# 2017-18 May Revision

**Edmund G. Brown Jr. Governor**
*State of California*

## Introduction

As the state's economy has recovered from the Great Recession, the past four budgets have significantly expanded government spending. The Legislature and the Governor have focused the spending on counteracting the effects of poverty. The May Revision includes funding for:

- The rising state minimum wage, which is scheduled to increase to $11 per hour in 2018 and to $15 per hour over time.
- The expansion of health care coverage to undocumented children and the millions of Californians covered under the federal Affordable Care Act.
- The provision of preventative dental benefits to adults covered by Medi-Cal.
- The first cost-of-living adjustment for Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients since 2005.
- The repeal of the maximum family grant rule in CalWORKs, which denied aid to children who were born while their parents were receiving aid.
- California's first-ever Earned Income Tax Credit to help the state's poorest working families.

The state has also paid down its budgetary borrowing and addressed some long-standing problems — such as restoring fiscal health to its retirement benefit plans and making major improvements to the state's water system.

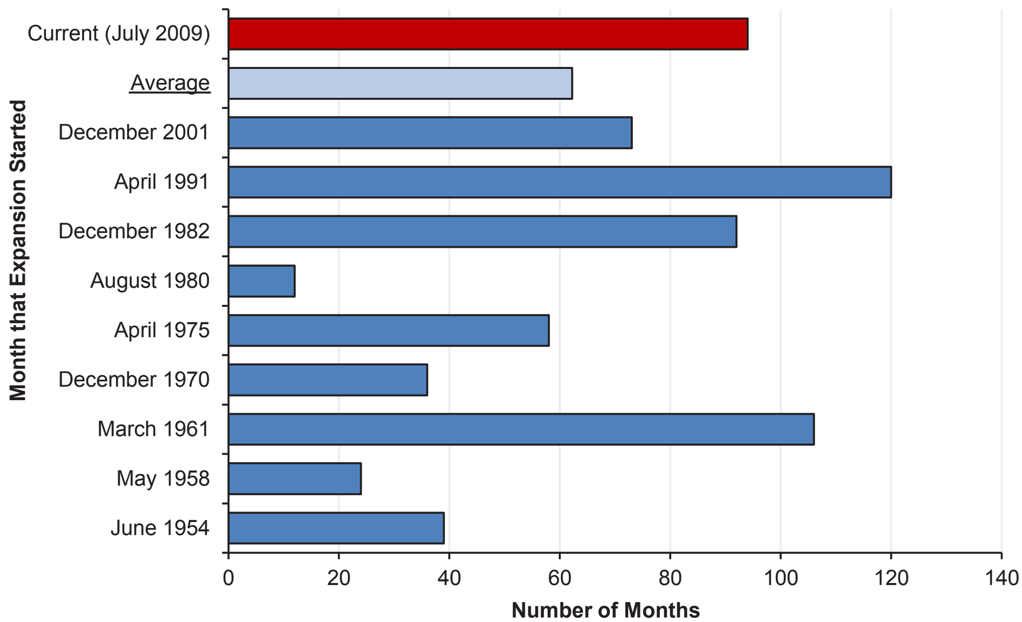
Over the past year, however, state revenues began to lag expectations. Compared to the 2016 Budget signed in June, the January Budget revenue forecast reflected a $5.8 billion reduction. Since January, the stock market has surged. As a result, the May Revision reflects higher revenues of $2.5 billion. Yet, this forecast remains $3.3 billion below the 2016 Budget forecast from one year ago. Consequently, the budget — which remained precariously balanced even in the strongest revenue years — is considerably more constrained than in any year since 2012.

The modestly improved fiscal outlook compared to January allows the May Revision to advance several key priorities:

- Increasing Money for Schools — With an increased Proposition 98 minimum guarantee, the May Revision increases funding for the Local Control Funding Formula for K-12 education, providing a total increase of $1.4 billion in 2017-18.
- Maintaining County Fiscal Health — Under current law, about $600 million in In-Home Supportive Services (IHSS) costs would be borne by county realignment funds next year. The May Revision substantially mitigates these increased costs and preserves counties' ability to provide key safety net programs.
- Restoring Child Care — The January Budget proposed pausing scheduled provider rate increases, but the May Revision restores the $500 million child care package from the 2016 Budget.
- Reducing Pension Liabilities — The May Revision proposes a $6 billion supplemental payment to CalPERS with a loan from the Surplus Money Investment Fund that will reduce unfunded liabilities, stabilize state contribution rates, and save $11 billion over the next two decades. The General Fund share of the repayment will come from Proposition 2's revenues dedicated to reducing debts and long-term liabilities.

The state must also continue to plan for and save for tougher budget times ahead. The federal government is contemplating actions — such as defunding health care for five million Californians, eliminating the deductibility of state taxes, and zeroing out funding for organizations like Planned Parenthood — that could send the state budget into turmoil. Moreover, by the time the budget is enacted in June, the economy will have finished its eighth year of expansion—only two years shorter than the longest recovery since World War II (see Figure INT-01). A recession at some point is inevitable.

Figure INT-01
**Current Recovery Is Approaching Three Years Longer than Average**



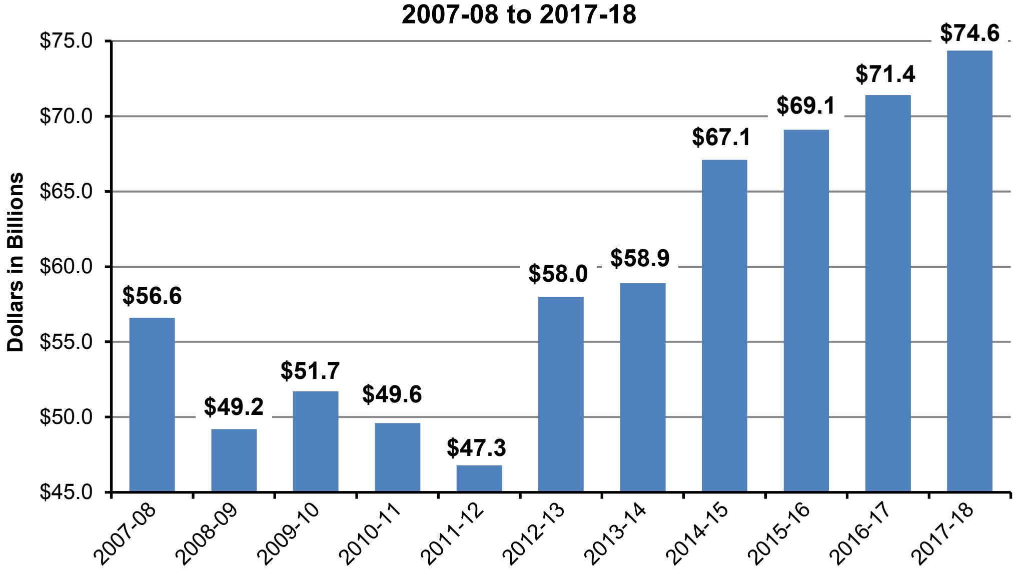

## Preserving Core Achievements

The May Revision maintains a balanced budget while preserving the state's core achievements from the past four years.

### K-12 Education

As shown in Figure INT-02, the minimum guarantee of funding for K-14 schools was \$56.6 billion in 2007-08 and sank to \$47.3 billion in 2011-12. From this recent low, funding has been at all-time highs since 2012-13. Funding is expected to grow to \$74.6 billion in 2017-18—an increase of \$1.1 billion since January and \$27.3 billion over six years (58 percent).

Figure INT-02
**Proposition 98 Funding**
**2007-08 to 2017-18**




For K-12 schools, funding levels will increase by about $4,058 per student in 2017-18 over 2011-12 levels. This reinvestment provides the opportunity to correct historical inequities in school district funding with $1.4 billion in new funding to continue implementation of the Local Control Funding Formula. The formula focuses most new funding to districts with low-income students, English Learners, and students in foster care. The Budget increases the formula's implementation to 97 percent complete. The increased funding also eliminates the deferral of funding that was included in the January Budget.

## Higher Education

The Administration's higher education efforts—keeping student costs low, promoting new technology and innovation, and improving graduation rates—will support students' success in achieving their educational goals. The May Revision continues to provide each university system and the community colleges with annual General Fund growth. The May Revision also prevents a scheduled reduction in financial aid awards to low-income students at private colleges and universities, while tying those extra expenditures to meeting state goals regarding serving low-income students, expanding online education, and easing the transfer process from community colleges. In response to the State Auditor's review of the UC Office of the President, the May Revision sequesters $50 million in UC funding until such time that the Auditor's recommendations and other UC commitments are implemented.

## Counteracting the Effects of Poverty

California has an extensive safety net for the state's neediest residents who live in poverty. Since 2012, the General Fund has supported new poverty-focused obligations totaling almost $19 billion annually. Based on reduced revenues, the January Budget proposed pausing scheduled rate increases for child care providers and an expansion of slots for preschool. The May Revision reverses that proposal, resulting in over a $500 million increase for child care programs from 2016-17 through 2018-19.

In January, the Administration determined that the Coordinated Care Initiative, begun in 2012-13, was not cost-effective. Under existing law, this determination would result in about $600 million in state savings and a corresponding increase in annual county realignment IHSS costs (by returning to the historic cost-sharing ratio for the program). The May Revision prioritizes the mitigation of this increase to county costs by contributing $400 million from the General Fund and then smaller amounts in future years as realignment revenues grow. This funding will allow counties to continue providing key health, social, and mental health services to the state's residents.

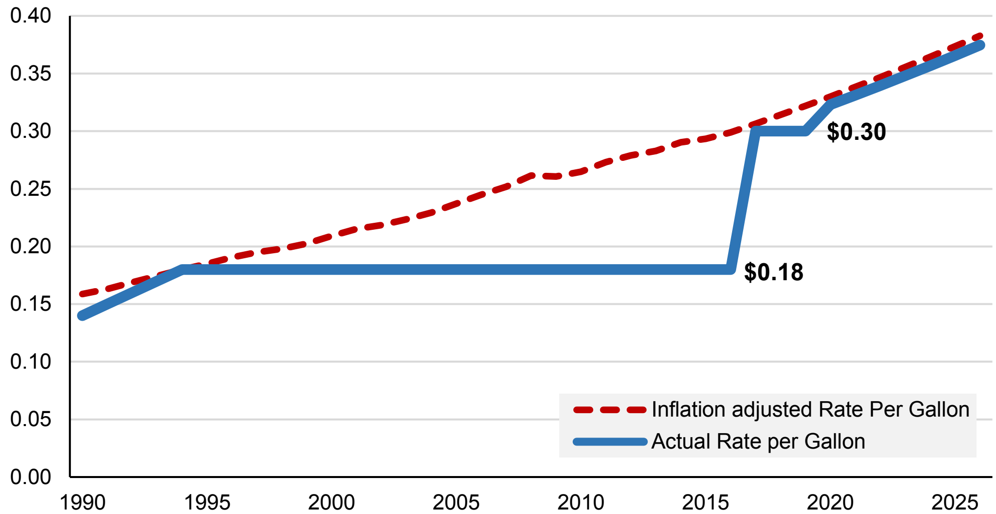
## Strengthening Infrastructure

The repair, maintenance, and efficient operation of the state's transportation system are vital to California's economic growth. State and local funding has fallen dramatically below the levels needed to maintain the system, and a recent transportation study found that Californians spend on average $762 annually on vehicle repair costs due to poorly maintained roads. California continues to be in the top five states with the longest commutes.

In response, the Legislature and Governor agreed on a historic transportation funding package this spring, contained in The Road Repair and Accountability Act of 2017 (SB 1). The funding package returns the gas tax's purchasing power to 1994 levels (see Figure INT-03) and will provide $54 billion in new funding over the next decade, split evenly between state and local funding. The May Revision reflects the first $2.8 billion of new funding to:

- Focus on "fix-it-first" investments to repair neighborhood roads and state highways and bridges.
- Make key investments in trade and commute corridors to support continued economic growth and implement a sustainable freight strategy.

Figure INT-03
**SB 1 Restores Lost Purchasing Power for the Gas Tax**




- Match locally generated funds for high-priority transportation projects.
- Invest in passenger rail and public transit modernization and improvement.

Drivers deserve improved performance and efficiency at Caltrans in exchange for paying more (less than $10 per month for most drivers). The package enhances oversight by the California Transportation Commission and the new Inspector General. Moreover, new performance metrics will allow the state to hold Caltrans accountable for its improvement of state highways. State and local governments must implement the SB 1 plan in a cost-effective manner without delay.

## Paying Down Debts and Liabilities

Over the past several years, the Governor and Legislature have taken significant steps to address the long-term costs of state retirement programs. In 2012, the California Public Employees' Pension Reform Act was enacted to save billions of taxpayer dollars by capping benefits, increasing the retirement age, stopping abusive practices, and requiring employees to pay at least half of their pension costs. In 2014, a funding plan was implemented to restore fiscal solvency to the state's teacher pension system over three decades. In 2016, the state and its employees began to share equally in the prefunding of retiree health benefits to eliminate the unfunded liability over three decades, now estimated at $76.5 billion.

As shown in Figure INT-04, the state now has $282 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$279 billion—are related to retirement costs of state and University of California employees. These retirement liabilities have grown by $51 billion in the last year alone due to poor investment returns and the adoption of more realistic assumptions about future earnings.

Figure INT-04

**Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2**

(Dollars in Millions)

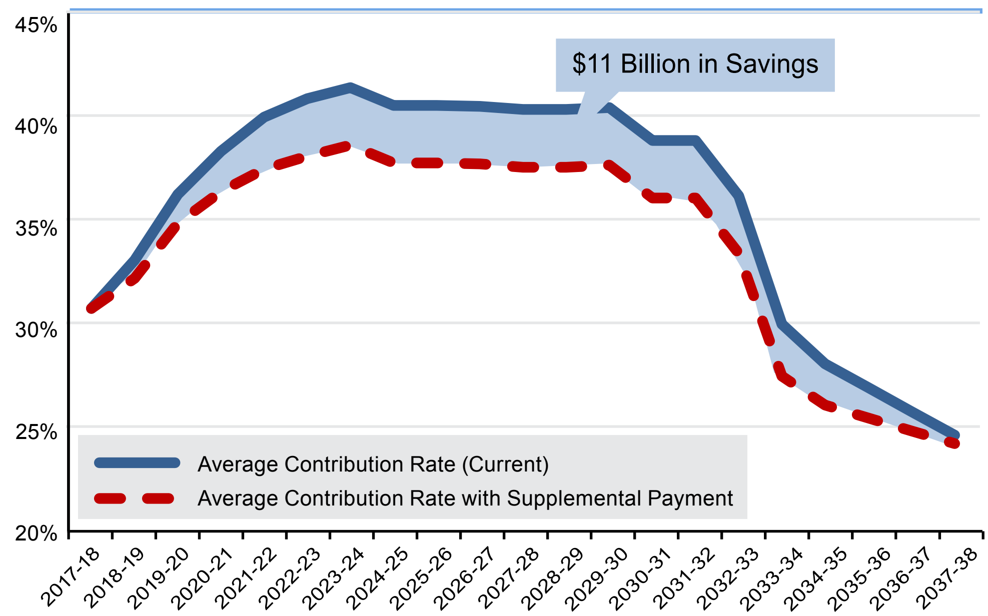
| | Outstanding Amount at Start of 2017-18 | Proposed Use of 2017-18 Pay Down at Governor's Budget | Changes from Governor's Budget | Proposed Use of 2017-18 Pay Down at May Revision |
|---|---|---|---|---|
| **Budgetary Borrowing** | | | | |
| Loans from Special Funds | $1,365 | $252 | $0 | $252 |
| Underfunding of Proposition 98—Settle-Up | 1,043 | 400 | 203 | 603 |
| Repayment of pre-Proposition 42 Transportation Loans | 706 | 235 | 0 | 235 |
| **State Retirement Liabilities** | | | | |
| State Retiree Health | 76,533 | 100 | -11 | 89 |
| State Employee Pensions | 59,578 | 0 | 427 | 427 |
| Teachers' Pensions[1/] | 101,586 | 0 | 0 | 0 |
| Judges' Pensions | 3,489 | 0 | 0 | 0 |
| Deferred payments to CalPERS | 627 | 0 | 0 | 0 |
| **University of California Retirement Liabilities** | | | | |
| University of California Employee Pensions | 15,141 | 169 | 0 | 169 |
| University of California Retiree Health | 21,860 | 0 | 0 | 0 |
| **Total** | **$281,928** | **$1,156** | **$619** | **$1,775** |

[1/]The state portion of the unfunded liability for teachers' pensions is $29.332 billion.

Absent additional action to address these growing liabilities, paying off retirement liabilities will require an increasing percentage of the state budget. For example, the state's contributions to CalPERS are on track to nearly double from $5.8 billion ($3.4 billion General Fund) in 2017-18 to $9.2 billion ($5.3 billion General Fund) in 2023-24. In response, the May Revision proposes a $6 billion supplemental payment to CalPERS through a loan from the Surplus Money Investment Fund. This payment is expected to earn a 7 percent return from CalPERS, compared to the less than 1 percent currently earned from the fund. Over the next two decades, this supplemental payment will save an estimated $11 billion (after paying the costs of the loan). Figure INT-05 illustrates that the supplemental payment will lower the state's contribution rates by an average of 2.1 percent of payroll. The General Fund costs associated with the payment will be repaid with Proposition 2's dedicated revenues for long-term liabilities.

Figure INT-05

**Supplemental Retirement Payment Would Save Billions**

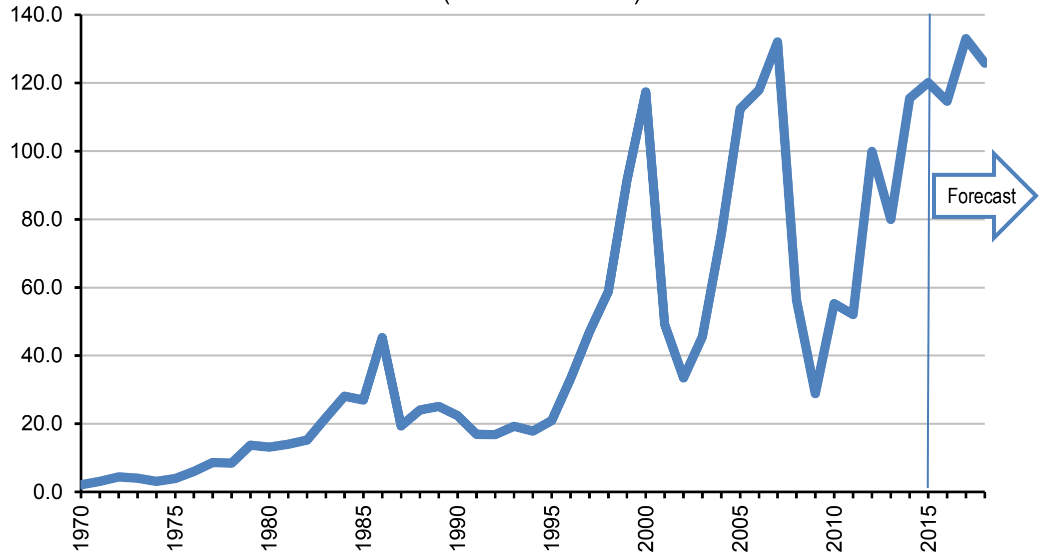



## Maintaining a Balanced Budget in Uncertain Times

Over the next several years, California faces dramatically higher risks than normal, with major threats that could drive the budget significantly out of balance.

The May Revision reflects a modest improvement in the state's fiscal outlook—primarily from the recent rise in the stock market. As shown in Figure INT-06, the May Revision would be relying on an all-time high of capital gains in 2017—the state's most volatile and unpredictable revenue source.

Figure INT-06
**Volatile Capital Gains on the Rise**
(Dollars in Billions)



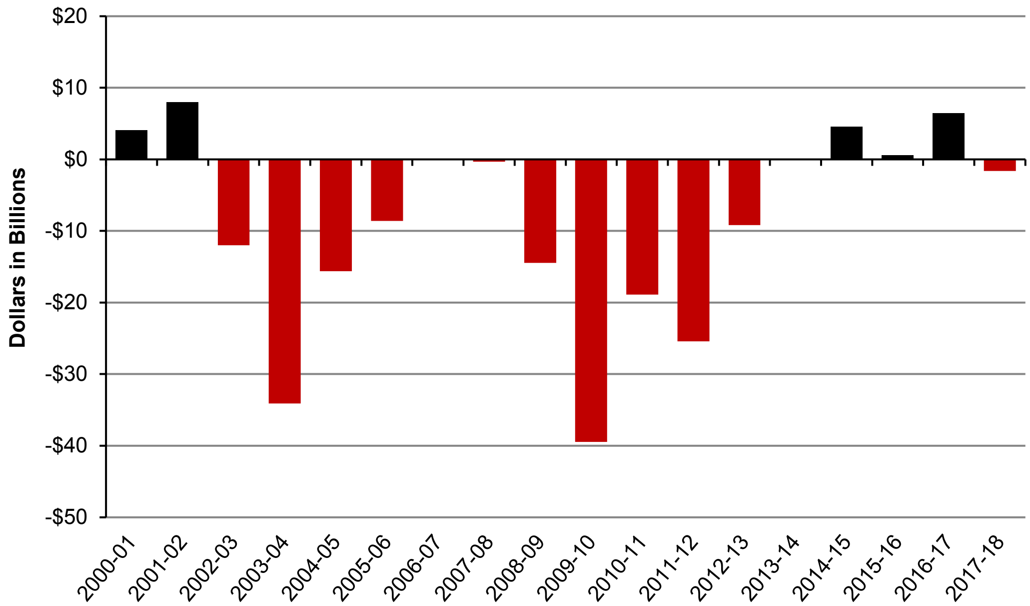

The May Revision assumes the continued expansion of the economy. Yet, economic expansions do not last forever. In the post-war period, the average expansion has been about five years, and the current expansion is approaching three years longer than that. A moderate recession will drop state revenues by about $20 billion annually for several years.

The May Revision also assumes the continuation of existing federal fiscal policy. Yet, Congress and the President have suggested major changes to Medicaid, trade and immigration policy, and the federal tax structure. Many of the proposed changes could have serious and detrimental effects on the state's economy and budget. For instance, the repeal of the Affordable Care Act passed by the House of Representatives in early May would cost the state an estimated $4.3 billion in lost federal funds in 2020, increasing to $18.6 billion by 2027 (with a General Fund impact of $3.3 billion in 2020, increasing to $13 billion in 2027). Such a massive cost shift to the state would necessitate major spending cuts and threaten the health care of the 5 million Californians who have gained coverage in recent years.

Proposition 2 establishes a constitutional goal of having 10 percent of tax revenues in the Rainy Day Fund. By the end of 2017-18, the state's Rainy Day Fund will have a total balance of $8.5 billion (66 percent of the constitutional target). While a full Rainy Day

Fund might not eliminate the need for further spending reductions in case of a recession or major federal policy changes that trigger a budget crisis, saving now will allow the state to spend from its Rainy Day Fund later to soften the magnitude and length of any necessary cuts. In contrast, the state was forced to address the huge budget shortfalls from 2002 through 2012 shown in Figure INT-07 without the benefit of a significant Rainy Day Fund.

Figure INT-07
**Balanced Budgets Have Been Quickly Followed by Huge Deficits**[1/]




[1/] Budget shortfalls or surplus, measured by the annual Governor's Budget.

# Summary Charts

This section provides various statewide budget charts and tables.

Figure SUM-01
**2017-18 May Revision**
**General Fund Budget Summary**
(Dollars in Millions)

| | 2016-17 | 2017-18 |
|---|---|---|
| **Prior Year Balance** | $4,515 | $723 |
| Revenues and Transfers | $118,540 | $125,912 |
| **Total Resources Available** | **$123,055** | **$126,635** |
| Non-Proposition 98 Expenditures | $71,729 | $71,166 |
| Proposition 98 Expenditures | $50,603 | $52,852 |
| **Total Expenditures** | **$122,332** | **$124,018** |
| **Fund Balance** | **$723** | **$2,617** |
| Reserve for Liquidation of Encumbrances | $980 | $980 |
| Special Fund for Economic Uncertainties | -$257 | $1,637 |
| **Budget Stabilization Account/Rainy Day Fund** | **$6,713** | **$8,488** |

Figure SUM-02

**General Fund Expenditures by Agency**

(Dollars in Millions)

| | 2016-17 | 2017-18 | Change from 2016-17 Dollar Change | Change from 2016-17 Percent Change |
|---|---|---|---|---|
| Legislative, Judicial, Executive | $3,507 | $3,333 | -$174 | -5.0% |
| Business, Consumer Services & Housing | 494 | 382 | -112 | -22.7% |
| Transportation | 225 | 241 | 16 | 7.1% |
| Natural Resources | 3,024 | 2,873 | -151 | -5.0% |
| Environmental Protection | 90 | 85 | -5 | -5.6% |
| Health and Human Services | 34,685 | 33,669 | -1,016 | -2.9% |
| Corrections and Rehabilitation | 10,944 | 11,194 | 250 | 2.3% |
| K-12 Education | 50,813 | 53,575 | 2,762 | 5.4% |
| Higher Education | 14,606 | 14,743 | 137 | 0.9% |
| Labor and Workforce Development | 179 | 127 | -52 | -29.1% |
| Government Operations | 1,789 | 745 | -1,044 | -58.4% |
| General Government: | | | | |
| Non-Agency Departments | 805 | 692 | -113 | -14.0% |
| Tax Relief/Local Government | 459 | 435 | -24 | -5.2% |
| Statewide Expenditures | 712 | 1,924 | 1,212 | 170.2% |
| **Total** | **$122,332** | **$124,018** | **$1,686** | **1.4%** |

Note: Numbers may not add due to rounding.

Figure SUM-03

**2017-18 Total State Expenditure by Agency**

(Dollars in Millions)

| | General Fund | Special Funds | Bond Funds | Total |
|---|---|---|---|---|
| Legislative, Judicial, Executive | $3,333 | $3,369 | $175 | $6,877 |
| Business, Consumer Services & Housing | 382 | 856 | 414 | 1,652 |
| Transportation | 241 | 11,639 | 863 | 12,743 |
| Natural Resources | 2,873 | 1,457 | 973 | 5,303 |
| Environmental Protection | 85 | 2,928 | 25 | 3,038 |
| Health and Human Services | 33,669 | 25,441 | - | 59,110 |
| Corrections and Rehabilitation | 11,194 | 2,664 | - | 13,858 |
| K-12 Education | 53,575 | 109 | 658 | 54,342 |
| Higher Education | 14,743 | 177 | 321 | 15,241 |
| Labor and Workforce Development | 127 | 718 | - | 845 |
| Government Operations | 745 | 231 | 6 | 982 |
| General Government: | | | | 0 |
| Non-Agency Departments | 692 | 1,979 | 5 | 2,676 |
| Tax Relief/Local Government | 435 | 1,905 | - | 2,340 |
| Statewide Expenditures | 1,924 | 2,490 | - | 4,414 |
| **Total** | **$124,018** | **$55,963** | **$3,440** | **$183,421** |

Note: Numbers may not add due to rounding

Figure SUM-04
**General Fund Revenue Sources**
(Dollars in Millions)

| | 2016-17 | 2017-18 | Change from 2016-17 Dollar Change | Change from 2016-17 Percent Change |
|---|---|---|---|---|
| Personal Income Tax | $83,161 | $88,961 | $5,800 | 7.0% |
| Sales and Use Tax | 24,494 | 24,470 | -24 | -0.1% |
| Corporation Tax | 10,210 | 10,894 | 684 | 6.7% |
| Insurance Tax | 2,483 | 2,538 | 55 | 2.2% |
| Alcoholic Beverage Taxes and Fees | 375 | 377 | 2 | 0.5% |
| Cigarette Tax | 79 | 65 | -14 | -17.7% |
| Motor Vehicle Fees | 24 | 24 | 0 | 0.0% |
| Other | 727 | 358 | -369 | -50.8% |
| **Subtotal** | **$121,553** | **$127,687** | **$6,134** | **5.0%** |
| Transfer to the Budget Stabilization Account/Rainy Day Fund | -3,013 | -1,775 | 1,238 | -41.1% |
| **Total** | **$118,540** | **$125,912** | **$7,372** | **6.2%** |

Note: Numbers may not add due to rounding.

Figure SUM-05
**2017-18 Revenue Sources**
(Dollars in Millions)

| | General Fund | Special Funds | Total | Change From 2016-17 |
|---|---|---|---|---|
| Personal Income Tax | $88,961 | $1,888 | $90,849 | $5,825 |
| Sales and Use Tax | 24,470 | 11,032 | 35,502 | 816 |
| Corporation Tax | 10,894 | - | 10,894 | 684 |
| Highway Users Taxes | - | 6,864 | 6,864 | 1,959 |
| Insurance Tax | 2,538 | - | 2,538 | 55 |
| Alcoholic Beverage Taxes and Fees | 377 | - | 377 | 2 |
| Cigarette Tax | 65 | 2,026 | 2,091 | 906 |
| Motor Vehicle Fees | 24 | 8,599 | 8,623 | 1,580 |
| Other Regulatory Fees | 1 | 7,140 | 7,141 | -2,155 |
| Other | 357 | 14,234 | 14,591 | 686 |
| **Subtotal** | **$127,687** | **$51,783** | **$179,470** | **$10,358** |
| Transfer to the Budget Stabilization Account/Rainy Day Fund | -1,775 | 1,775 | 0 | 0 |
| **Total** | **$125,912** | **$53,558** | **$179,470** | **$10,358** |

Note: Numbers may not add due to rounding.

# K-12 Education

California provides instruction and support services to roughly six million students in grades kindergarten through twelve in more than 10,000 schools throughout the state. A system of 58 county offices of education, more than 1,000 local school districts, and more than 1,000 charter schools provides instruction in English, mathematics, history, science, and other core competencies to provide students with the skills they will need upon graduation for either entry into the workforce or higher education.

The May Revision includes total funding of $92.3 billion ($54.2 billion General Fund and $38.1 billion other funds) for all K-12 education programs.

## Proposition 98

Proposition 98 is a voter-approved constitutional amendment that guarantees minimum funding levels for K-12 schools and community colleges. The Guarantee, which went into effect in the 1988-89 fiscal year, determines funding levels according to multiple factors including the level of funding in 1986-87, General Fund revenues, per capita personal income, and school attendance growth or decline. The Local Control Funding Formula is the primary mechanism for distributing funding to support all students attending K-12 public schools in California.

Last June, the 2016 Budget Act set Proposition 98 funding for 2015-16 at the minimum level allowed under the Constitution. Since then, due to lower revenues, that funding level overappropriates the Guarantee by $432 million, which also creates a higher funding base for Proposition 98 going forward.

In January, the Governor's Budget proposed to eliminate this overappropriation based on actual revenues received in 2015-16, which also reduced the Guarantee in the 2016-17 and 2017-18 fiscal years. Additionally, the Governor's Budget proposed an $859 million expenditure shift from 2016-17 to 2017-18. The school community expressed concerns about reducing funding provided in a prior year and the expenditure shift.

Relative to the Governor's Budget, General Fund revenues that drive the calculation of the Guarantee are up by $326 million in 2015-16, down by $489 million in 2016-17, and are up by more than $2.5 billion in 2017-18. With this modest increase in revenues, the May Revision proposes an approach that does not reduce funding for 2015-16, while generating savings similar to the January proposal over the long term.

To achieve this balance, the Administration proposes to suspend the statutory Proposition 98 Test 3B supplemental appropriation in 2016-17, as well as the 2018-19 through 2020-21 fiscal years. Test 3B is a mechanism designed so that school funding grows at the same rate as the rest of the budget in years when economic growth is slower. Any funding reduced through this mechanism will be automatically added to the maintenance factor obligation, ensuring that school funding is restored in the long term.

The additional resources now available in both 2015-16 and 2016-17, combined with a proposed settle-up payment of $603 million, are sufficient to eliminate the $859 million expenditure shift from 2016-17 to 2017-18 proposed in the Governor's Budget.

The adjustments noted above, combined with the increase in 2017-18 revenues of more than $2.5 billion, result in increased Proposition 98 funding for the budget year of almost $1.1 billion, providing a significant boost to both the Local Control Funding Formula and one-time discretionary grants as discussed in greater detail below.

The Proposition 98 maintenance factor—an indicator of past reductions made to schools and community colleges—totaled nearly $11 billion as recently as 2011-12. At the Governor's Budget, the outstanding maintenance factor was over $1.6 billion. Primarily as a result of the increase in revenues attributable to 2017-18, Proposition 98 triggers a maintenance factor repayment of $614 million in 2017-18, reducing the outstanding maintenance factor balance to $823 million.

## K-12 Funding Priorities

The May Revision proposes to use the combination of increased one-time and ongoing resources to further advance the core priorities of the Administration—paying down debts owed to schools and investing significantly in the Local Control Funding Formula. The formula provides local flexibility on spending decisions and additional funding for students most in need of these resources in an effort to narrow the achievement gap and improve outcomes for low-achieving students. The May Revision increases funding for the formula by an additional $661 million—building upon the almost $770 million provided in the Governor's Budget. In total, the more than $1.4 billion investment will bring the formula to 97 percent of full implementation. Added investments will continue to reverse the inequities that characterized the prior school finance system, while providing the resources necessary to support core programs and services, as well as other key local investments and priorities. Funding is also provided for various workload adjustments under the new formula, as detailed in the K-12 Budget Adjustments section.

The Governor's Budget proposed almost $290 million in discretionary one-time Proposition 98 funding for school districts, charter schools, and county offices of education. The May Revision proposes almost $750 million in additional funds, providing more than $1 billion in one-time discretionary funding to schools in 2017-18. This funding will be available to further the implementation of the state-adopted academic standards, make necessary investments in professional development, provide teacher induction to beginning teachers, address infrastructure and deferred maintenance needs, and purchase instructional materials and technology to prepare both students and teachers for success. All of the funds provided will offset any applicable mandate reimbursement claims for these entities. These resources, coupled with more than $4.8 billion in one-time Proposition 98 funding provided to schools over the last three budgets for the same purposes, will reduce the outstanding mandate debt owed to local educational agencies to $1.3 billion, consistent with the Administration's goal to pay down debt.

## Educator Workforce

The 2016 Budget provided funding for several programs at the Commission on Teacher Credentialing to increase teacher recruitment. To date, the Commission has accomplished the following:

- Forty-one grants have been awarded to 33 public and private postsecondary institutions to create or improve four-year programs that integrate a baccalaureate degree and a teacher preparation program. These grants will save new teachers approximately $20,000 by eliminating an additional year of school.
- A total of 24 grants have been awarded under the Classified School Employee Teacher Training Program to school districts and county offices of education, enabling 960 classified employees to work toward earning a teaching credential. The first report of program and participant progress is due on January 1, 2018.
- The Tulare County Office of Education has been awarded a five-year grant to create the California Center on Teaching Careers. The Center will recruit individuals into the teaching profession by providing outreach and referral services, both online and at regional centers. The Center will be online in July and open regional centers at County Offices of Education in Los Angeles, Riverside, Shasta, San Diego, and Sonoma, Ventura, and Sacramento counties before the start of the 2017-18 school year.

To further teacher recruitment, the May Revision proposes to leverage federal funds to attract and support the preparation and continued learning of committed teachers, principals, and other school leaders. Using the flexibility provided under the federal Every Student Succeeds Act, the May Revision directs additional federal resources to enhance the state's efforts to address recruitment and retention issues throughout the state, with particular focus on critical shortage areas and high need fields.

## Special Education

As outlined in the 2017-18 Governor's Budget summary, the Department of Finance held four special education stakeholder discussions during the spring to solicit feedback on the current special education program and reactions to recent reports on special education finance in California. The discussions were open to all interested parties and included parents, as well as representatives from school districts, Special Education Local Plan

Areas, charter schools, community-based organizations and county offices of education. The meetings were held in Sacramento, Los Angeles, San Mateo and Fresno.

Much of the input received centered on the core elements outlined in the Governor's Budget. Given the scope of the feedback and the complexity of this program area, the Administration will spend additional time in the coming months examining these issues to chart a path forward that will maximize resources to serve students while increasing transparency and accountability.

## K-12 School Facilities

A 2016 audit of Proposition 1D School Facilities Program expenditures issued by the Office of State Audits and Evaluations determined that 1,533 projects, representing over $3 billion in Proposition 1D funds, have been completed without ensuring the bond funds were appropriately expended. The audit found instances in which school districts inappropriately used school facilities bond funding to purchase vehicles, tractors, tablets, golf carts, mascot uniforms, and custodial/cleaning supplies. To ensure the appropriate use of all School Facilities Program bond funds and effective program accountability and oversight, the Administration proposed the following two-fold approach in the Governor's Budget:

- Design grant agreements that define basic terms, conditions, and accountability measures for participants that request funding through the School Facilities Program.
- Enact legislation requiring facility bond expenditures to be included in the annual K-12 Audit Guide, where independent auditors verify that local educational agencies participating in the School Facilities Program have appropriately expended state resources.

The Office of Public School Construction has presented a comprehensive grant agreement to the State Allocation Board for approval, and the Administration has proposed legislation to require independent audits of school facilities expenditures. It is anticipated that the State Allocation Board will take action on a final grant agreement at its next meeting. As stated in the Governor's Budget, the Administration will support the expenditure of Proposition 51 funds when both the grant agreement and audit requirement are in place to ensure that taxpayers' dollars are spent appropriately.

## K-12 Budget Adjustments

Significant Adjustments:

- Local Property Tax Adjustments—An increase of $188.7 million Proposition 98 General Fund in 2016-17 and $327.9 million in 2017-18 for school districts, special education local plan areas, and county offices of education as a result of lower offsetting property tax revenues in both years.
- Average Daily Attendance (ADA)—An increase of $26.2 million in 2016-17 and $74.1 million in 2017-18 for school districts, charter schools, and county offices of education under the Local Control Funding Formula as a result of a smaller drop in ADA growth overall between those two years.
- Proposition 39—The California Clean Energy Jobs Act was approved by voters in 2012, and increases state corporate tax revenues. For 2013-14 through 2017-18, the measure requires half of the increased revenues, up to $550 million per year, be used to support energy efficiency projects. The May Revision decreases the amount of energy efficiency funds available to K-12 schools in 2017-18 by $46.7 million to $376.2 million to reflect reduced revenue estimates.
- Categorical Program Growth—An increase of $2.4 million Proposition 98 General Fund for selected categorical programs, based on updated estimates of ADA.
- Cost-of-Living Adjustments—An increase of $3.2 million Proposition 98 General Fund to selected categorical programs for 2017-18 to reflect a change in the cost-of-living factor from 1.48 percent at the Governor's Budget to 1.56 percent at the May Revision.

## Child Care and State Preschool

The state funds nine child care and early education programs and dozens of other programs that support services including quality of care, family resource and referral agencies, and local child care planning councils. These programs are administered by the Department of Education and the Department of Social Services. Families can access child care and early education subsidies through centers that contract directly with the Department of Education, local educational agencies, or through vouchers from county welfare departments or alternative payment program providers.

The 2016 Budget Act increased provider reimbursement rates and added an additional 2,959 full-day State Preschool slots. The Governor's Budget proposed pausing these additional augmentations until 2018-19, due to lower-than-expected General Fund revenue growth projected at that time. However, with modest General Fund revenue improvement, the May Revision proposes fully restoring this funding.

Significant Adjustments:

- Standard Reimbursement Rate—An increase of $67.6 million General Fund ($43.7 million Proposition 98, $23.9 million non-Proposition 98) to increase the reimbursement rate to reflect the full 10 percent increase made at the 2016 Budget Act. An additional increase of $92.7 million General Fund ($60.7 million Proposition 98, $32 million non-Proposition 98) to provide a six-percent increase to the reimbursement rate for State Preschool and other direct-contracted child care and development providers, beginning July 1, 2017.
- Regional Market Reimbursement Rate—An increase of $42.2 million General Fund to increase the maximum reimbursement ceiling for voucher-based child care providers to the 75th percentile of the 2016 survey, beginning January 1, 2018.
- Full-Day State Preschool—An increase of $7.9 million Proposition 98 for an additional 2,959 slots.
- Cal WORKs Stage 2—A decrease of $18.1 million non-Proposition 98 General Fund in 2017-18 to reflect revised estimates for CalWORKs Stage 2 caseload and the cost per case.
- CalWORKs Stage 3—A decrease of $12.8 million non-Proposition 98 General Fund in 2017-18 to reflect revised estimates for CalWORKs Stage 3 caseload and cost per case.

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# Higher Education

Higher Education includes the California Community Colleges (CCC), the California State University (CSU), the University of California (UC), the Student Aid Commission, and several other entities.

The Budget includes total funding of $33 billion ($18 billion General Fund and local property tax and $15 billion other funds) for all higher education entities in 2017-18.

## Making Investments in Community Colleges for Student Success

The May Revision adds new investments on top of the funding included in the Governor's Budget to support community colleges' efforts to improve student success. With an additional $160 million investment in discretionary base resources (totaling $184 million Proposition 98 General Fund in 2017-18), it is the Administration's expectation that the CCCs will improve completion rates, reduce time-to-degree, close gaps in achievement between underrepresented student groups and their peers, and improve students' employment opportunities. These efforts will require community colleges to implement an integrated, institution-wide approach to student success, which is supported by the Governor's Budget proposal investing $150 million Proposition 98 General Fund for the Guided Pathways Program. This program will provide colleges the opportunity to develop a framework for integrating many community college programs, including

Student Success and Support, Student Equity, Student Success for Basic Skills, and Strong Workforce.

The May Revision proposes to strengthen the CCC Chancellor's Office capacity to provide greater leadership and expertise to the colleges, focused on improving student outcomes. After engaging with staff from the Chancellor's Office throughout the spring, the May Revision proposes six new positions and additional resources, including funding for a Deputy Chancellor responsible for shifting the office's operations away from compliance and regulatory oversight toward providing colleges with direct technical assistance and guidance.

## Encouraging Progress on CSU Graduation Initiative

Through the Graduation Initiative 2025, the CSU is making progress on ambitious goals—increasing the four-year graduation rate to at least 40 percent, increasing the two-year transfer graduation rate to at least 45 percent, and closing achievement gaps for low-income students, first-generation college students, and students from underrepresented minority groups.

The Governor's Budget stated that the Graduation Initiative can only be successful if education leaders across the system are clear about what a CSU education entails—both upon entry and at graduation. When freshmen are not able to take college-level courses when they arrive on campuses—and instead get placed in "developmental" or "remedial" courses—they are less likely to graduate in four years. Since that time, the CSU has announced it will make significant changes to its alignment with K-12 schools, how college readiness is determined, and its own curriculum and pedagogy. The CSU is discussing a new goal that all students complete at least 30 units of college-level courses in their first year. The Administration intends to continue to work with the CSU and its campuses to move these completion efforts forward as rapidly as possible.

## Reducing the Cost Structure at the University of California

Two years ago, the Governor reached an agreement with the UC President focused on reducing the cost structure of the UC. The Board of Regents endorsed the framework in May 2015. The commitments recognize that lowering the cost structure while maintaining quality requires the University to reevaluate how students' prior academic experiences are recognized as part of UC degree programs, how academic programs are structured, and how instruction is delivered.

The UC has fulfilled many key commitments, including articulating more clearly across more than 20 majors the courses community college students need to transfer to UC campuses; testing the use of new learning technologies that adapt instruction to meet student needs and targeted advising and other resources to students who might need the support; and piloting new policies on pricing for summer sessions. The UC appears to be on track in other areas—such as creating sequences of courses that allow students to graduate in three years and reviewing the requirements of more than 75 percent of majors on all campuses.

However, the UC has not made progress consistent with the timelines in the agreement in the following two areas:

- The agreement requires the UC to have piloted activity-based costing in the College of Humanities, Arts and Social Sciences at Riverside and in three departments at two other campuses. Campus leaders can use data to better plan enrollment and determine which, and how, courses should be offered by understanding both costs and student outcomes. While the Office of the President has selected Davis and Merced to participate in the other pilots, progress on completing the pilot has been insufficient.
- The agreement requires that by the 2017-18 academic year, each campus except Merced and San Francisco will enroll at least one entering transfer student for every two entering freshmen. Such a policy lowers students' costs and maximizes the use of state resources across the higher education system. The Office of the President expects to achieve this target in 2017-18 systemwide and at seven campuses —but not at Riverside and Santa Cruz.

In April, the State Auditor released a report on the UC Office of the President that identified concerns related to undisclosed reserves, budgeting practices, employee compensation, and justification for systemwide initiatives, and made recommendations to the Board of Regents and the Office of the President. Activity-based costing could provide campus leaders and the public with more transparency about costs and budgeting at the University.

The May Revision sets aside $50 million from the funds appropriated to the UC to be released only once the Director of Finance certifies that the UC has made progress in implementing these reforms and the Auditor's recommendations. These changes are vital to improving public confidence in the use of tuition and state revenues.

## Addressing Rising Tuition at the Public Universities

The state's direct support to UC and CSU has grown by nearly $2 billion since 2012-13. Since the Governor's Budget was released, both the UC Board of Regents and the CSU Board of Trustees have approved tuition increases for 2017-18. Specifically:

- In January, the Regents approved a 2.5-percent increase, growing annual tuition from $11,220 to $11,502 (growth of $282).
- In March, the Trustees approved a 5-percent increase for undergraduate students, growing annual tuition from $5,472 to $5,742 (growth of $270), and 6.5-percent increases for graduate students. These growth rates exceed any standard measure of inflation.

A significant portion of any tuition increase at the UC or the CSU is borne by the state's General Fund, because the state traditionally has maintained the maximum Cal Grant award amounts equal to the tuition charges at the UC and the CSU. For 2017-18, the boards' actions grow Cal Grant costs by $48.9 million—$20.9 million for UC students and $28 million for CSU students—above the amount provided in the Governor's Budget. Of the $2 billion estimated to be spent on the Cal Grant program in 2017-18, $896.7 million (45 percent) is for UC students and $699.7 million (35 percent) is for CSU students.

When the public universities raise tuition, therefore, there is less funding available for other financial aid programs. The May Revision recognizes the role that private institutions play in providing access to postsecondary education for California students. The May Revision reverses a scheduled reduction in the maximum Cal Grant tuition award for new students attending private institutions accredited by the Western Association of Schools and Colleges (WASC), maintaining the award at $9,084 (instead of $8,056) at a cost of $8 million in 2017-18. These costs are funded by redirecting some of the state funds the UC and the CSU would have otherwise received—shifting $4 million from each budget. With this increased commitment of state support, the private WASC-accredited institutions must do more to enroll California's neediest students, ease the transfer process from community colleges, and expand online programs. The increase in funding is contingent on the institutions making measurable achievements in these areas.

Rising Cal Grant costs from tuition hikes will also limit the state's ability to increase General Fund support in the future. The state has increased General Fund spending by at least 4 percent annually since 2012—while tuition has been flat. Going forward, the universities should plan for 3-percent growth annually beginning in 2018-19. If the universities raise tuition in the future, additional downward adjustments to state support may be needed to cover the higher Cal Grant costs.

## Expanding Online Education

Online education can provide students with scheduling flexibility, improve time to degree, and reduce a student's cost of attendance—such as transportation costs for students not in close proximity to a college and textbook costs, particularly when these courses incorporate the use of open educational resources.

The system offices for each of the public segments are collectively spending more than $30 million annually specifically to expand access to quality instruction through online education, and many campuses are spending significant additional resources from their own budgets. The Administration intends to bring together segment leaders and other stakeholders to determine how deployment of these resources can be aligned to achieve shared goals and better serve students. In addition, the Governor is requesting the Community College Chancellor's Office to develop a proposal by November 2017 for a completely online community college.

## Significant Adjustments

The following are significant adjustments included in the Budget.

### California Community Colleges

- Chancellor's Office State Operations—In lieu of the Governor's Budget proposal to provide the Chancellor's Office with two new Vice Chancellor positions, the May Revision proposes $618,000 General Fund and $454,000 in reimbursement authority to provide the Chancellor's Office with six positions and funding to support a second Deputy Chancellor. The resources are expected to shift the mission of the Chancellor's Office from regulatory oversight to assisting colleges in improving student outcomes.

- Increased Operating Expenses—A net increase of $160 million Proposition 98 General Fund to support increased community college operating expenses in areas such as employee benefits, facilities, professional development, converting faculty from part time to full time, and other general expenses.
- Apportionments—An increase of $34.1 million Proposition 98 General Fund, which includes the following:
  - An increase of $28.5 million to reflect the amounts earned back by community college districts that declined in enrollment during the previous three fiscal years.
  - An increase of $23.6 million to reflect unused prior-year enrollment growth funding.
  - An increase of $3.5 million to reflect a change in the cost-of-living adjustment from 1.48 percent to 1.56 percent.
  - A decrease of $21.5 million to adjust enrollment growth from 1.34 percent to 1 percent.
- Deferred Maintenance and Instructional Equipment—An increase of $92.1 million in one-time Proposition 98 General Fund and settle-up for deferred maintenance, instructional equipment, and specified water conservation projects.
- Full-Time Student Success Funding—An increase of $1.9 million Proposition 98 General Fund to reflect an increased estimate of eligible Cal Grant B and Cal Grant C recipients in 2017-18 and to align grant amounts with a statewide annual academic year average of $600 per full-time student.
- Equal Employment Opportunity Program—An increase of $1.8 million Employment Opportunity Fund to promote equal employment opportunities in hiring and promotion at community college districts.
- Categorical Program Cost of Living Adjustment—An increase of $229,000 Proposition 98 General Fund to reflect a change in the cost-of-living adjustment from 1.48 percent to 1.56 percent for the Disabled Student Programs and Services program, the Extended Opportunities Programs and Services program, the Special Services for CalWORKs Recipients program, and the Child Care Tax Bailout program.

- Proposition 39—The California Clean Energy Jobs Act was approved by voters in 2012 and increases state corporate tax revenues. For 2013-14 through 2017-18, the measure requires half of the increased revenues, up to $550 million per year, to be used to support energy efficiency projects. The May Revision decreases the amount of energy efficiency funds available to community colleges in 2017-18 by $5.8 million to $46.5 million to reflect reduced revenue estimates.
- Local Property Tax Adjustment—An increase of $68.2 million Proposition 98 General Fund in 2016-17 as a result of decreased offsetting local property tax revenues.
- Student Enrollment Fee Adjustment—A decrease of $24.8 million Proposition 98 General Fund as a result of increased offsetting student enrollment fee revenues.

## California State University

- Redirection of Funds to Cal Grant Program—A reduction of $4 million General Fund ongoing, with funds redirected to fund increased costs of the Cal Grant program.
- Transportation Research, Education, and Training—An increase of $2 million State Transportation Fund for transportation research and transportation-related education and training pursuant to SB 1.

## University of California

- Implementation of Commitments Related to Cost Structure—A set-aside of $50 million General Fund, the release of which is conditioned on certification by the Director of Finance that the UC has achieved the commitments made in the agreement with the Governor related to activity-based costing and enrollment of transfer students and completed recommendations to the Regents and UC Office of the President made by the State Auditor in its recent report on the UC Office of the President.
- Redirection of Funds to Cal Grant Program—A reduction of $4 million General Fund ongoing, with funds redirected to fund increased costs of the Cal Grant program.
- Transportation Research—An increase of $5 million State Transportation Fund for transportation research pursuant to SB 1.

## California Student Aid Commission

- Cal Grant Program Costs—An increase of $33.3 million in total funds in 2016-17 and a decrease of $71.2 million in total funds in 2017-18 to account for the following:
    - Temporary Assistance for Needy Families (TANF) Reimbursements—An increase of $194 million in federal TANF reimbursements in 2017-18, which reduces the amount of General Fund needed for program costs. Combined with the TANF reimbursements included in the Governor's Budget, the May Revision offsets $1.1 billion in General Fund costs for Cal Grants with TANF reimbursements in 2017-18.
    - Participation Estimates—An increase of $33 million in 2016-17 and $71.6 million in 2017-18 to reflect an increase in the number of new recipients in 2016-17.
    - Tuition Award for CSU Students—An increase of $28 million in 2017-18 to reflect the costs of an increase in the maximum Cal Grant tuition award for students attending the CSU. Because the CSU Board of Trustees approved an increase in tuition of $270, the maximum award would increase by a corresponding amount.
    - Tuition Award for UC Students—An increase of $20.9 million in 2017-18 to reflect the costs of an increase in the maximum Cal Grant tuition award for students attending the UC. Because the UC Board of Regents approved an increase in tuition of $282, the maximum award would increase by a corresponding amount.
    - Tuition Award for Students at Private Institutions—An increase of $8 million General Fund in 2017-18 to maintain the maximum Cal Grant tuition award for students attending private institutions accredited by Western Association of Schools and Colleges at $9,084 (growing by $1,028 from $8,056 in existing law).
    - Cal Grant B Supplement—A decrease of $5.6 million College Access Tax Credit Fund to align with revised estimates of resources in the fund. The May Revision includes a total of $5.6 million for this program, which will fund a supplemental award of $24 for each student who receives a Cal Grant B Access Award.
- Middle Class Scholarship Program Appropriation—A net decrease of $10 million for revised cost estimates related to the Governor's Budget's proposal to phase out the Middle Class Scholarship Program.

# Health and Human Services

The Health and Human Services Agency oversees departments and other state entities that provide health and social services to California's vulnerable and at-risk residents.

The May Revision includes $158.7 billion ($33.7 billion General Fund and $125.1 billion other funds) for all health and human services programs, a decrease of $324.8 million General Fund compared to the Governor's Budget.

## End of Coordinated Care Initiative

The Coordinated Care Initiative (CCI) was created in 2012 in an effort to reduce state costs and improve health care delivery by coordinating services through a single health plan. The Governor's Budget reflected the finding that the CCI was no longer cost-effective and that under current law, the program would end in 2017-18. This resulted in removing In-Home Supportive Services (IHSS) benefits from Medi-Cal managed care capitation rates, returning bargaining for IHSS workers' wages and benefits to the seven CCI counties, and re-establishing the county share-of cost in IHSS at 35 percent of non-federal costs rather than a maintenance-of-effort structure. The state pays 65 percent of the non-federal costs. The net fiscal result to counties was an estimated cost of $623 million. In recognition that 1991 Realignment funds, which fund counties' share of IHSS, were insufficient to cover this magnitude of increase, the Administration indicated its desire to mitigate, to the extent possible, the impact on counties.

The May Revision reflects an updated estimate of $592.2 million to return to the share-of-cost structure for counties. In discussions this spring, counties emphasized the need for financial assistance, more predictability of costs, and time to adjust to any changes. The May Revision provides significant help in each of these areas. The May Revision includes an infusion of General Fund and other state resources to help offset these costs as well as additional mitigations to assist the counties during this transition. The proposal assumes all other programs supported by the 1991 Realignment Social Services Subaccount continue to be funded as they have been.

The proposal includes the following fiscal provisions:

- General Fund Assistance—$400 million General Fund in 2017-18; $330 million in 2018-19; $200 million in 2019-20 and $150 million in 2020-21 and ongoing.
- Use of Growth Funds—Redirection of all Vehicle License Fee growth for three years from the Health, County Medical Services Program (CMSP), and Mental Health Subaccounts to provide additional resources for IHSS. In years four and five, 50 percent of this Vehicle License Fee growth will be redirected. The portion of the growth funds redirected from the Health Services Subaccount, which would have offset General Fund costs in CalWORKs, are reflected in the General Fund assistance totals above.
- Maintenance-of-Effort Structure—Institute a maintenance-of-effort (MOE) structure rather than a 65-percent state/35-percent county share-of-cost structure. The General Fund will pay the difference between the MOE and the non-federal share of IHSS costs.
- More Current Cost Data—Change the methodology for calculation of IHSS caseload in the Social Services Subaccount to use the current estimate of caseload and cost information.
- Inflation Factor—Create a new base for county costs of IHSS in 2017-18 that includes services and administrative costs. An annual inflation factor will be phased in and applied to the base. In year one (2017-18), the inflation factor will be zero; in the second year, the inflation factor will be 5 percent. In future years, the inflation factor would be on a sliding scale based on 1991 Realignment revenue performance. If revenue growth is negative, then there would be no inflation factor applied. If revenue growth is less than 2 percent, then the inflation factor would be 3.5 percent. If revenue growth is above 2 percent, the inflation factor would be 7 percent (the expected IHSS annual cost growth).

The estimated net amounts of county costs not covered are:

- 2017-18: $141 million
- 2018-19: $129 million
- 2019-20: $230 million
- 2020-21: $251 million

Based on revenue growth allocations under the CCI pilot, the Health, CMSP, and Mental Health Subaccounts received funding that allowed their base amounts to grow beyond normal expectations. While not receiving growth for a limited-time period—as proposed in the May Revision—requires an adjustment, redirecting the growth to IHSS reflects the highest funding priority. Under current law, counties are obligated to provide a 3.5-percent annual rate increase to Institutions for Mental Disease. In recognition of the reduced amount of growth funding going to the Mental Health Subaccount, the May Revision proposes that in any year the Mental Health Subaccount does not receive its full growth allocation, this rate increase requirement will be suspended.

The May Revision also proposes that counties experiencing financial hardship due to the increased costs of IHSS may apply to the Department of Finance for a low-interest loan to help cover those costs. The Department of Finance will work with counties to determine how such a loan would be structured and what documentation would be needed for application.

Because IHSS costs and 1991 Realignment revenues can be volatile, the Administration has agreed to on-going discussions with the counties about the costs of the program within the structure of 1991 Realignment and the impact of the inflation factor as it relates to overall 1991 Realignment revenues.

The May Revision also proposes that any amounts counties may owe the state through 2015-16 because of the Board of Equalization's miscalculations of sales tax revenue allocations will not have to be repaid.

### IHSS Collective Bargaining

With the return of collective bargaining to all counties, the Administration reviewed the current structure of local bargaining and is proposing several adjustments.

Under CCI, if a county negotiated a wage and benefit increase, its MOE increased by its 35 percent share. State participation has been capped at $12.10 per hour for wages and benefits since 2007-08. The May Revision maintains the 35-percent county share of negotiated increases and proposes that the state participation cap should float to always be $1.10 above the hourly minimum wage set in Chapter 4, Statutes 2016 (SB 3), for large employers. Like SB 3, the cap would rise with inflation once the minimum wage reaches $15 per hour.

Many counties are at or exceed the current state cap of $12.10. For those counties, the state would agree to participate at its 65-percent share of costs up to a 10-percent increase in wages and benefits over three years.

Beginning July 1, 2017, the May Revision proposes that if a county does not conclude bargaining with its IHSS workers within nine months, the union may appeal to the Public Employment Relations Board.

## Department of Health Care Services

Medi-Cal, California's Medicaid program, is administered by the Department of Health Care Services. Medi-Cal is a public health care coverage program that provides comprehensive health care services at no or low cost for low-income individuals. The federal government mandates basic services, including: physician services; family nurse practitioner services; nursing facility services; hospital inpatient and outpatient services; laboratory and radiology services; family planning; and early and periodic screening, diagnosis, and treatment services for children. In addition to these mandatory services, the state provides optional benefits such as outpatient drugs, home and community-based services, and medical equipment. The Department also operates the California Children's Services and the Primary and Rural Health programs, and oversees county-operated community mental health and substance use disorder programs.

Significant Adjustments:

- Current Year Shortfall—The Medi-Cal shortfall has decreased by approximately $620 million General Fund compared to the Governor's Budget. The reduction is primarily attributable to savings from drug rebates in Medi-Cal managed care, retroactive managed care rate adjustments, and slower caseload growth than previously estimated. Medi-Cal program expenditures are expected to exceed the appropriation included in the 2016 Budget Act by approximately $1.1 billion.

- Medi-Cal Estimate—Given the size of the current year shortfall, the May Revision provides $495,000 ($248,000 General Fund) to upgrade the system used to produce the Medi-Cal estimate. These upgrades would enhance system stability and improve flexibility, making it more adaptable to changes in the Medi-Cal program. The system enhancements will provide estimates that are more accurate and improve reporting capabilities. In addition, a request for information to solicit contractors to assist the Department in refining the current estimate process will be issued in 2017-18.

- Duals Demonstration Pilot—Pursuant to the provisions of current law, the Coordinated Care Initiative (CCI) is discontinued in 2017-18; however, the Governor's Budget proposed reinstating three programmatic components of the CCI. Based on the lessons learned from CCI, the May Revision continues: (1) extension of the Cal MediConnect program, (2) mandatory enrollment of dual eligibles, and (3) long-term services and supports integration into managed care, except IHSS. The May Revision includes savings of approximately $8 million General Fund based on the proposed continuation of the Cal MediConnect duals demonstration pilot. This represents a decrease of approximately $12 million in General Fund savings compared to Governor's Budget due to a decrease in the number of beneficiaries choosing to participate in the pilot. Although CCI was not cost-effective during the initial demonstration period, the duals demonstration program provides the potential to reduce the cost of health care and improve health outcomes for individuals that maintain Cal MediConnect enrollment.

- Proposition 56—An increase of $19.8 million in the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 (Proposition 56) allocation to Medi-Cal based on updated revenue projections. Overall revenue from Proposition 56 increased by $23.3 million compared to the Governor's Budget.

- Newly Qualified Immigrants (NQI) Affordability and Benefit Program—An increase of $48 million General Fund from the elimination of the NQI Affordability Benefit Program. Existing law authorizes the Department to implement a program to transition most NQIs in the state-only full-scope Medi-Cal to a Covered California qualified health plan. Due to operational and programmatic uncertainties, the Administration will stop efforts to implement the program.

- Palliative Care—Net General Fund costs of $1.3 million in 2017-18 for the implementation of the Palliative Care Services program no later than January 1, 2018. This program will serve adult Medi-Cal beneficiaries and provide one-time grants to health care plans of up to $50,000 for provider network development, data analysis, and other palliative care program development costs. Conditions eligible for palliative care include cancer, congestive heart failure, chronic obstructive pulmonary disease, or liver disease for patients with no more than a one-year life expectancy.

- California Medicaid Management Information System (CA-MMIS)—$14.9 million ($5.2 million General Fund), to fund 7 new positions, an extension of 21 limited-term positions, and contract resources to support both the ongoing maintenance and operations of the existing Legacy CA-MMIS claims processing system and to continue the design, development, and implementation efforts to modernize the CA-MMIS system using a modular approach.

- Implementation of the Covered Outpatient Drug Final Rule—The May Revision proposes statutory changes to outpatient drug reimbursement in the Medi-Cal program consistent with the requirements of the federal Covered Outpatient Drug Rule and the proposal released by the Department earlier this year. The proposed legislation codifies a new drug ingredient reimbursement methodology and dispensing fee based on a study of pharmacy provider costs in the Medi-Cal program.

- Contract Pharmacies and the 340B Program—The May Revision also proposes statutory changes to end the use of contract pharmacies in the 340B program in Medi-Cal, consistent with recent concerns raised by federal agencies. This change avoids inappropriate duplicate discounts by claiming federal drug rebates on already discounted drugs and prevents unnecessary overpayment in Medi-Cal. Planned Parenthood, a 340B entity, does not use contract pharmacies and is unaffected by this change.

- Performance Outcomes System—$6.2 million General Fund for the implementation of functional assessment tools for populations receiving specialty mental health services through county mental health plans. These assessment tools will gather data from both a clinician's and caregiver's perspective and will be used to track outcomes for Medi-Cal mental health services provided to children up to age 21. The revised funding reflects training, staff, and information technology costs associated with implementation of the newly selected functional assessment tools.

- Federal Cures Act Opioid Targeted Response Grant—$44.7 million in federal funding to reflect the award of the federal Opioid State Targeted Response grant. This grant will allow for increased medication-assisted treatment for individuals with substance use disorders. The Department will establish 15 "hub and spoke" systems, where a Narcotic Treatment Program will serve as a "hub" and the "spokes" are regional physicians approved to prescribe medication-assisted treatment. For counties that do not have a Narcotic Treatment Program, the lead entity could be the county, an alcohol and other drug facility, a federally qualified health center, or other group. Narcotic Treatment Programs will begin providing expanded substance use disorder services by September 1, 2017 as required by the grant provisions.

- School-Based Mobile Vision Care Services—The Department authorized a three-year pilot program in Los Angeles County for school-based mobile vision services that ends on June 30, 2018. Based on requirements under current law, the Department will conduct an evaluation of the pilot program by the end of calendar year 2017. Pending the outcome of the evaluation, the Administration proposes to expand the mobile vision services program statewide in 2018-19 provided it resulted in improved treatment for children in the county.

### 1991 State-Local Realignment Health Account Redirection

Chapter 24, Statutes of 2013 (AB 85), modified the 1991 Realignment Local Revenue Fund (LRF) distributions to capture and redirect county savings due to the implementation of federal health care reform. The net savings are redirected for county CalWORKs expenditures, which reduce General Fund spending on the CalWORKs program.

County savings are estimated to be $585.9 million in 2016-17, and $688.8 million in 2017-18, or approximately $143 million higher compared to Governor's Budget estimates. A portion of these additional General Fund savings will be redirected to offset increased county IHSS program costs. Additionally, actual expenditure data reported by counties indicates county net savings in 2014-15 were $255.6 million higher than estimated based on the preliminary reconciliation of 2014-15. This amount is slightly higher than the estimate included in the Governor's Budget. The May Revision continues to assume reimbursement of this amount from the counties in 2017-18. Final reconciliation for 2014-15 will be completed in June 2017 using audited data from the counties. The General Fund savings are reflected in the CalWORKs program within the Department of Social Services' budget.

## Department of Social Services

The Department of Social Services serves, aids, and protects needy and vulnerable children and adults in ways that strengthen and preserve families, encourage personal responsibility, and foster independence. The Department's major programs include CalWORKs, CalFresh, IHSS, Supplemental Security Income/State Supplementary

Payment (SSI/SSP), Child Welfare Services, Community Care Licensing, and Disability Determination.

Significant Adjustments:

- Immigration Services—An increase of $15 million General Fund—bringing total funding to $30 million—to further expand the availability of legal services for people seeking naturalization services, deportation defense, or assistance in securing other legal immigration status.
- Continuum of Care Reform—An increase of $11.2 million General Fund to implement a higher hourly rate for county social worker and probation staff for certain administrative components, and to provide foster youth placed with relative caregivers the same infant supplement grant and dual agency rate as federally eligible foster youth.
- IHSS—A net decrease of $22.5 million General Fund in 2016-17 and $80.8 million General Fund in 2017-18 due primarily to a projected decrease in costs associated with IHSS provider travel time and medical accompaniment wait time, partially offset by increases in caseload growth, average hours per case, average cost per case, and other miscellaneous adjustments.
- CalWORKs—A decrease of $19.1 million General Fund and federal Temporary Assistance for Needy Families (TANF) block grant funds in 2016-17 and $35.5 million General Fund and TANF in 2017-18 to reflect updated caseload and average cost per case projections.
- SSI/SSP—A decrease of $34.1 million General Fund in 2016-17 and $37.3 million General Fund in 2017-18 to reflect updated caseload and average cost per case projections.

## Department of State Hospitals

The Department of State Hospitals administers the state mental health hospital system, the Forensic Conditional Release Program, the Sex Offender Commitment Program, and the evaluation and treatment of judicially and civilly committed patients.

### Metropolitan State Hospital

To address the long-term needs of a growing in-patient population, the 2016 Budget Act included $31.2 million to develop a security fence at the Metropolitan State Hospital, enabling the department to increase the number of beds by over 200 in 2018-19. With these new unit activations scheduled for the fall of 2018, staff recruitment, training, and personnel for patient movement is needed. The May Revision includes $7.8 million General Fund to support the movement of approximately 150 civilly-committed patients at the Metropolitan State Hospital to another building, to allow additional Incompetent to Stand Trial (IST) waitlist commitments to be placed in secured treatment beds beginning in 2018-19.

### Incompetent to Stand Trial Admissions

The Department of State Hospitals continues to experience a significant increase in the number of IST referrals from local courts, with an annual growth rate of approximately 10 percent since 2013-14. Despite 188 authorized jail-based competency restoration beds, referrals continue to outpace capacity, with the IST pending placement list at approximately 550 individuals in early May 2017.

To further address this ongoing growth, the Administration continues to work with county partners, the Judicial Council, and stakeholders to find approaches to address the growth of IST referrals.

In addition to previous proposals to increase bed capacity, the May Revision includes $3.1 million General Fund to establish additional jail-based competency treatment programs for up to 24 beds. DSH continues to identify opportunities for collaboration with counties that will result in efficiencies and reduced costs for housing and treatment of ISTs.

## Department of Developmental Services

The Department of Developmental Services provides individuals with developmental disabilities a variety of services that allow them to live and work independently or in supported environments. California is the only state that provides developmental services as an individual entitlement. The state is in the process of closing all state-operated developmental centers, except for the secure treatment area at the Porterville Developmental Center, and the Canyon Springs community facility.

### Safety Net Services

The May Revision proposes $7.5 million General Fund in 2017-18 to establish acute crisis services in the community given the closure of the developmental centers and the state-run crisis units at the Fairview and Sonoma Developmental Centers. These new services are part of the Department's overall Safety Net Plan to provide access to crisis services after the closure of the developmental centers. The Department will also allocate existing resources for this purpose.

These additional resources will be used to develop Stabilization, Training, Assistance and Reintegration (STAR) acute crisis facilities in the community that will provide services similar to those currently provided at the Northern and Southern STAR homes, as well as to establish two, 24-hour mobile acute crisis teams to provide in-home treatment and associated stabilization services and supports to help maintain individuals in their existing residences.

In addition, DDS proposes to establish intensive transition and support services to promote a successful transition into the community for those leaving secured treatment settings as well as to prevent such placements. These services will provide wrap-around residential services through individual evaluations, assessments, and treatment recommendations. These are targeted to individuals with developmental disabilities who are transitioning from the Secure Treatment Program at Porterville Developmental Center or are currently living in the community but require additional mental health and behavioral supports to address significant behavioral challenges.

# Public Safety

This Chapter describes items in the May Revision related to California's correctional system and local public safety.

## Department of Corrections and Rehabilitation

The California Department of Corrections and Rehabilitation incarcerates the most violent felons, supervises those released to parole, and provides rehabilitation programs to help them reintegrate into the community. The Department provides safe and secure detention facilities and necessary support services to inmates, including food, clothing, academic and vocational training, as well as health care services. The May Revision includes total funding of $11.4 billion ($11.1 billion General Fund and $308 million other funds) for the operation of the Department in 2017-18.

Compared to the Governor's Budget projections, changes in the adult inmate and parole population have resulted in decreases of $29.4 million General Fund in 2016-17 and $21.3 million General Fund in 2017-18. The revised average daily population projections for adult inmates are 129,275 in the current year and 127,693 in the budget year, an increase of 260 in 2016-17 and a decrease of 466 inmates in 2017-18. The revised average daily parolee population projection is 44,445 in the current year and 47,274 in the budget year, an increase of 759 and 2,513 parolees, respectively. Figure SAF-01 reflects the population impacts of Proposition 57, the Public Safety and Rehabilitation Act of 2016, as a result of the revised implementation timeline proposed in the emergency regulations discussed in more detail below.

Figure SAF-01

**Spring 2017 Population Estimates**

| | 2016-17 | 2017-18 |
|---|---|---|
| Adult Inmate Average Daily Population Projection | 129,275 | 130,368 |
| Proposition 57 Juvenile Sentencing | - | -81 |
| Proposition 57 Non-Violent Parole Process | - | -469 |
| Proposition 57 Enhanced Credit Earning | - | -2,125 |
| **Total Inmate Average Daily Population Projection** | **129,275** | **127,693** |
| | | |
| Adult Parole Average Daily Population Projection | 44,445 | 45,707 |
| Proposition 57 Parole Impact | - | 1,567 |
| **Total Parole Average Daily Population Projection** | **44,445** | **47,274** |

Since the Governor's Budget estimate, changes in the juvenile population have resulted in a decrease of 22 wards in the current year and 43 wards in the budget year, resulting in a decrease of $813,000 General Fund in 2016-17 and $3.3 million General Fund in 2017-18. The revised average daily population projections for wards are 683 in the current year and 736 in the budget year. The increase in the overall ward population from 2016-17 to 2017-18 is attributable to the expected increase in juvenile court commitments as a result of Proposition 57.

## Proposition 57 — Public Safety and Rehabilitation Act of 2016

Proposition 57 reforms the juvenile and adult criminal justice system in California by creating a parole consideration process for non-violent offenders who have served the full term for their primary criminal offense in state prison, authorizing the California Department of Corrections and Rehabilitation to award credits earned for good conduct and approved rehabilitative or educational achievements, and requiring judges to determine whether juveniles charged with certain crimes should be tried in juvenile or adult court. Proposition 57 is intended to enhance public safety and stop the revolving door of crime by establishing more incentives for inmates to participate in rehabilitative programs. The implementation of Proposition 57 is expected to provide a durable solution for the state to maintain compliance with the court-ordered population cap of 137.5 percent of design capacity, thereby avoiding the court-ordered release of inmates and ending federal court oversight.

As of May 3, 2017, the prison population was at 135.0 percent of design capacity, which is below the court-ordered population cap of 137.5 percent of design capacity.

The state has used a variety of measures to stay below the population cap, including the implementation of several population reduction measures, and the addition of new bed and programming space. Absent the implementation of Proposition 57, it is estimated that adult inmate population projections estimate that population would increase by approximately 1,000 inmates per year.

On April 13, 2017, the Office of Administrative Law approved the Department's Proposition 57 emergency regulations. Pursuant to the emergency regulations, implementation of the Good Conduct Credits began on May 1, 2017; the new parole consideration process for non-violent offenders will go into effect on July 1, 2017; and Milestone Completion, Rehabilitative Achievement, and Educational Merit Credits will go into effect on August 1, 2017. The juvenile justice provisions went into effect immediately after Proposition 57 passed in November 2016.

The Governor's Budget assumed that the non-violent parole process and credit earning changes authorized by Proposition 57 would be implemented on October 1, 2017, and estimated an average daily adult inmate population reduction of 1,959 inmates in 2017-18. The May Revision reflects the accelerated implementation dates proposed in the emergency regulations, which results in a revised estimated population impact of 2,675 inmates in 2017-18, growing to an inmate reduction of approximately 11,500 in 2020-21. These figures are preliminary and subject to considerable uncertainty. The inmate reduction will allow the Department to remove all inmates from one of two remaining out-of-state facilities in 2017-18, and begin removing inmates from the second facility as early as January 2018.

Overall, the May Revision estimates that Proposition 57 will result in net savings of $38.8 million in 2017-18, growing to net savings of approximately $186 million in 2020-21. These estimates will be updated in the 2018-19 Governor's Budget based on the final regulations.

The Governor's Budget proposed resources for additional case records staff to review and make various changes to inmate classification files related to the new credit earning structure and parole process, parole workload due to additional releases from prison, and Board of Parole Hearings workload for the increased number of inmates considered for release. The May Revision augments the Governor's Budget proposal by $1 million General Fund, for a total of $6.7 million to implement Proposition 57.

## Drug and Contraband Interdiction

The Department's three-year drug and contraband interdiction pilot program, aimed at reducing illegal drugs and contraband entering prisons, ends on June 30, 2017. The Department implemented the pilot program at 11 institutions, including more intensive interdiction at Calipatria State Prison; California State Prison, Solano; and California State Prison, Los Angeles County. Interdiction strategies include searching of staff, visitors and vendors entering prisons, as well as packages received by these prisons; drug and contraband canine search teams; and increased surveillance technology.

The University of California, Berkeley evaluated the pilot program, and while the evaluation found some improvement at the three institutions that used intensive interdiction strategies, the overall results were mixed and inconclusive. Given these results, the Department determined expanding its current canine program is the most effective use of resources.

The Department currently has 28 permanent canine teams. The May Revision adds 42 canine teams to provide two canine teams at each institution. The canine teams will conduct routine searches of housing units, classrooms, offices, buildings and primary entrance points for contraband, including incoming mail and packages, as well as the institution perimeter, parking lots and vehicles. The total cost of the canine expansion is $6.7 million in 2017-18 and $5.9 million ongoing.

These efforts are intended to reduce inmate violence, increase safety for staff and inmates, and promote a drug-free rehabilitative environment.

## Prison Infrastructure

California has experienced record levels of rainfall in the past year, and severe storms caused significant damage to prison roofs. Failing prison roofs have resulted in damage to electrical systems and housing units, and interruptions in rehabilitation programs, education programs, and mental health treatment. The May Revision includes $34.9 million to replace roofs at institutions with the greatest need—Salinas Valley State Prison, Pleasant Valley State Prison, and the California Correctional Institute.

## Proposition 47

Proposition 47, passed by the voters on November 4, 2014, requires misdemeanor rather than felony sentencing for certain property and drug crimes, and permits inmates previously sentenced for these reclassified crimes to petition for resentencing. Based on spring projections, Proposition 47 is expected to reduce the 2016-17 adult inmate average daily population by 4,425, compared to 5,247 in 2015-16. The 2016-17 population reduction is attributable primarily to avoided new admissions since the effect of the resentencing component was mostly realized in 2015-16.

Proposition 47 requires state savings resulting from the proposition to be transferred into the Safe Neighborhoods and Schools Fund. The fund is used to reduce truancy and support drop-out prevention programs in K-12 schools, increase victim services grants, and support mental health and substance use disorder treatment services. The Director of Finance is required, on or before July 31 of each fiscal year, to calculate the state savings for the previous fiscal year compared to 2013-14.

The Department of Finance currently estimates net savings of $45.6 million when comparing 2016-17 to 2013-14, an increase of $3.5 million over the estimated savings in 2015-16 and an increase of $2.6 million over the January estimate for 2016-17. See Figure SAF-02 for the distribution of the net savings. This estimate assumes savings from a reduction in the state's adult inmate population, and increased costs due to a temporary increase in the parole population and trial court workload associated with resentencing. The estimate also takes into consideration the savings associated with fewer felony filings and more misdemeanor filings, and the number of offenders resentenced and released from the Department of State Hospitals. In calculating state savings attributable to Proposition 47, the state considers the average length of stay of offenders that are no longer prison-eligible. Consequently, in future years, Proposition 57 will reduce the estimated length of stay for offenders that would have, absent Proposition 47, otherwise been sentenced to prison. Savings are currently estimated to increase to approximately $75 million by 2019-20.

## Post Release Community Supervision

The May Revision includes $15.4 million General Fund for county probation departments to supervise the temporary increase in the average daily population of offenders on Post Release Community Supervision as a result of the implementation of court-ordered measures and Proposition 57. This is an increase of $4.4 million over the amount estimated in the Governor's Budget as a result of the revised implementation schedule of Proposition 57.

Figure SAF-02

**Proposition 47 2017-18 Allocation**

| | | Finance Calculation per Proposition 47 | |
|---|---|---|---|
| *Department* | *Purpose* | *Percentage* | *2017-18* [1] |
| Board of State and Community Corrections | Mental Health Treatment<br>Substance Use Disorder Treatment<br>Diversion Programs | 65% | $29,370,000 |
| State Department of Education | Improve Outcomes for K-12 Students<br>Reduce Truancy<br>Support Students at Risk of Dropping Out of School or who are Victims of Crime | 25% | $11,296,000 |
| California Victim Compensation and Government Claims Board | Support Trauma Recovery Centers that Serve Crime Victims | 10% | $4,518,000 |
| State Controller's Office | Audit of Grant Programs | - | $389,000 |
| | **Total** | 100% | $45,573,000 |

[1] 2017-18 calculation is based on estimated 2016-17 savings. Programmatic allocations are determined after accounting for the administrative costs of the State Controller's Office.

# Transportation

The Transportation Agency is responsible for developing and coordinating the policies and programs of the state's transportation entities to improve the mobility, safety, and environmental sustainability of California's transportation system.

## Implementing the Road Repair and Accountability Act of 2017

The repair, maintenance, and efficient operation of the state's transportation system are vital to California's economic growth. State and local funding has fallen dramatically below the levels needed to maintain the system, and a recent transportation study found that Californians spend on average $762 annually on vehicle repair costs due to poorly maintained roads. California continues to be among the top five states with the longest commute duration.

The gas tax historically has been state and local governments' primary source of funding for highways and roads. Yet, since the last time it was raised in 1994, the effect of inflation has eroded its purchasing power. Construction and repair costs have risen over the past two decades, but gas tax revenues have been stagnant as vehicles became more fuel efficient.

In response, the Administration and the Legislature recently passed a historic agreement that reverses years of inflation eroding transportation funding and provides stable long-term funding for both state and local transportation infrastructure priorities.

The Road Repair and Accountability Act of 2017 provides an average of $5.4 billion per year for state and local transportation, per Chapter 5, Statutes of 2017 (SB 1). The package includes a combination of new revenues, accelerated loan repayments, reforms, accountability measures, and constitutional protections. The new revenues are split evenly between state and local transportation priorities, and a ten-year funding plan provides $54 billion with an emphasis on a "fix-it first" strategy that focuses on repairing and maintaining the existing transportation infrastructure. Also included are significant investments in public transit.

Over the next ten years, the $54 billion transportation package will provide $15 billion for highway repairs and maintenance, $4 billion in bridge repairs, $3 billion in the state's trade corridors, and $2.5 billion for the state's most congested commute corridors. Local roads will receive more than $15 billion in new funding for maintenance and repairs and $2 billion in matching funds for local partnership projects. Transit and intercity rail will receive $8 billion in additional funding, and local governments will have access to $1 billion for active transportation projects to better link travelers to transit facilities.

The improvements will be implemented starting in 2017-18, and the Administration is working to quickly advance the benefits of these programs to the public. Caltrans, cities, and counties are already accelerating projects into early 2017-18. New revenues will be allocated by formula to cities and counties for local roads, and to transit agencies for operations and capital expenditure in February 2018. The California Transportation Commission and the State Transportation Agency will move quickly to develop guidelines for new competitive funding programs, so that grant awards can be made next spring in programs such as the Transit and Intercity Rail Capital Program, the Trade Corridor Enhancement Program, the Solutions for Congested Corridor Program, and the Active Transportation Program.

The transportation package also includes the following reforms and efficiencies at Caltrans to streamline project delivery and advance projects more quickly:

- Inspector General — Establish an Inspector General to audit Caltrans operations and find efficiencies.

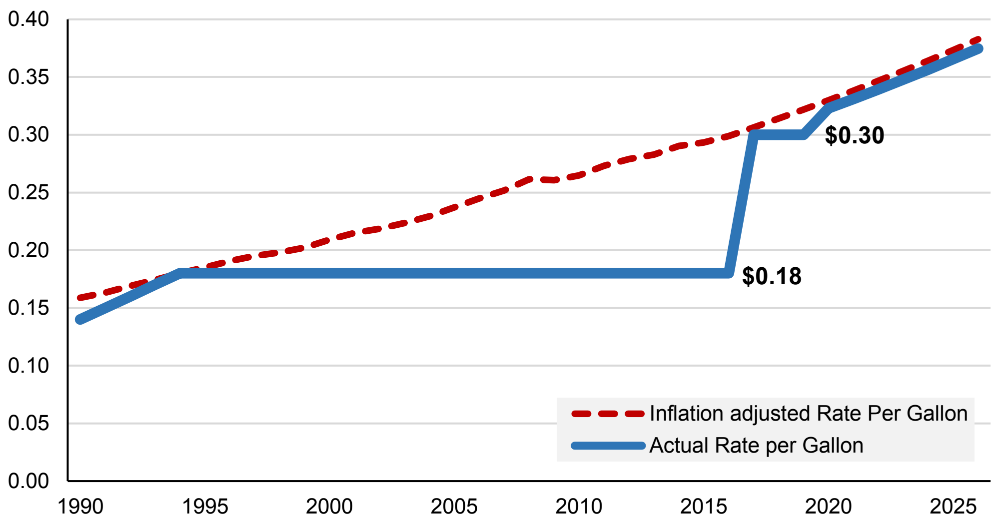
- State Highway Performance Plan — Establish measurable targets for improvements including regular reporting to the California Transportation Commission, the Legislature, and the public.

- Advanced Mitigation—Advance project environmental mitigation to get early permitting approval as well as stakeholder and advocate buy-in on activities, reducing the challenges that can occur later which sometimes delay projects.
- California Transportation Commission Oversight—Expand the Commission's oversight to cover each phase of project delivery to better track Caltrans' staffing needs and increase transparency.

The Act's resources come from the following annual sources:

- Transportation Improvement Fee—$1.6 billion from a new, graduated fee from $25 to $175 per vehicle, with inflation adjustments starting in 2020-21. This is expected to generate $16.3 billion over the next 10 years.
- Increase and Stabilize Gasoline Excise Tax—$2.4 billion from a 12-cent increase in the base gasoline excise tax rate and by stabilizing the incremental rate starting in 2019-20. The broader gasoline tax would then be adjusted annually for inflation. As shown in Figure TRN-01, this increase restores the gas tax's purchasing power to 1994 levels.

Figure TRN-01
**SB 1 Restores Lost Purchasing Power for the Gas Tax**




- Diesel Excise Tax—$725 million from an 11-cent increase in the diesel excise tax, with inflation adjustments starting in 2020-21.

- Diesel Sales Tax—$353 million from an increase in the diesel sales tax from 9 percent to 13 percent.
- Zero Emission Vehicle Fee—$19 million from an annual fee of $100 on Zero Emission Vehicles starting in 2020-21 and adjusted annually for inflation.
- Accelerated Loan Repayments—$706 million in loan repayments over the next three years, with $256 million to be used for transit projects in the Transit and Intercity Rail Capital Program, and $450 million to be used for maintenance and repairs on local roads and the state highway system.
- Caltrans Efficiencies—$100 million in cost-saving reforms.

The May Revision includes $2.8 billion in new appropriations, and these partial-year revenues will be distributed evenly between state and local transportation priorities (See Figure TRN-02).

## California Transportation Agency

Significant Adjustment:

- Intercity and Commuter Rail Program—$25 million Public Transportation Account from increased diesel sales tax revenues to be allocated by the Agency for operations and capital improvements of intercity and commuter rail services.

## California Transportation Commission

The California Transportation Commission advises and assists the Secretary of the Transportation Agency and the Legislature in formulating and evaluating state policies, plans, and funding for California's transportation infrastructure.

Significant Adjustment:

- Expanded Oversight—$1.1 million Public Transportation Account and State Highway Account for 4 positions to oversee the annual development and ongoing management of the State Highway Operation and Protection Program and Local Streets and Roads Program funding. Additionally, the Commission will allocate and oversee Caltrans' Capital Outlay Support project budgets and assist in implementation of the Congested Corridors, Local Partnership, and Trade Corridor Enhancement programs. Finally, the Commission will have an increased role in administering new program funding for the current Active Transportation and State Transportation Improvement programs.

Figure TRN-02

**2017-18 Road Maintenance and Accountability Act Funding**

(Dollars in Millions)

| | Program | | Amount |
|---|---|---|---|
| Local Allocations | Local Streets and Roads | | $445.4 |
| | Transit and Intercity Rail Capital Program | | $330.0 |
| | State Transit Assistance | | $305.1 |
| | Local Partnership Program | | $200.0 |
| | Active Transportation Program | | $100.0 |
| | Local Planning Grants | | $25.0 |
| | | Total: | **$1,405.5** |
| State Allocations | SHOPP/Maintenance | | $445.4 |
| | Bridges and Culverts | | $400.0 |
| | Congested Corridors | | $250.0 |
| | Trade Corridor Enhancement | | $199.8 |
| | Department of Parks and Recreation | | $54.3 |
| | Freeway Service Patrol | | $25.0 |
| | Department of Food and Agriculture | | $17.3 |
| | CSU and UC Research | | $7.0 |
| | Workforce Development Board | | $5.0 |
| | | Total: | **$1,403.8** |
| Administration | State Controller's Office | | $0.1 |
| | California Transportation Commission | | $0.2 |
| | Department of Motor Vehicles | | $3.8 |
| | | Total: | **$4.1** |
| Revenue | Transportation Improvement Fee | | $727.0 |
| | Gasoline Excise Tax | | $1,251.5 |
| | Diesel Excise Tax | | $399.7 |
| | Diesel Sales Tax | | $200.1 |
| | General Fund Loan Repayment | | $235.0 |
| | | Total: | **$2,813.3** |

## State Transit Assistance Program

The State Transit Assistance program provides a share of revenues from diesel sales taxes and the new Transportation Improvement Fee, as well as a statutory share of proceeds from Proposition 1B bonds and the sale of cap and trade credits, to fund operating subsidies for local transit agencies. The State Controller distributes these revenues based on a statutory allocation formula.

Significant Adjustment:

- Increased State Transit Assistance Grants—$305 million Public Transportation Account to local transit agencies for operations and capital costs.

## Department of Transportation

The Department of Transportation has nearly 20,000 employees and a budget of $10.9 billion. Caltrans designs and oversees the construction of state highways, operates and maintains the highway system, funds three intercity passenger rail routes, and provides funding for local transportation projects. The Department maintains 50,000 road and highway lane miles and more than 12,000 state bridges, and inspects 407 public-use and special-use airports and heliports.

Significant Adjustments:

- Increased Highway Repair and Maintenance—$445 million Road Maintenance and Repair Account and redirection of 48 positions associated with expiring base workload to accelerate repaving efforts and pavement repair projects.

- Increased Bridge and Culvert Repairs—$400 million Road Maintenance and Repair Account to begin addressing the backlog of maintenance and repairs on these components of the state's infrastructure.

- Solutions for Congested Corridor Program—$250 million Road Maintenance and Repair Account for projects to begin addressing some of the state's most urgent regional traffic congestion concerns.

- Trade Corridor Enhancement Program—$200 million Trade Corridor Enhancement Account to fund projects along the state's major trade corridors, providing ongoing funding for a program originally established with one-time Proposition 1B bond funding.

- Expanded Freeway Service Patrols—$25 million Road Maintenance and Repair Account to expand these local services that partner with local and state law enforcement to reduce traffic by clearing vehicles and other incidents during rush hours.
- Expanded Transit and Intercity Rail Capital Program—$330 million Public Transportation Account, including $85 million in General Fund loan repayments.
- Local Partnership Program—$200 million in matching funds for local and regional transportation projects in jurisdictions which contribute new locally-generated revenues.
- Expanded Active Transportation Program—$100 million for pedestrian and bicycle infrastructure projects that will increase access to transit facilities.
- Local Planning Grants—$25 million in grants available to regional transportation planning agencies to update regional transportation plans consistent with the sustainability and greenhouse gas reduction requirements of SB 375.
- Support—$40 million Road Maintenance and Repair Account to redirect 195 positions associated with expiring base workload to initiate the most urgent pavement repair projects. The Department will work with the California Transportation Commission and the Department of Finance to assess workload, identify efficiencies, and determine future staffing needs.
- Office of the Inspector General—$9.5 million State Highway Account to establish the new Office of the Inspector General to audit Caltrans and find efficiencies. The office will be resourced with 58 total staff, composed of 10 new positions and 48 positions redirected from Caltrans' Division of Audits.

## Shared Revenues

Funding provided through the Shared Revenue program is apportioned to local jurisdictions based on statutory formulas to help maintain the fiscal strength of the various governmental entities throughout the state.

Significant Adjustment:

- Local Road Maintenance—$445 million Road Maintenance and Rehabilitation Account for cities and counties to be distributed by the State Controller.

## Department of Motor Vehicles

The Department of Motor Vehicles promotes driver safety by licensing drivers, and protects consumers and ownership security by issuing vehicle titles and regulating vehicle sales.

Significant Adjustments:

- Collection of the Transportation Improvement Fee—$3.8 million Road Maintenance and Rehabilitation Account for higher credit card transaction costs associated with collecting the additional Transportation Improvement Fee revenues.
- Motor Voter Expansion—$1.8 million General Fund and $5.2 million Motor Vehicle Account to implement a single-step opt-out voter registration process, pursuant to Chapter 729, Statutes of 2015 (AB 1461).
- Federal Conformity—$23 million Motor Vehicle Account and 166 positions to address workload requirements associated with conforming to federal requirements for driver licenses and identification cards.

# Natural Resources

The Natural Resources Agency consists of 26 departments, boards, commissions, and conservancies responsible for administering programs to conserve, protect, restore, and enhance the natural, historical, and cultural resources of California. The Budget includes total funding of $9.4 billion ($2.9 billion General Fund) for all programs included in this Agency.

## Drought Ends, But Adaptation to Climate Change Continues

The recent drought included the driest four consecutive years on record in California. As testament to California's extreme variability in precipitation, the winter and spring of 2016-17 have been the wettest on record in the northern Sierra Nevada Mountains. Nearly all of the state's major reservoirs hold above-average storage, and the water content of the snowpack—the source of one-third of the water Californians use—is currently nearly double the statewide average.

In April 2017, following unprecedented water conservation and plentiful winter rain and snow, the Governor ended the drought state of emergency in most of California. However, the long-term damage from the drought will continue for years in many areas. For example, a state of emergency still exists in Fresno, Kings, Tulare and Tuolumne—as the state continues to work on infrastructure projects to connect households with dry wells to water systems. Recent drought conditions have killed an estimated 100 million trees as a result of an unprecedented bark beetle outbreak in drought-stressed forests.

The May Revision reflects a shift from immediate emergency drought actions to ongoing efforts to make the state more resilient to climate change and to continue water conservation.

## Concluding Drought Response

Since the first emergency drought declaration in January 2014, the Administration has worked with the Legislature to appropriate $3.9 billion to assist drought-impacted communities and provide additional resources for critical water infrastructure projects, wildfire suppression and wildlife emergencies.

In January, the Governor's Budget proposed an additional $178.7 million to continue the state's emergency response to the drought, with the expectation that the Administration would continue to monitor conditions through the 2017 rainy season and reevaluate budget year needs.

The May Revision proposes $62.9 million, a decrease of $115.8 million, to address continuing drought legacy issues, such as tree mortality and groundwater shortages in the Central Valley. (See Figure RES-01).

Significant Adjustments:

- Department of Forestry and Fire Protection (CAL FIRE)—$38.7 million General Fund and $3 million State Responsibility Area Fund for expanded fire protection in the 2017 fire season in recognition of continuing tree mortality. These funds will support the continuation of firefighter surge capacity, California Conservation Corps fire crews, and exclusive use of one large air tanker. In addition, the May Revision includes additional ongoing firefighting resources for CAL FIRE to respond to the changes brought on by climate change, demographics, invasive species and forest health conditions. (See Climate Adaptation Extended Fire Season.)
- Department of Water Resources—$8.5 million, including: (1) $5 million General Fund to provide emergency drinking water supplies for small communities in the Central Valley still faced with dry private domestic wells, and (2) $2.6 million General Fund and $900,000 Harbors and Watercraft Fund to implement the state's Delta Smelt Resiliency Strategy such as aquatic weed control, adaptive food management and distribution, and wetlands flood and drain operations.

Figure RES-01
**Concluding Drought Response**
(Dollars in Millions)

| Investment Category | Department | Program | Governor's Budget Amount | May Revision Amount |
|---|---|---|---|---|
| Protecting Water Supplies and Water Conservation | Department of Water Resources | Local Assistance for Small Communities | $5.0 | $5.0 |
| | Water Board | Water Rights Management | $5.3 | $0.6 |
| | Department of Water Resources | Drought Management and Response | $7.0 | — |
| | Department of Water Resources | Save Our Water Campaign | $2.0 | $1.0 |
| Emergency Response | Department of Forestry and Fire Protection | Enhanced Fire Protection | $91.0 | $41.7 |
| | Office of Emergency Services | Emergency Water Tank Program/ Tree Mortality | $52.7 | $8.5 |
| | Office of Emergency Services | State Operations Center | $4.0 | — |
| Protecting Fish and Wildlife | Department of Fish and Wildlife | At-Risk Fish Monitoring | $8.2 | $2.6 |
| | Department of Water Resources | Delta Smelt | $3.5 | $3.5 |
| **Total** | | | **$178.7** | **$62.9** |

- Department of Fish and Wildlife—$2.6 million General Fund to sustain resilient systems for protection of fish and wildlife affected by future drought and climate change. During the recent drought, significant investments have been made to ensure that the state is better prepared to mitigate the harmful effects of future droughts on fish and wildlife resources. These resiliency measures include installation of filtration equipment at fish hatcheries, improved water use efficiency at wildlife areas, and a network of fish and wildlife monitoring systems throughout the state.
- Office of Emergency Services—$8.5 million General Fund, including $2 million for local agencies to remove dead or dying trees and $6.5 million to continue providing through the next year water tanks, periodic refills of tanks, and tank storage and sanitization to nine counties that continue to experience the effects of the recent drought.
- State Water Resources Control Board—$600,000 General Fund to conclude water curtailment compliance and enforcement actions.

## Making Water Conservation a Way of Life

A key priority in the California Water Action Plan—the Administration's priorities for addressing water policies—is to make conservation a way of life. Improving water conservation is essential for a more reliable water supply and to make the state more resilient to future droughts, particularly given population increases and climate change.

While declaring the end to the drought emergency, the Governor directed the Water Board to maintain urban water use reporting requirements and prohibitions on wasteful practices, such as hosing off sidewalks. At the same time, the Department of Water Resources, Energy Commission, Public Utilities Commission, Department of Food and Agriculture, and the Water Board issued a final report with recommendations to (1) use water more wisely, (2) eliminate water waste, (3) establish permanent water use and conservation reporting requirements, (4) strengthen local drought resilience, and (5) improve agricultural water use efficiency and drought planning. The recommendations were developed through a public process and implementation will require new legislation to establish new water efficiency standards and additional drought planning requirements.

The May Revision supports these efforts to make conservation a way of life through the following adjustments:

- Water Board—An additional five positions to be funded within existing resources to implement the Administration's proposed legislation, released in early April, which would (1) establish new urban water use efficiency standards, (2) enhance state and local enforcement of these standards, (3) establish permanent water use and conservation reporting requirements, and (4) implement new urban water shortage contingency plans and agricultural water management plans.
- Department of Water Resources—$1 million General Fund to support the Save Our Water campaign, which will continue public outreach to encourage water conservation.

## Pursuing Collaborative Solutions to Water Supply Reliability and Watershed Health

The Bay-Delta Water Quality Control Plan establishes water quality control measures needed to protect municipal, industrial, agricultural, and environmental uses of water in the watershed of the Sacramento-San Joaquin Delta and San Francisco Bay.

This watershed, comprising millions of acres of farmland, is a source of drinking water for two-thirds of the state's population. The waterways of the Bay-Delta estuary and its tributaries also provide critical habitat for numerous threatened and endangered species and recreationally and commercially important species. The Water Board is currently in the process of updating the Plan.

The Water Board relies on a regulatory approach to balance competing demands for water in the Delta. As directed by the Governor, the Natural Resources Agency is leading negotiations with water districts and environmental groups to develop voluntary agreements to achieve similar goals. These agreements would improve ecological flows and habitat for species, create water supply and regulatory certainty for water users, and facilitate a collaborative approach to the Water Board's update to the Plan. If sufficient, voluntary agreements could be accepted by the Water Board in lieu of a regulatory proceeding to amend water right permits and licenses.

The May Revision includes the following proposals to reach voluntary agreements with federal, state, local, and non-governmental organizations:

- Department of Fish and Wildlife—An increase of $1.1 million General Fund and five positions for the Department of Fish and Wildlife to provide legal, scientific, and other expertise. Voluntary efforts are needed to integrate watershed restoration projects with updated river flow regimes to help salmon and other fisheries thrive. Agreements would describe additional water flows and habitat restoration and other measures in the major rivers that flow to the Delta.
- Department of Water Resources—An increase of $50 million Proposition 1 to support Central Valley multi-benefit flood management projects that include, but are not limited to, actions identified by voluntary agreements. State funding would incentivize and complement additional contributions from local public agencies, federal agencies, and others. This proposal is a component of the $387.1 million acceleration of Proposition 1 flood control investments (see Enhancing Dam Safety and Flood Control).

In addition, the Administration proposes $21 million Proposition 13 water bond funds over the next five years for the Department of Water Resources to provide scientific and engineering expertise and construction funds to support salmon habitat restoration actions on the San Joaquin River and its tributaries.

### Climate Adaption Extended Fire Season

Calendar year 2016 was the state's hottest on record. This is the third consecutive year such a record has been set. Climate change has and will continue to lengthen the fire season in California. In 2016, CAL FIRE responded to nearly 1,000 more fires than average. Furthermore, half of California's 20 largest wildfires on record have occurred in the last 10 years. With warming temperatures, California can expect droughts to occur in the future with greater frequency and intensity.

Recent drought conditions have resulted in millions of acres of forestland becoming vulnerable to bark beetle infestation. With approximately 100 million dead and dying trees statewide, forests face a higher risk of destructive wildfires.

Significant adjustment:

- CAL FIRE—$42 million General Fund and $309,000 various special funds and reimbursements to expand the state's firefighting capabilities and extend the fire season. Specifically, this proposal will: (1) add 42 year-round engines, (2) staff CAL FIRE engines and helitack bases one month earlier in spring, and (3) extend peak staffing in fall by approximately two weeks. These additional resources will allow CAL FIRE to complete a greater number of fuel reduction projects during the off-peak season, helping to reduce the fire risk from climate change, drought and tree mortality. The General Fund cost of this proposal will be offset through lower expenditures in CAL FIRE's Emergency Fund.

## State Fire Marshal

The Office of the State Fire Marshal is responsible for regulating hazardous liquid pipelines, developing and reviewing regulations and building standards, providing training and education in fire protection methods and enforcing fire and life safety laws and regulations in all state-owned and state-occupied buildings. Specific activities include the review of plans and construction inspections of all state-occupied facilities, as well as regular periodic inspections after occupancy.

Currently, the State Fire Marshal has a high vacancy rate, which is delaying the review of construction plans and the completion of inspections. CAL FIRE is actively working with the Department of Human Resources to improve recruitment and retention for State Fire Marshal classifications. Once the employee compensation issues have been resolved and the vacancy rate has been reduced, the Administration will work with the State Fire Marshal to provide additional resources as needed.

## Enhancing Dam Safety and Flood Control

The Department of Water Resources' Division of Safety of Dams is nationally recognized and inspects 1,250 public and private dams annually. Over the last ten years, the Department has prioritized review of existing dams for seismic risk, an effort that has led to more than $1 billion in modernization and seismic safety retrofits.

The February 2017 spillway event at Oroville Dam illustrated the public safety importance of investing in the state's water infrastructure and emergency preparedness. After both the gated flood control spillway and emergency spillway at Oroville Dam eroded during operations, the Governor directed state dam inspectors to conduct more detailed evaluations of dam structures, including spillways. The Governor ordered this new review to be expedited for dams with spillways similar to Oroville before the next flood season.

Furthermore, in recognition of the additional pressure that had been placed on flood control systems in the Central Valley as a result of several atmospheric river storms in January and February, the Administration redirected up to $50 million of existing General Fund for emergency preparedness, response, and flood risk reduction project implementation. These resources were initially utilized to (1) support flood fight specialists to work on flood protection activities like sandbagging boil rings and overtopping protection, (2) pre-position and deploy flood fighting supplies to numerous counties in anticipation of high water, and (3) complete emergency repairs such as rip-rap erosion protection, seepage berms, and breach closures. It is anticipated that remaining funds will be used for emergency rehabilitation projects to repair damages in the Sacramento and San Joaquin flood control systems as a result of this year's high flows.

The Administration proposed a comprehensive Dam Safety and Emergency Flood Response package for enactment in the current fiscal year. Since this package has not yet been enacted, the May Revision reflects this comprehensive proposal for implementation in 2017-18.

### Enhancing Dam Safety

The current dam inspection program includes a visual evaluation of appurtenance structures (like the spillway that eroded at Oroville). Over 100 dams have spillways and structures that are relatively old and pose a potential hazard to life, property, and environment in the event of failure. Although 70 percent of high hazard dams have emergency action plans (including Oroville), these plans are not currently required for all dams regulated by the Department. Furthermore, inundation maps are only created at the time a dam is built or enlarged and such maps are limited to a complete dam failure scenario.

Significant Adjustments:

- Emergency Action Plans and Inundation Maps—The Administration is proposing legislation to: (1) require dams to have an emergency action plan that is updated every ten years, or more frequently as needed, with limited exceptions for low hazard dams, (2) require all dams and critical appurtenant structures to have updated inundation maps and to update the maps every ten years, or sooner if local development patterns change, and (3) provide regulatory tools for the Department to support the above requirements, ranging from monetary fines to operational restrictions for failure to comply.
- Improvements to Emergency Action Plans—An increase of $3.5 million Dam Safety Fund for the Department and $1.8 million General Fund for the Office of Emergency Services to review and approve required inundation maps and coordinate the review of emergency action plans for incorporation into all-hazard emergency plans.
- Enhanced Dam Evaluations—An increase of $3 million Dam Safety Fund for the Department to conduct more extensive evaluations of appurtenant structures, such as spillways, gates, and outlets, than the current visual inspections. The inspections will include additional geological and hydrological evaluations as well as structural evaluations based on current design and construction standards. By October 1, 2017, the Department will perform this more comprehensive review of the 108 largest spillways under its jurisdiction. By January 1, 2018, the Department will have dam owners complete a thorough site investigation and evaluation of those spillways found to be potentially at risk, and take immediate action as needed to reduce the risk of any spillway identified to be in poor condition. By January 1, 2019, the Department will complete evaluations of the remaining spillways and direct dam owners to make required repairs or restrict reservoir operations as needed.

### Acceleration of Flood Control Investments

The state has a unique role in flood protection in the Central Valley. The Central Valley Flood Protection Plan, adopted in June 2012, describes a system-wide approach considering the interaction of all flood system components. In particular, the Plan looks beyond the traditional project-by-project approach and justification and incorporates actions on both flood system improvement and proactive floodplain management. Integrated flood management is an approach to flood risk reduction that recognizes the interconnection of flood management actions with water resources management and land use planning, including the value of coordinating across geographic and agency boundaries, integrating environmental stewardship, and promoting sustainability.

Significant Adjustment:

- Flood Management Allocation of 2014 Water Bond—An increase of $387.1 million Proposition 1 for the Department to accelerate a balanced portfolio of flood control projects over the next two fiscal years. These new funds, provided from the flood management allocation of Proposition 1, will complement existing Proposition 1E and Proposition 84 bond funds that have already been appropriated. Over the next two years, more than $1 billion will be allocated to enhance flood protection in the Central Valley, the Sacramento-San Joaquin Delta, and in other areas of the state with significant flood risk. Consistent with the system-wide approach identified in the Central Valley Flood Protection Plan, these funds will help meet the urgent needs of urban, small community, and rural areas throughout the Central Valley, Delta, and beyond.

## Natural Resources and Parks Preservation Fund

General Obligation Bond measures have been a main funding source for natural resources programs for almost two decades. Prior to 2000, bond funding was relatively modest, totaling $4.1 billion from 1976-1996. However, California voters have authorized a total of $26.7 billion for seven resources bond measures from 2000-2014. These bonds, for instance, have allowed California's substantial investments in land acquisitions over the last 16 years (1.2 million acres in fee title and 950,000 acres in easements).

While bond funding allows the state to spread payments over time, an overreliance on bond funding for natural resources programs comes with a high price. General Fund costs for debt service for natural resources bonds have increased from $200 million in 2000 to more than $1 billion in 2016-17. The debt service of the bonds ultimately costs the state more than double the initial value as interest accrues over 30 years. Furthermore, this debt service cost limits the amount of General Fund resources available for operational costs of natural resources programs and other policy priorities.

Significant Adjustment:

- Natural Resources and Parks Preservation Fund—Establish a "pay as you go" special fund to support natural resources programs previously funded by bond measures, such as water and flood management, parks, forestry, land preservation, wildlife habitat, and climate adaptation. This Fund will be established with an initial transfer of $65 million General Fund from previous appropriations for deferred maintenance at state parks. This new approach will be cost effective, as the state will get double the value for each dollar compared to bond financing. The amount of funding allocated for this Fund will be determined on a year-to-year basis.

## Department of Parks and Recreation

The Department of Parks and Recreation protects and preserves significant cultural and natural resources while providing recreational opportunities, including hiking, camping, mountain climbing, horseback riding, boating and off-highway vehicle activities. The Department achieves its mission through grant programs and a network of 280 parks, which includes beaches, trails, wildlife areas, open spaces, off-highway vehicle areas, and historic sites.

Under the Road Repair and Accountability Act of 2017 (SB 1), the Department of Parks and Recreation will receive additional revenues which will support state parks, including off-highway vehicle and boating programs. These funds derive from traditional allocation formulas for gas tax revenues and supplement the existing allocation. The Department is developing an overall spending plan for inclusion in the 2018-19 Governor's Budget. The May Revision includes an initial investment of $54 million State Parks and Recreation Fund from 2017-18 revenues:

- Fix Our Parks—An increase of $31.5 million to repair and maintain the aging infrastructure of the state park system and repair the recent damage sustained from the severe winter storms. These funds will be used to fix roads, bridges, buildings, aging water treatment systems, campgrounds, interpretive signage and archeological sites, as well as to manage forests, native habitats, plant and animal species. These projects will help mitigate future increases to the deferred maintenance backlog. A portion of these funds will provide the state's matching share to receive Federal Emergency Management Agency funding to address storm-damaged areas, including Big Sur State Park.

- Establish Partnerships to Improve Access to Parks—An increase of $1.5 million to establish a pilot project to provide transportation to Parks from urban areas and schools. This pilot program could be expanded through philanthropic support and new partnerships.

- Support Off-Highway Vehicle Recreation—An increase of $1 million for increased law enforcement, environmental monitoring, and maintenance grants supporting federal off-highway vehicle recreation. While State Parks manages nine State Vehicular Recreation Areas, which provide for off-highway vehicle recreation, nearly 80 percent of the state's off-highway vehicle recreation occurs on federal lands, supported through the grants program. This increase is in addition to the $4 million Off-Highway Vehicle Fund increase to this program included in the Governor's Budget.

- Reduce Boating Hazards—An increase of $1 million for the Abandoned Watercraft Abatement grant program to remove abandoned watercraft from California's waterways. Submerged water vessels pose a hazard to boating recreation throughout the state.

- Establish a Recruitment and Training Program—An increase of $1 million to establish a recruitment and training program for hard-to-fill classifications, including park rangers, lifeguards, maintenance workers, administrators and managers. The program also will develop strategies to better reach candidates from diverse communities.

- Fund Jurupa Parks—An increase of $18 million for the Jurupa Area Recreation and Park District.

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# Statewide Issues and Various Departments

This Chapter describes items in the Budget that are statewide issues or related to various departments.

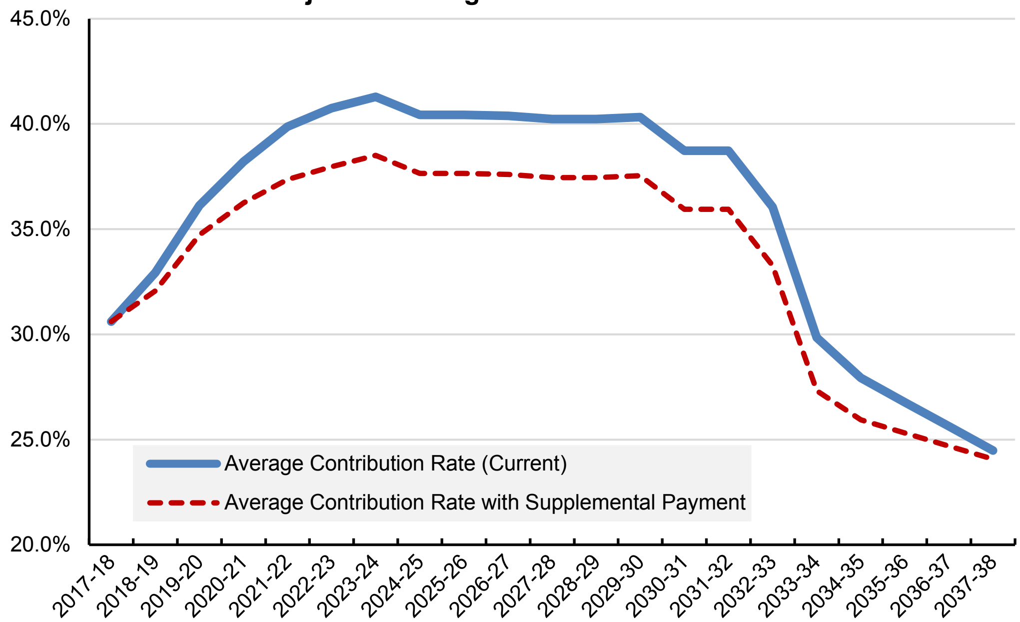
## Stabilization of State Retirement Contributions

The May Revision includes a one-time $6 billion supplemental payment to the California Public Employees Retirement System (CalPERS) in 2017-18. This action effectively doubles the state's annual payment and will mitigate the impact of increasing pension contributions due to the state's large unfunded liabilities and the CalPERS Board's recent action to lower its assumed investment rate of return from 7.5 percent to 7 percent.

As of June 30, 2016, CalPERS reported that the state plans' unfunded liability totals $59.5 billion and is 65 percent funded, meaning that CalPERS only has 65 percent of the funding required to make pension payments to state retirees.

Without this supplemental pension payment, the state's contributions to CalPERS are on track to nearly double by fiscal year 2023-24. Barring any changes to CalPERS' actuarial assumptions, this one-time payment will reduce the unfunded liability, and help lower and stabilize the state's annual contributions through 2037-38. As shown in Figure SWE-01, contribution rates as a percent of payroll will be about 2.1 percentage points lower, on average, than the currently scheduled rates. For example, peak rates would drop from 38.4 percent to 35.7 percent for State Miscellaneous (non-safety) workers, and peak rates would drop from 69 percent to 63.9 percent for CHP officers.

Figure SWE-01
**Projected Average State Contribution Rate**




The additional $6 billion pension payment will be funded through a loan from the Surplus Money Investment Fund. Although the loan will incur interest costs (approximately $1 billion over the life of the loan), actuarial calculations indicate that the additional pension payment will yield net savings of $11 billion over the next 20 years.

As the loan will repay state pension plans' unfunded liabilities in excess of the base amounts scheduled, repayment of the loan is eligible for debt payments under Proposition 2. As such, repayment of the loan will be made under Proposition 2 for the General Fund's share and other funds will repay the remainder.

For 2017-18, the state's contribution to CalPERS is estimated at $5.8 billion ($3.4 billion General Fund). These amounts are slightly lower than estimated at Governor's Budget due to various factors (e.g. increase in new hires entering the system under lower benefit formulas pursuant to the Public Employees' Pension Reform Act of 2013, greater than expected contributions to the system, and lower cost of living increases than initially estimated). Without the supplemental payment, by 2023-24, the state's contribution is estimated to reach $9.2 billion ($5.3 billion General Fund), due to anticipated payroll growth and the lower assumed investment rate of return. With the supplemental payment, the state's 2023-24 pension costs are estimated to be $8.6 billion ($4.9 General Fund).

Figure SWE-02 provides a historical overview of contributions to CalPERS, CalSTRS, the Judges' Retirement System (JRS), the Judges' Retirement System II (JRS II), and the Legislators' Retirement System (LRS) for pension and health care benefits.

Figure SWE-02

**State Retirement and Health Care Contributions** [1/]

(Dollars in Millions)

| | CalPERS[2/] | CSU CalPERS | CalSTRS | JRS | JRS II | LRS | Active Health & Dental[3/] | Retiree Health & Dental | CSU Retiree Health | Employer OPEB Prefunding[4/] |
|---|---|---|---|---|---|---|---|---|---|---|
| 2008-09 | $3,063 | | $1,133 | $189 | $40 | | $2,146 | $1,183 | | |
| 2009-10 | 2,861 | | 1,191 | 184 | 32 | | 2,120 | 1,182 | | $3 |
| 2010-11 | 3,230 | | 1,200 | 166 | 54 | | 2,277 | 1,387 | | 2 |
| 2011-12 | 3,174 | | 1,259 | 195 | 58 | | 2,439 | 1,505 | | 0 |
| 2012-13 | 2,948 [5/] | $449 [5/] | 1,303 | 160 | 51 | | 2,567 | 1,365 [5/] | $222 [5/] | 0 |
| 2013-14 | 3,269 | 474 | 1,360 | 188 | 52 | $1 | 2,697 | 1,383 | 225 | 22 |
| 2014-15 | 4,042 | 543 | 1,486 | 179 | 63 | 1 | 2,797 | 1,462 | 256 | 38 |
| 2015-16 | 4,338 | 585 | 1,935 | 190 | 67 | 1 | 2,968 | 1,556 | 264 | 61 |
| 2016-17[6/] | 4,754 | 621 | 2,473 | 202 | 68 | 1 | 3,101 | 1,647 | 273 | 339 [7/] |
| 2017-18[6/] | 5,188 | 661 | 2,790 | 197 | 76 | 1 | 3,250 | 1,783 | 295 | 184 |

1/ The chart does not include contributions for University of California pension or retiree health care costs, and does not reflect the proposed supplemental payment in 2017-18.

2/ In addition to the Executive Branch, this includes Judicial and Legislative Branch employees. Contributions for judges and elected officials are included in JRS, JRS II, and LRS.

3/ These amounts include health, dental, and vision contributions for employees within state civil service, the Judicial and Legislative Branches, and CSU.

4/ Amount reflects the employer contribution to pay down the Other Post-Employment Benefits (OPEB) unfunded liability.

5/ Beginning in 2012-13, CSU pension and health care costs are displayed separately.

6/ Estimated as of the 2017-18 May Revision. 2017-18 General Fund costs are estimated to be $2,727 million for CalPERS, $661 million for CSU CalPERS, $2,074 million for Retiree Health & Dental, $1,526 million for Active Health & Dental, and $89 million for OPEB Prefunding. The remaining totals are all General Fund.

7/ Amount includes a one-time prefunding contribution of $240 million pursuant to Chapter 2, Statutes of 2016 (AB 133).

## Employee Compensation and Collective Bargaining

Collective bargaining has concluded and the Administration negotiated successor contract agreements with all bargaining units. Through this process, the state successfully addressed and implemented the strategy necessary to address the $76.5 billion unfunded liability for retiree health benefits. As a result, more than $470 million is currently set aside in the prefunding trust fund to pay for future retiree health benefits. By the end of 2017-18, the trust fund balance will approach $1 billion in assets.

The May Revision reflects a $20 million General Fund increase and a $3 million other funds decrease for adjustments related to employee compensation resulting from increased enrollment in health and dental plans for active state employees as well as retiree health care prefunding for active employees. These costs also include salary and benefit increases as a result of the recent completion of contract negotiations with the Union of American Physicians and Dentists, which was the last bargaining unit without an agreement.

## Public Employment Relations Board

The Public Employment Relations Board administers and enforces California public sector collective bargaining laws and provides a timely and cost-effective method through which employers, employee organizations, and employees can resolve labor relations disputes. The May Revision includes $750,000 General Fund to address the Board's budgetary pressures and provide the appropriate level of funding to support existing permanent positions. This includes increased funding for fact-finding fees and Southern California regional office relocation costs to move staff to a building that fully complies with federal and state disability access laws.

## Board of Equalization

As mandated by the 2016 Budget Act, the Department of Finance's Office of State Audits and Evaluations (OSAE) performed an evaluation of the Board of Equalization's (BOE) sales and use tax reporting, and of its outreach activities.

The evaluation found that "BOE's operational culture impacts its ability to report accurate and reliable information to decision makers, including the Legislature, (and) Finance," and noted "certain board member practices have intervened in administrative activities and created inconsistencies in operations, breakdowns in centralized processes, and in certain instances result in activities contrary to state law and budgetary and legislative directives." The evaluation also noted the BOE provided 11 different versions of its proposed adjustments to correct possible sales and use tax allocation errors, and that OSAE found errors and omissions in each revised version. OSAE also received numerous anonymous complaints from BOE employees alleging threats of retaliation from BOE management, including from individual Board Members, if they fail to carry out management directives that the employees perceived as inappropriate.

As a first step in response to the audit, the BOE was notified by the Governor on April 13, 2017, that its delegated authority for personnel, contracting, and technology is indefinitely suspended. Any BOE actions in these areas must now be reviewed and approved by the Department of Human Resources, the Department of General Services, and the Department of Technology.

The Governor also stated in his April 13 letter that he would convene legislative leaders to identify and enact changes by June 2017 to address the troubling problems at the BOE. Conversations between the Administration and the Legislature are ongoing.

## Cannabis Regulation

In November 2016, voters passed Proposition 64, which legalized the adult use of recreational cannabis. To implement Proposition 64, the state has appropriated $52.2 million for cannabis programs across various state entities. Funding provided includes resources for the initial development of regulations, the development of licensing and track and trace programs, programs to develop standards and other outreach material related to the use of pesticides in the cultivation of cannabis, programs to protect instream flows for fish from water diversions related to cannabis cultivation, and to study the health risks associated with cannabis use. Figure SWE-03 displays expenditures for cannabis programs.

The Administration continues to implement the regulatory framework for cannabis. The May Revision reflects the ongoing efforts to provide adequate resources to protect consumers, the environment, and public safety. To assist with the regulation of both medicinal and adult use of cannabis, the Administration proposed legislation to blend the various components of the regulatory structure to avoid duplicative costs and provide clarity for licensees, regulatory agencies, and the public. The proposed legislation seeks to clarify and enhance the Medical Cannabis Regulation and Safety Act, the Compassionate Use Act (Proposition 215), and the Adult Use of Marijuana

Figure SWE-03
**Cannabis Expenditures through 2016-17**
(Dollars in Millions)

| Department | Program | Amount |
|---|---|---|
| Department of Consumer Affairs/ Bureau of Cannabis Control | Cannabis Regulation and Licensing | $11.3 |
| Department of Public Health | Office of Manfactured Cannabis Safety | $4.6 |
| Department of Health Care Services | Public Information Program – surveillance, education, and prevention | $5.0 |
| Department of Fish and Wildlife | Water Quality and Instream Flows | $13.7 |
| State Water Resources Control Board | Cannabis Cultivation Waste Discharge Regulatory Program | $7.2 |
| Department of Pesticide Regulation | Cannabis Pesticide Regulation and Enforcement | $0.7 |
| Board of Equalization | Tax Collection | $1.1 |
| Department of Food and Agriculture | Calcannabis Cultivation Licensing | $8.6 |
| **Total** | | **$52.2** |

Act (Proposition 64), as passed by the voters, by providing a clear regulatory structure and eliminating ambiguity. The Administration also seeks to safeguard local control of cannabis and industry compliance with all of California's environmental laws.

The cannabis licensing entities have released proposed regulations for all license types. In addition, each entity is developing a licensing system to manage applications, and the California Department of Food and Agriculture (CDFA) is implementing a robust Track and Trace system that will follow all cannabis from seed to sale, which will be available January 1, 2018.

The May Revision includes an additional $43.2 million for cannabis-related activities, for a total of $94.6 million in 2017-18, as shown in Figure SWE-04.

Significant Adjustments:

- Department of Fish and Wildlife—$17.2 million from multiple fund sources and 63 positions to support the development and implementation of the regulatory programs by the CDFA and the State Water Resources Control Board (Water Board). The Department will consult on fish and wildlife considerations related to the development of regulations and guidelines by CDFA and the Water Board, provide law enforcement to support regulatory compliance efforts, and issue Lake and

Figure SWE-04
**2017-18 Cannabis Resources**
(Dollars in Millions)

| Investment Category | Department | Program | Governor's Budget | May Revision | Total |
|---|---|---|---|---|---|
| Licensing | Bureau of Cannabis Control | Dispensaries, microbusinesses, distributors, testing laboratories | $4.4 | $0.7 | $5.1 |
| | Department of Public Health | Manufacturers | - | $1.8 | $1.8 |
| | Department of Food and Agriculture | Cultivation | $1.6 | $2.3 | $3.9 |
| Enforcement | Department of Consumer Affairs/ Bureau of Cannabis Control | Inspection and Investigation | $7.9 | - | $7.9 |
| | Department of Public Health | Manufacturers | - | $2.5 | $2.5 |
| | Department of Food and Agriculture | Inspection and Investigation | $3.0 | $0.4 | $3.4 |
| | Department of Fish and Wildlife | Law enforcement support for compliance inspections | - | $6.5 | $6.5 |
| | State Water Resources Control Board | Inspection and Investigation | - | $7.3 | $7.3 |
| Regulatory Development | Department of Fish and Wildlife | Develop conditions for licenses and permits | - | $2.4 | $2.4 |
| Information Technology | Bureau of Cannabis Control | Licensing System | $5.1 | - | $5.1 |
| | Department of Public Health | Licensing System | $1.4 | $0.9 | $2.3 |
| | Department of Food and Agriculture | Track and Trace & Licensing System | $16.9 | $1.2 | $18.1 |
| | State Water Resources Control Board | Cannabis Identificaiton and Priortization System | - | $0.9 | $0.9 |
| Laboratory Services | Bureau of Cannabis Control | Testing Lab Contract | $1.2 | - | $1.2 |
| | Department of Public Health | Cannabis Testing | -$0.4 | $0.6 | $0.2 |
| Permitting | Department of Fish and Wildlife | Permitting for Lake and Streambed Alterations | - | $6.8 | $6.8 |
| | State Water Resources Control Board | Water Quality/Rights | $0.0 | $1.3 | $1.3 |
| Restoration Grants | Department of Fish and Wildlife | Local Assistance | - | $1.5 | $1.5 |
| Administration and Oversight | Department of Consumer Affairs/ Bureau of Cannabis Control | Legal, Budgets, Accounting, Human Resources | $4.0 | - | $4.0 |
| | Department of Public Health | Education, training, and outreach | - | $3.5 | $3.5 |
| | Department of Food and Agriculture | Legal, Budgets, Accounting, Human Resources, and Outreach | $0.9 | - | $0.9 |
| | Board of Equalization | Excise Tax Implementation | $5.4 | - | $5.4 |
| | State Water Resources Control Board | Fee Collections | - | $0.3 | $0.3 |
| | Cannabis Control Appeals Panel | Appeals Panel Operations | - | $1.0 | $1.0 |
| | Department of Pesticide Regulation | Training, Outreach, Education, and Worker Safety | - | $1.3 | $1.3 |
| **Total** | | | **$51.4** | **$43.2** | **$94.6** |

Streambed Alteration Permits or notifications that a permit is not needed for each proposed cannabis cultivation site. Beginning in 2018-19, the Department's General Fund appropriation level will be adjusted upward consistent with the requirements of Proposition 64.

- Water Board—$9.8 million from multiple fund sources and 65 positions to develop a statewide water quality permit and expanded water rights registration process for cannabis cultivation. These resources will allow the Water Board to expand its water quality permitting program statewide, develop interim and long-term instream flow policies, process water right registrations, and enforce cannabis-related water rights.
- Department of Pesticide Regulation—$1.3 million Cannabis Control Fund to develop and update guidelines for pesticide use on cannabis, prepare training programs and outreach materials to inform cultivators and protect workers during the cultivation and harvesting processes, and evaluate requests for Special Local Needs pesticide registrations. In 2018-19 and 2019-20, the allocation increases by $1 million annually for County Agricultural Commissioners to provide training, outreach, and education to industry regarding the proper and safe use, handling, and disposal of pesticides at cultivation sites.
- Cannabis Control Appeals Panel—$1 million Cannabis Control Fund and 8 positions to provide the necessary resources for the operations of the Appeals Panel to effectively review all appeals related to cannabis licensing decisions.
- Bureau of Cannabis Control—$664,000 Cannabis Control Fund and 5 positions for environmental impact review activities as required under the California Environmental Quality Act.
- Department of Public Health—$9.3 million Cannabis Control Fund to implement cannabis manufacturer regulations, licensing, enforcement, training, and information technology activities by the January 1, 2018 statutory deadline. Provisional language is also proposed to provide Public Health the flexibility to increase resources if the licensing workload is higher than estimated.
- Department of Food and Agriculture—$3.9 million Cannabis Control Fund and 10 positions for required environmental impact review activities. The funding also will support information technology projects and cooperative agreements with County Agricultural Commissioners for cannabis cultivation licensing, inspection, and enforcement.

## Department of Justice

The May Revision provides $6.5 million General Fund and 31 positions for the Department of Justice to address new legal workload related to various actions taken at the federal level that impact public safety, healthcare, the environment, consumer affairs, and general constitutional issues. From January 20, 2017, through the end of April, the Department of Justice expended over 11,000 hours of legal resources in response to these actions. The Department anticipates a continued level of legal workload to address concerns regarding further actions taken at the federal level.

## Public Utilities Commission

The Public Utilities Commission (PUC) regulates privately owned telecommunications, electric, natural gas, and water companies, in addition to overseeing railroad/rail transit, moving companies, and transportation companies. The PUC is the only agency in the state charged with protecting private utility consumers and overseeing that the public has safe, reliable utility service at reasonable rates.

During the last legislative session, the Governor signed a package of bills enacting various reforms to improve public safety, as well as PUC governance, accountability, and transparency. In an accompanying signing message, the Governor directed the Administration to work with the PUC to reorganize duties and responsibilities over transportation-related regulation.

Within existing constitutional parameters, the May Revision includes legislation to transfer transportation functions effective July 1, 2018, as follows:

- Private carriers of passengers—Transfer to the Department of Motor Vehicles.
- Household goods carriers—Transfer to the Department of Consumer Affairs' Bureau of Electronic and Appliance Repair, Home Furnishings and Thermal Insulation.
- For-hire vessels—Transfer to the Department of Parks and Recreation's Division of Boating and Waterways.
- Commercial air operators—Transfer to local jurisdictions.

These transfers of functions will create efficiencies and improve the public's interactions and customer service with government. Furthermore, streamlining the PUC's existing functions will improve the program performance for the transportation responsibilities that remain with the PUC, while the Administration further evaluates the most effective approach to administer these regulatory functions.

Significant Adjustment:

- Strengthen Transportation Enforcement Branch—An increase of $636,000 PUC Transportation Reimbursement Account and six positions to begin addressing the issues identified in the report prepared pursuant to Chapter 718, Statutes of 2015 (SB 541). As required by this chapter, the PUC hired an independent entity to assess certain Transportation Enforcement Branch capabilities. The reforms the PUC will undertake include increasing enforcement tools, streamlining licensing processes, prioritizing timely processing of customer complaints, and developing staff skill sets to promote a more effective transportation oversight program. This proposal includes legislation providing impoundment authority, a new enforcement tool to improve the Branch's ability to enforce laws governing unlicensed carriers.

## Precision Medicine

The May Revision provides a one-time augmentation of $10 million General Fund to the Office of Planning and Research to further the efforts of the California Initiative to Advance Precision Medicine, building upon the $10 million appropriation made in the 2016 Budget Act. California's resources in technology, biotechnology, and healthcare in both public and private sectors equip the state with the tools to further advance this important area of development. This initiative has already proven valuable by attracting non-state funds and in-kind support to promising projects. This augmentation continues funding to the Office of Planning and Research to make additional investments into precision medicine.

## Governor's Office of Business and Economic Development

The May Revision includes $2 million for the Governor's Office of Business and Economic Development which will be used as a match to draw down federal funds made available to the California Small Business Development Center network for efforts to expand small businesses in California. This funding will be administered through a one-time competitive grant application process. Emphasis will be placed on applications with strong performance goals and/or targeted efforts for high unemployment and high poverty areas.

## Community Based Transitional Housing Program

The 2016 Budget Act appropriated $25 million for this newly created program, which encourages cities and counties to support transitional housing that provides treatment and reentry programming to offenders released from the criminal justice system, and to any other persons who the applicant city or county believes may benefit. The applicant must partner with a private entity, either for-profit or non-profit, to operate the transitional housing facility and provide a slate of statutorily prescribed services.

The May Revision broadens the purposes for which cities and counties may use their program funds based on feedback from many potential applicants. The proposed statutory changes do the following:

- Allow cities and counties to provide a portion of their program funds to the facility operator, if the facility operator agrees to use those funds for facility operations and services to residents. There is no limit on the amount the city or county may provide the facility operator.
- Allow cities and counties to use program funds for other purposes that their governing boards determine are in furtherance of the program's goals as long as the proposed uses are specified in the application.

## Governor's Office of Emergency Services

The May Revision proposes $500,000 from the Antiterrorism Fund for the California Nonprofit Security Grant Program which provides support for target hardening and other physical security enhancements to nonprofit organizations that are at high risk of terrorist attack. The program promotes coordination and collaboration in emergency preparedness activities among public and private community representatives, and nonprofit organizations, as well as state and local government agencies.

## 2016 Budget Act Funding

Based on lower than expected revenues, the Governor's Budget proposed reverting funding for a number of allocations included in the 2016 Budget Act. Based on the modest improvement in the state's fiscal outlook, the May Revision proposes to move ahead with $11 million in General Fund spending for low carbon fuel research at the Lawrence Berkeley National Lab; atmospheric rivers research at UC San Diego; and allocations for the Armenian Museum, Pasadena Playhouse, Excelsior Auditorium, Lark Music Society, and the Micke Grove Zoo.

## State Appropriations Limit Calculation

2017-18 State Appropriations Limit (SAL) Calculation—Pursuant to Article XIIIB of the California Constitution, the 2017-18 SAL is estimated to be $103.390 billion. This amount is used for various calculations related to state budgeting. The revised limit is the result of applying the growth factor of 4.22 percent. The revised 2017-18 limit is $399 million above the $102.991 billion estimated in January. This increase is due to changes in the following factors:

- Per Capita Personal Income
  - January Percentage Growth: 3.32%
  - May Revision Percentage Growth: 3.69%
- State Civilian Population
  - January Percentage Growth: 0.72%
  - May Revision Percentage Growth: 0.88%
- K-14 Average Daily Attendance
  - January Percentage Growth: 0.15%
  - May Revision Percentage Growth: -0.01%

# Economic Outlook

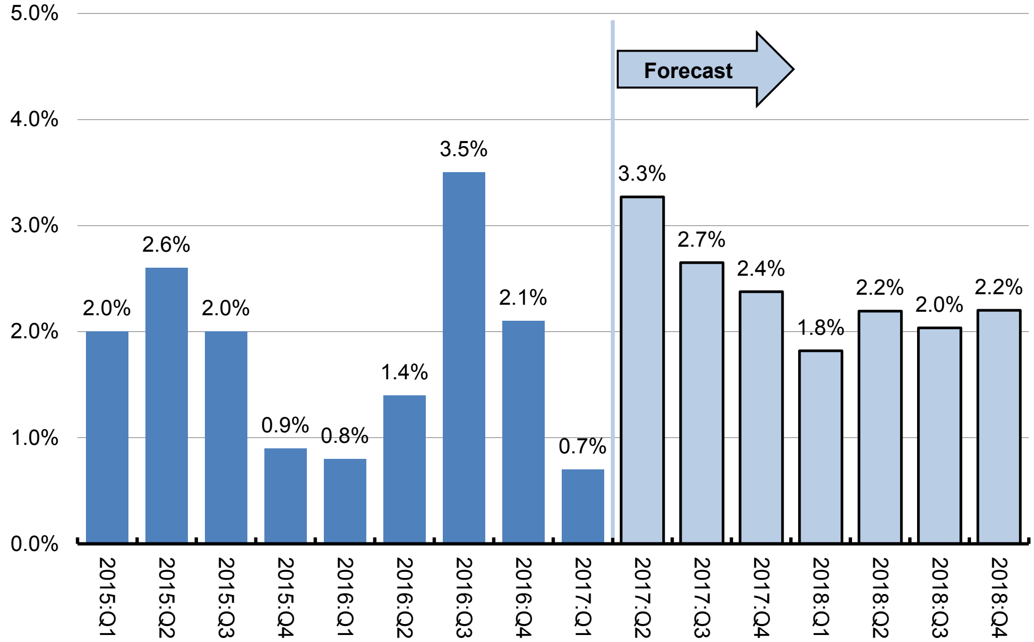
Moderate growth is expected throughout the forecast period, with unemployment rates remaining low and inflation beginning to rise in the U.S. and California. The risk of a stock market correction, an eventual recession, geopolitical events, or housing constraints could lead to disruptions in the economy.

## The Nation – Moderate Growth

The forecast assumes federal tax and spending policies remain relatively constant compared to 2016, with moderate economic growth continuing over the next few years. In 2016, real GDP grew by 1.6 percent, as stronger consumption was offset by weak business investment. Residential building and business investment are expected to pick up, and consumption growth is expected to continue, leading to moderate growth (Figure ECO-01).

The U.S. unemployment rate reached 4.4 percent in April 2017 and was equal to its pre-recession low (Figure ECO-02). This is leading to higher wage growth. Meanwhile, jobs continued to be added at a slower pace, as both the U.S. and California have fewer people looking for work. U.S. inflation was 1.3 percent in 2016 and is expected to exceed 2 percent in 2017 as housing, gas, and medical costs rise. After the interest rate hike in March, the Federal Reserve is expected to continue gradually raising interest rates.

Figure ECO-01
**U.S. Real Gross Domestic Product
Quarter-to-Quarter Growth, Annualized**



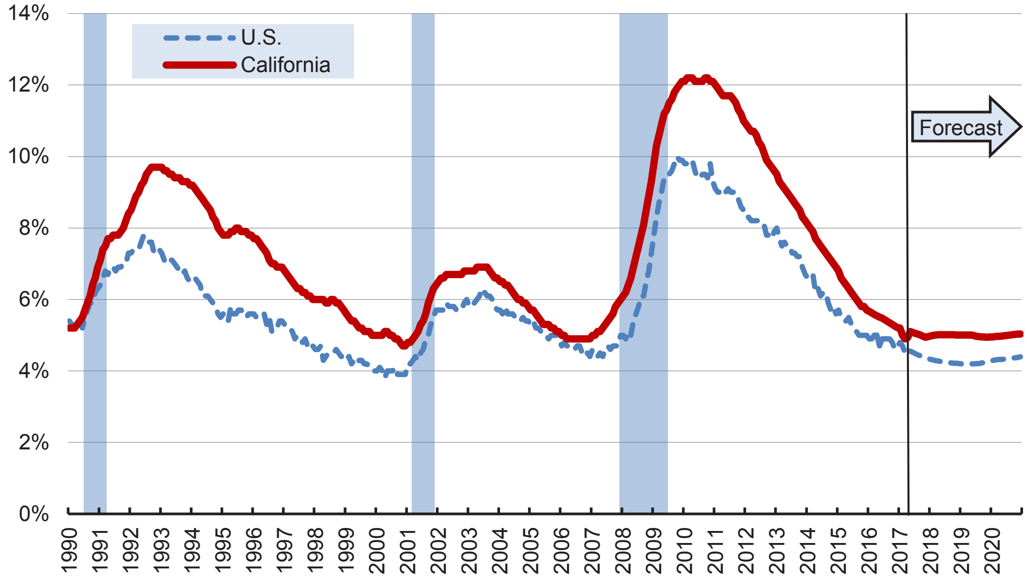

Source: U.S. Bureau of Economic Analysis; CA Department of Finance May Revision Forecast.

## California – Shifting Growth

California's unemployment rate fell to 4.9 percent in March 2017 and is expected to remain near that level throughout the forecast. With job growth slowing, average wages are starting to rise. The source of personal income growth is shifting from increased employment to higher income per worker. Labor force growth is expected to keep up with job growth, despite increasing numbers of retirees in California.

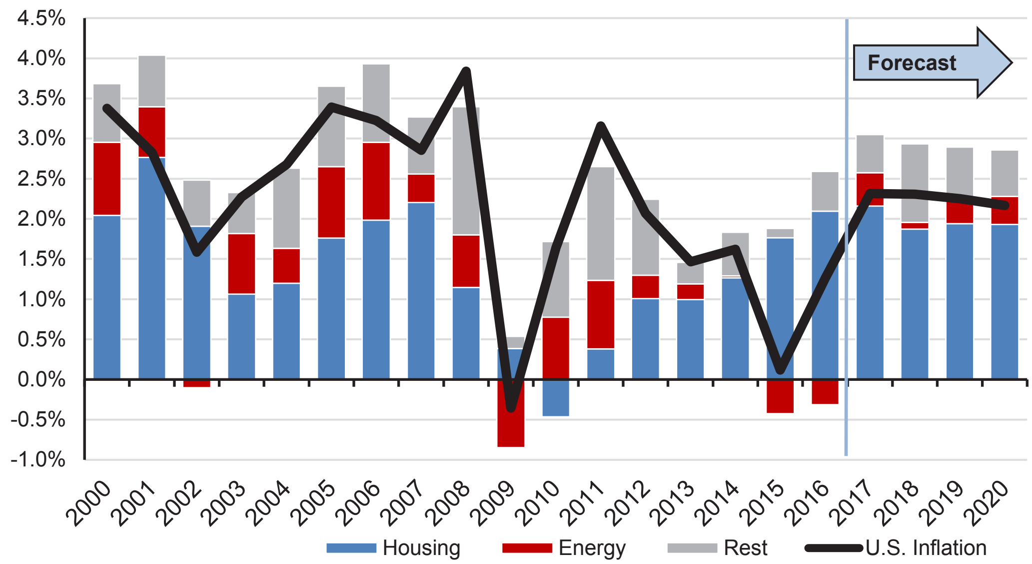
Consumer inflation is expected to remain higher in California than the nation, with California inflation expected to average 3.0 percent in 2017, and 2.9 percent in 2018 and afterwards. Housing permits issued by local authorities remain well below levels needed to account for population growth, a trend that is expected to continue throughout the forecast. Low levels of housing relative to demand are expected to continue in 2017 and 2018, contributing to faster inflation in the state (Figure ECO-03). The statewide median sales price of an existing single-family home was $502,250 in 2016, still more than double the national median price of $235,500. See Figure ECO-04 for highlights of the national and California forecasts.

Figure ECO-02
**U.S. and California Unemployment Rate**




Shaded areas indicate U.S. recessions.
Source: U.S. Bureau of Labor Statistics; CA Employment Development Department, Labor Market Information Division; CA Department of Finance May Revision Forecast.

Figure ECO-03
**Housing Costs Forecast to Drive Inflation**




Source: U.S. Bureau of Labor Statistics; CA Department of Finance May Revision Forecast.

Figure ECO-04

**Selected Economic Indicators**

| United States | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 Projected | 2018 Projected |
|---|---|---|---|---|---|---|---|
| Nominal gross domestic product, $ billions | $ 16,155 | $ 16,692 | $ 17,393 | $ 18,037 | $ 18,569 | $ 19,440 | $ 20,282 |
| Real gross domestic product, percent change | 2.2% | 1.7% | 2.4% | 2.6% | 1.6% | 2.4% | 2.2% |
| *Contributions to real GDP growth* | | | | | | | |
| Personal consumption expenditures | 1.0% | 1.0% | 2.0% | 2.2% | 1.9% | 1.9% | 1.8% |
| Gross private domestic investment | 1.5% | 1.0% | 0.7% | 0.8% | -0.3% | 0.8% | 0.6% |
| Net exports | 0.1% | 0.3% | -0.2% | -0.7% | -0.1% | -0.3% | -0.3% |
| Government purchases of goods and services | -0.4% | -0.6% | -0.2% | 0.3% | 0.1% | 0.0% | 0.0% |
| Personal income, $ billions | $ 13,915 | $ 14,074 | $ 14,810 | $ 15,459 | $ 16,012 | $ 16,721 | $ 17,486 |
| Corporate profits, percent change | 10.0% | 1.7% | 5.9% | -3.0% | -0.1% | 7.3% | 4.0% |
| Housing permits, thousands | 830 | 991 | 1,052 | 1,183 | 1,190 | -- | -- |
| Housing starts, thousands | 784 | 928 | 1,001 | 1,108 | 1,176 | 1,259 | 1,309 |
| Median sales price of existing homes | $ 177,200 | $ 197,400 | $ 208,900 | $ 223,900 | $ 235,500 | -- | -- |
| Federal funds rate, percent | 0.1% | 0.1% | 0.1% | 0.1% | 0.4% | 1.1% | 1.7% |
| Consumer price index, percent change | 2.1% | 1.5% | 1.6% | 0.1% | 1.3% | 2.3% | 2.3% |
| Unemployment rate, percent | 8.1% | 7.4% | 6.2% | 5.3% | 4.9% | 4.5% | 4.3% |
| Civilian labor force, millions | 155.0 | 155.4 | 155.9 | 157.1 | 159.2 | 160.1 | 162.0 |
| Nonfarm employment, millions | 134.2 | 136.4 | 138.9 | 141.8 | 144.3 | 146.6 | 148.4 |
| **California** | | | | | | | |
| Personal income, $ billions | $ 1,839 | $ 1,862 | $ 1,978 | $ 2,104 | $ 2,197 | $ 2,295 | $ 2,398 |
| California exports, percent change | 1.5% | 4.0% | 3.4% | -4.9% | -1.1% | -- | -- |
| Housing permits, thousands | 59 | 86 | 86 | 98 | 100 | 106 | 115 |
| Housing unit net change, thousands | 45 | 59 | 69 | 68 | 89 | -- | -- |
| Median sales price of existing homes | $ 319,310 | $ 407,150 | $ 446,890 | $ 476,320 | $ 502,250 | -- | -- |
| Consumer price index, percent change | 2.2% | 1.5% | 1.8% | 1.5% | 2.3% | 3.0% | 2.9% |
| Unemployment rate, percent | 10.4% | 8.9% | 7.5% | 6.2% | 5.4% | 5.1% | 5.0% |
| Civilian labor force, millions | 18.5 | 18.6 | 18.7 | 18.9 | 19.1 | 19.3 | 19.4 |
| Nonfarm employment, millions | 14.8 | 15.2 | 15.6 | 16.1 | 16.5 | 16.8 | 17.0 |
| *Percent of total nonfarm employment* | | | | | | | |
| Mining and logging | 0.2% | 0.2% | 0.2% | 0.2% | 0.1% | 0.1% | 0.2% |
| Construction | 4.0% | 4.2% | 4.3% | 4.6% | 4.7% | 4.8% | 5.0% |
| Manufacturing | 8.5% | 8.3% | 8.2% | 8.1% | 7.9% | 7.8% | 7.7% |
| High technology | 2.4% | 2.3% | 2.2% | 2.2% | 2.1% | 2.1% | 2.1% |
| Trade, transportation, and utilities | 18.5% | 18.4% | 18.3% | 18.3% | 18.1% | 18.1% | 18.0% |
| Information | 2.9% | 3.0% | 3.0% | 3.0% | 3.2% | 3.2% | 3.2% |
| Financial activities | 5.2% | 5.2% | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |
| Professional and business services | 15.2% | 15.4% | 15.5% | 15.5% | 15.4% | 15.3% | 15.2% |
| High technology | 2.4% | 2.4% | 2.5% | 2.6% | 2.6% | 2.6% | 2.6% |
| Educational and health services | 15.1% | 15.2% | 15.2% | 15.3% | 15.4% | 15.6% | 15.7% |
| Leisure and hospitality | 10.8% | 11.1% | 11.3% | 11.4% | 11.5% | 11.5% | 11.6% |
| Other services | 3.4% | 3.4% | 3.4% | 3.4% | 3.4% | 3.4% | 3.3% |
| Government | 16.1% | 15.7% | 15.5% | 15.3% | 15.2% | 15.1% | 15.1% |

*Forecast based on data available as of April 2017.*
*Percent changes calculated from unrounded data.*

## Risks to the Outlook

The main risks to the California economic outlook are a stock market correction, an eventual recession in the U.S., geopolitical risks that affect U.S. growth, or continued lack of housing in California that limits growth.

This forecast assumes that there are no large changes to federal tax policy. Yet, it appears recent stock market behavior already reflects expected cuts to corporate tax rates. Valuations of companies are relatively high compared with historical benchmarks. Unless the federal government follows through with such a tax cut, the stock market could drop precipitously. This would likely affect investment and hiring decisions at California companies, even in the absence of a recession.

The risk of a U.S. recession also remains. Almost eight years after the end of the last recession, both the U.S. and California are at unemployment rates only seen close to the end of an expansion. The U.S. unemployment rate stayed at or below 4.5 percent for eight out of nine months in late 2006 to early 2007, while the California unemployment rate stayed at 4.9 percent for less than a year before beginning to rise in early 2007. To keep growth on the current path, businesses would have to slow their hiring and wage increases in tandem with slowing consumer demand. Otherwise, inflation will rise further, and imbalances that trigger a recession would result. Large policy changes that might affect economic growth, such as trade, immigration, or government spending, may also cause businesses and individuals to pull back on investment or consumption and cause a recession.

Geopolitical events such as wars in the Middle East, conflicts in Asia, uncertainty about the European Union, or other incidents could also reduce U.S. growth or cause a recession. Many California companies sell their products and services worldwide, and have supply chains that cross many borders. Disruptions to trade or lower demand abroad would reduce California growth.

Finally, California housing growth continues to lag population growth, raising housing costs and potentially limiting the number of jobs that companies can add. In 2016, the state added 89,000 net housing units, but population increased by 335,000. Housing costs are a major component of consumer spending, and have also been increasing faster than inflation since 2012, a trend that is expected to continue. While the forecast assumes that increasing numbers of permits will be issued by local authorities, if permits remain low, it will reduce the number of available workers in those areas.

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# Revenue Estimates

Overall, the May Revision forecast for 2015-16 through 2017-18 revenues has increased by $2.5 billion. There are three factors that largely contribute to this increase:

- Personal income tax receipts are up $2.9 billion due to the recent strong stock market performance, which is forecast to increase capital gains significantly in 2017. To a lesser extent, a renewed concentration of wage income among higher-income taxpayers and stronger growth in business income positively impacted the personal income tax forecast.
- Sales tax revenues were revised down by $1.2 billion, reflecting weak cash receipts.
- An increase of $400 million in corporation tax revenues due largely to lower refunds and higher payments related to prior years.

After accounting for transfers, which includes transfers to the Rainy Day Fund and loan repayments, General Fund revenues under the May Revision forecast are lower than the Governor's Budget by $225 million in 2016-17 and higher by $1.9 billion in 2017-18.

Figure REV-01 compares the revenue forecasts by source in the Governor's Budget and the May Revision. Total May Revision revenue, including transfers, is projected to be $118.5 billion in 2016-17 and $125.9 billion in 2017-18.

Figure REV-01
**2017-18 May Revision**
**General Fund Revenue Forecast**
(Dollars in Millions)

| Source | Governor's Budget | May Revision | Change From Governor's Budget Forecast | |
|---|---|---|---|---|
| **Fiscal 15-16** | | | | |
| Personal Income Tax | $78,947 | $78,735 | -$212 | -0.3% |
| Sales & Use Tax | 24,890 | 24,871 | -19 | -0.1% |
| Corporation Tax | 9,902 | 10,460 | 557 | 5.6% |
| Insurance Tax | 2,562 | 2,562 | 0 | 0.0% |
| Alcoholic Beverage | 369 | 369 | 0 | 0.0% |
| Cigarette | 85 | 85 | 0 | 0.0% |
| Pooled Money Interest | 41 | 41 | 0 | 0.0% |
| Other Revenues | 1,742 | 1,742 | 0 | 0.0% |
| **Subtotal** | $118,538 | $118,864 | $326 | |
| Transfers [1/] | -3,038 | -3,205 | -166 | 5.5% |
| **Total** | **$115,500** | **$115,660** | **$160** | 0.1% |
| **Fiscal 16-17** | | | | |
| Personal Income Tax | $83,136 | $83,161 | $25 | 0.0% |
| Sales & Use Tax | 24,994 | 24,494 | -500 | -2.0% |
| Corporation Tax | 10,389 | 10,210 | -178 | -1.7% |
| Insurance Tax | 2,309 | 2,483 | 174 | 7.6% |
| Alcoholic Beverage | 370 | 375 | 4 | 1.1% |
| Cigarette | 79 | 79 | 0 | 0.0% |
| Pooled Money Interest | 60 | 67 | 7 | 11.9% |
| Other Revenues | 1,104 | 1,184 | 80 | 7.3% |
| **Subtotal** | $122,441 | $122,054 | -$387 | |
| Transfers [1/] | -3,676 | -3,514 | 162 | -4.4% |
| **Total** | **$118,765** | **$118,540** | **-$225** | -0.2% |
| **Fiscal 17-18** | | | | |
| Personal Income Tax | $85,866 | $88,961 | $3,095 | 3.6% |
| Sales & Use Tax | 25,179 | 24,470 | -710 | -2.8% |
| Corporation Tax | 10,878 | 10,894 | 17 | 0.2% |
| Insurance Tax | 2,368 | 2,538 | 169 | 7.1% |
| Alcoholic Beverage | 372 | 377 | 5 | 1.2% |
| Cigarette | 65 | 65 | 0 | 0.1% |
| Pooled Money Interest | 97 | 106 | 9 | 9.5% |
| Other Revenues | 913 | 904 | -9 | -1.0% |
| **Subtotal** | $125,738 | $128,316 | $2,577 | |
| Transfers [1/] | -1,711 | -2,404 | -693 | 40.5% |
| **Total** | **$124,027** | **$125,912** | **$1,884** | 1.5% |
| **Three-Year Total** | | | **$1,819** | |

Note: Numbers may not add due to rounding.

[1/] Includes transfers to the Budget Stabilization Account (BSA) for each year.

## Long-Term Forecast

The May Revision economic forecast reflects continued growth over the next four years. The projected average growth rate in U.S. real gross domestic product over the next four years is 2.2 percent. While the forecast does not project a recession, the current expansion has already exceeded the average post-World War II expansion by almost three years.

Figure REV-02 shows the forecast for the largest three General Fund revenues from 2015-16 through 2020-21. Total General Fund revenue from these sources is expected to grow from $114.1 billion in 2015-16 to $136.8 billion in 2020-21. The average year-over-year growth rate over this period is 3.7 percent.

Figure REV-02

**Long-Term Revenue Forecast — Three Largest Sources**

(General Fund Revenue — Dollars in Billions)

| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | 2020-21 | Average Year-Over-Year Growth |
|---|---|---|---|---|---|---|---|
| Personal Income Tax | $78.7 | $83.2 | $89.0 | $91.2 | $93.8 | $96.9 | 4.2% |
| Sales and Use Tax | $24.9 | $24.5 | $24.5 | $25.7 | $26.6 | $27.6 | 2.1% |
| Corporation Tax | $10.5 | $10.2 | $10.9 | $11.2 | $11.8 | $12.3 | 3.2% |
| Total | **$114.1** | **$117.9** | **$124.3** | **$128.1** | **$132.2** | **$136.8** | 3.7% |
| Growth | 4.4% | 3.3% | 5.5% | 3.1% | 3.2% | 3.5% | |

Note: Numbers may not add due to rounding.

## Earned Income Tax Credit

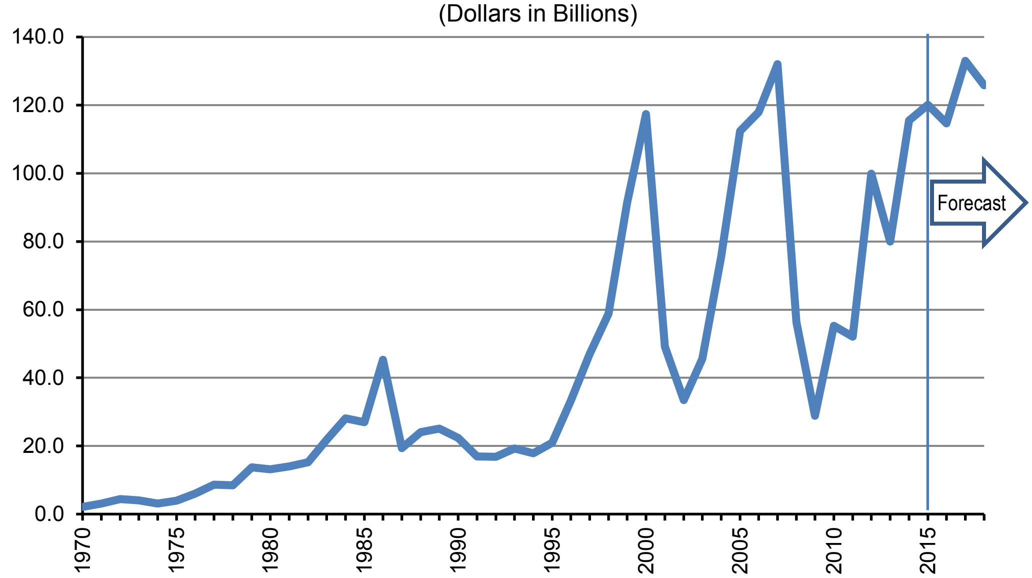
The 2015 Budget enacted the state's first-ever Earned Income Tax Credit to help the poorest working families in California. Over 300,000 households have claimed the EITC so far this year. Credit usage is estimated at $200 million in tax year 2016 and also in tax years 2017 and 2018 as the job market remains strong.

## Personal Income Tax

Compared to the Governor's Budget forecast, the personal income tax forecast is lower by $212 million in 2015-16, and higher by $25 million in 2016-17 and $3.1 billion in 2017-18. Over the three-year period, the personal income tax forecast reflects a total increase of $2.9 billion.

Stock market values have increased to record highs since the Governor's Budget, resulting in a significant increase to the capital gains forecast from $110 billion to $133 billion in 2017 and $107 billion to $126 billion in 2018 (see Figure REV-03). Capital gains for 2016 is nearly unchanged while 2015 was revised higher from $118 billion to $120 billion, based on new FTB taxpayer data for 2015. Capital gains are forecast to return to a normal level of 4.5 percent of personal income by 2020, two years later than assumed at the Governor's Budget.

Figure REV-03
**Volatile Capital Gains on the Rise**
(Dollars in Billions)




Forecasting revenue associated with capital gains is difficult since realizations are heavily dependent upon stock market performance and when taxpayers choose to buy or sell stock. This forecast assumes the S&P 500 will end 2017 at 2,401 and then grow around 1 percent per year for the next several years. The longer-term growth rate assumption has been lowered compared to the Governor's Budget to reflect the market's higher valuation. While the growth assumption is lower, projected S&P 500 levels are significantly higher in the near term due to recent market gains.

In addition to the upward revision to capital gains beginning in 2017, stronger business income and a renewed concentration of wage growth among higher-income taxpayers increased the personal income tax forecast. Withholding growth has been strong through April and has been outpacing economic wage growth, suggesting that a higher proportion of taxable wages has been going to higher-income earners who pay higher tax rates.

The personal income tax forecast includes Proposition 30 revenues, which are estimated at $7 billion in 2016-17 and $7.3 billion in 2017-18. These are higher than the Governor's Budget by $233 million and $411 million, respectively. Proposition 30 revenues are higher due to the factors discussed above.

The highest-income Californians pay a large share of the state's personal income tax. For the 2015 tax year, the top 1 percent of income earners paid nearly 48 percent of personal income taxes. This percentage has been greater than 40 percent for 11 of the last 12 years. Consequently, changes in the income of a relatively small group of taxpayers have a significant impact on state revenues.

## Sales and Use Tax

The sales tax forecast reflects decreases of $500 million in 2016-17, and $710 million in 2017-18. The forecast includes Proposition 30 revenues totaling $1.5 billion in 2015-16 and $800 million in 2016-17. The sales tax portion of Proposition 30 ended at the end of 2016, halfway through 2016-17.

The level of wages has been revised downward, and cash receipts have been significantly below forecast. Weak business spending, lower housing permits, and inflation in housing and medical costs are likely contributing to lower sales tax revenues. Taxable sales are forecast to grow at 1.5 percent in 2016-17 and 3.7 percent in 2017-18, which are below-average growth rates.

## Corporation Tax

The corporation tax forecast reflects an increase of $557 million in 2015-16, a decrease of $178 million in 2016-17, and an increase of $17 million in 2017-18. Cash receipts in 2016-17 are above forecast due primarily to lower refunds and higher payments related to prior year returns. These refunds and payments accrue to 2015-16 and increase revenues in that fiscal year. The negative revenue impact of the changes to the financing structure for managed care organizations is forecast to be $90 million in 2016-17 and $90 million in 2017-18, unchanged from the Governor's Budget.

## Insurance Tax

The insurance tax forecast reflects an increase of $174 million in 2016-17 and $169 million in 2017-18. The bulk of this increase assumes a change in the estimate of the revenue reduction tied to the financing structure for managed care organizations.

## Loan Repayments to Special Funds

The Budget reflects the repayment of loans to special funds based on the operational needs of the programs requiring these repayments. Total repayments are projected to be $413 million and $244 million in 2016-17 and 2017-18, respectively.

## Property Tax

The May Revision estimates statewide property tax revenues will increase 4.9 percent in 2016-17 and 5.4 percent in 2017-18. The 2016-17 estimate is down from the 5.9 percent estimated in the Governor's Budget, while the 2017-18 estimate is essentially unchanged. The 2016-17 estimate is based on actual property tax receipts reported by K-12 schools, county offices of education, and the California Community Colleges. Roughly 42 percent ($27.2 billion) of total property tax revenues will go to K-14 schools and county offices of education in 2017-18.

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