eligibility requirements for EZs that target 10 groups and often lead to the issuance of credit vouchers for employees regardless of income or other characteristics.

- **Expands the EZ sales tax program statewide.** The May Revision expands the EZ sales tax credit for manufacturing and biotech research and development (R&D) equipment purchases on a statewide basis in an effort to encourage job growth throughout the state rather than rewarding the transfer of jobs within the state. This sales tax exemption appears to be defined more narrowly than the current EZ sales and use tax exemption, which allows for a credit on equipment that is used within the boundaries of an EZ, such as equipment for manufacturing, renewable energy, data processing and communications, and motion picture production.

- **Creates a California Competes Recruitment and Retention Fund.** This new fund would be administered by the Governor's Office of Business and Economic Development (GO-Biz), which would use the fund to "negotiate agreements to provide businesses tax credits in exchange for investments and employment expansion in California," according to the Administration. It is unclear from budget documents whether the fund will be inside the EZ Program or operate independently from the EZ Program.

The details of the new proposals have yet to be fully released. In combination, the proposals in the May Revision have the potential to effectively narrow the EZ Program and improve its performance. However, the lack of results shown by the current EZ Program suggests that state policymakers will need to closely monitor program effectiveness as a basis for continuing to direct state dollars toward EZs.

Challenges and Choices Remain

While the May Revision improves on the Governor's January budget proposal in some key ways, it also underscores the daunting challenges still facing our state. California is a state with enormous wealth, diversity, and opportunity, but one challenged by widening inequality, long-term unemployment that is still high in the wake of the Great Recession, and a safety net and other critical systems severely weakened by recent years' spending cuts. Even amid the 2013-14 budget constraints, California policymakers have choices.

For example, the May Revision includes a $1.1 billion contribution to the state's reserves, a worthwhile investment in periods of economic growth, but funds that might wisely be directed elsewhere at a time when millions of Californians are still hurting. The Administration's proposal for reforming the state's Enterprise Zone Program is estimated to be revenue-neutral, meaning it would continue at a cost to the state that will reach $1 billion in foregone annual tax revenues by 2015-16. A more ambitious restructuring of the program could reduce the strain on the state budget and provide funds for needed investments elsewhere. Similarly, the Administration's plan for paying down California's budgetary debt includes more than $500 million in repayments to special funds. Adopting a more gradual repayment schedule could free up funds to support other budget priorities.

Some key examples of how these freed-up funds could be spent include:

- **Reinvestment in the 26,000+ subsidized child care and preschool slots eliminated in the 2012-13 budget agreement.** The cost of restoring these slots, about one-quarter of all child care and preschool slots eliminated since 2007-08, would be about $130 million.

- **Repealing the 10 percent cut to Medi-Cal provider payments, which would go into effect only if upheld by the federal courts.** Amid concerns that payment cuts on the eve of the Medi-Cal expansion could drive providers from the program at the very time when provider participation needs to increase, the provider rate cut could be repealed. The cost would be approximately $573 million in 2013-14.

- **Strengthening the CalWORKs Program.** Policymakers could structure CalWORKs grants to more effectively promote economic security for low-income families, such as by restoring the annual cost-of-living adjustment.

The budget realities and choices underlying the May Revision show why California needs to put in place short- and long-term strategies for strengthening state and local revenues and make the necessary investments in our economy and our communities.