



League Analysis of the 2016-17 California's *Fiscal Outlook*

Background

On November 18, the nonpartisan Legislative Analyst's Office (LAO) released the annual publication, *California's Fiscal Outlook*, including the revenue summaries for the first quarter of the 2016 fiscal year as well as a five-year fiscal forecast. The release of the report serves as a prelude to the annual budget deliberation process that begins every January with the release of the Governor's Budget Proposal.

Every year, state policymakers anticipate the *Fiscal Outlook* report as a first look at state revenue, reserve estimates, and spending commitments affecting the General Fund. Through an analysis of the economy, *Fiscal Outlook* outlines possible state revenue and spending trajectories over the next five years and illustrates any progress towards building budget reserves as required under Proposition 2, which was approved by voters in 2012. For education stakeholders, the LAO's analysis of Proposition 98 provides an insight into potential revenue growth or downturns. The report also discusses policy choices faced by the state, including debt repayment, budgetary commitments, and economic conditions.

Following is the Community College League of California's analysis and perspective on the LAO's *Fiscal Outlook* report. Please note, the *Fiscal Outlook* report, does not assume an extension of Proposition 30 sales tax or personal income tax revenues.

Economic Conditions

The *Fiscal Outlook* acknowledges that California's economic expansion continues, but warns that this expansion is at its midpoint. The bulk of the economic expansion has been driven by the Bay Area (San Francisco, Oakland, and San Jose) which has shown strong (mid four-percent range) job growth and the largest per capita personal income tax in the state. State revenue growth is primarily driven by personal income, which is expected to grow statewide by seven percent in 2015-16, however due to a weaker stock market in 2016-17 personal income is predicted to only increase by 3.2 percent. It is important to note that revenues from the sales and use tax (SUT) and the corporate tax (CT) are lower than anticipated in the current year. This is an important distinction since the higher tax rate on personal income is set to expire in 2018. Proposition 30 extension proposals are currently under negotiation but polls of likely voters show that an extension is not likely if the tax is perceived as being permanent.

State Budget Outlook

The LAO predicts a positive outlook for the 2016-17 budget. The report illustrates that the state is better prepared for an economic downturn than in past years. This optimistic outlook is based on the assumption that current state policies continue, that no new budget commitments beyond those policies are made. Provided those conditions are met, the LAO anticipates the state would end fiscal year 2016-17 with reserves of \$11.5 billion. The rules

established by Proposition 2 require that nearly two-thirds of these reserves be set-aside in the Budget Stabilization Account (BSA). The Legislature would then have control over the remaining \$4.3 billion. The LAO warns that if the Legislature were to make new funding commitments in the 2016-17 budget, it will likely face difficult choices by the end of the five-year forecast of 2019-20.

Current Year 2015-16

The 2015-16 Budget Act assumed revenue at \$113.3 billion. The LAO estimates this amount will increase \$3.6 billion due primarily to an increase in personal income tax (PIT) revenues, largely from Bay Area tax filers.

Budget Year 2016-17

The *Fiscal Outlook* predicts that revenues will increase \$6.9 billion, or 5.9 percent, in 2016-17. The LAO estimates that, under current law, General Fund spending will grow by \$5.9 billion, or 5.1 percent, in 2016-17.

Proposition 98 Outlook

From 2016-17 through 2019-20 of the LAO forecast, Test 3 of Proposition 98 is operative. Generally, Test 3 is operative when General Fund revenues fall or grow slowly. Through 2017-18, the LAO estimates that growth in the Proposition 98 minimum guarantee will be higher than the statutory COLA for those years, therefore allowing for continued program expansion. However, they predict that in the latter years of their forecast period, growth in the guarantee will actually be lower than COLA increases. For 2016-17, the LAO estimates the statutory COLA at 1.99%.

One-Time Resources

The LAO indicates that the Proposition 98 Guarantee for 2014-15 and 2015-16 combined is up by \$2.039 billion. If LAO predictions hold true, and the Governor and legislature allocate one-time funds based on the statutory Proposition 98 “split”, community colleges could receive approximately \$200 million in one-time funds.

New Proposition 98 Funds Available in 2016-17

The LAO projects the Proposition 98 guarantee will increase 3.3 percent, (\$2.3 billion) from \$69.1 billion (the adjusted guarantee) in 2015-16 to \$71.4 billion in 2016-17. Since only \$67.9 billion of the Proposition 98 guarantees were allocated as on-going resources, the LAO estimates the state will have \$3.6 billion in additional funding available for its 2016-17 K-14 education priorities. Using the approximate 11 percent statutory split between K-12 and community colleges, colleges could receive an estimated \$396 million in on-going increases for the 2016-17 fiscal year.

Further, the LAO predicts that the 2016-17 Proposition 98 guarantee is “modestly sensitive” to General Fund revenue changes. Meaning for every \$1 increase in the General Fund (up to about \$2 billion), \$0.50 would go to K-14 education. Above \$2 billion, the increases flatten out with the Proposition 98 guarantee being more closely linked to per capita personal income rather than General Fund growth.

2015-16	
On-Going Funds Allocated in Budget Act	\$67.9 billion
2016-17	
LAO Estimated Prop 98 Guarantee	\$71.4 billion
	New Prop 98 Funds \$3.6 billion
LAO Estimated CCC 2016-17 Split	\$396 million

Out-Year Projections

Growth in the total Proposition 98 minimum guarantee (including both General Fund and Local Property Tax) is relatively strong in the near term, with the guarantee projected to grow another 4.4 percent in 2017-18. However, the LAO notes a number of significant issues in K-14 that impact the five-year forecast period including, slower growth in Proposition 98 as Proposition 30 revenues phases out, the phase-in of K-12's new Local Control Funding Formula, and the increased costs associated with CalSTRS contributions. As a result, General Fund spending in Proposition 98 is expected to grow slowly over the five-year forecast period, at an average rate of 1.7 percent, due in part to the above-noted expiration of Proposition 30 and a healthy growth in local property taxes.

Local Property Tax Assumptions.

The LAO forecasts local property tax revenues to grow steadily during the forecast period at an average rate of about five percent. The *Fiscal Forecast* projects relatively large local property tax increases in the 2015-16 and 2016-17 fiscal years (15.2 percent and 7.8 percent respectively) due to the expiration of the "Triple Flip" (which according to the LAO is "a complex financing mechanism used by the state to divert local property tax revenue to pay off certain state bonds, backfilling cities and counties with property tax revenue, and backfilling schools and community colleges with state General Fund.)

Higher Education Issues

Growing pension costs continue to be a primary concern for community colleges. District contribution rates for CalSTRS will increase from 10.7 percent of payroll in 2015-16 to 18.1 percent by 2019-20. Both CalPERS and CalSTRS boards have recently considered proposals to reduce risks in their investment portfolios. If they decide to lower their assumptions concerning future investment returns, state contributions could be even higher by 2019-20.

The report again illustrates a steady decline in K-12 average daily attendance. While this trend may take some time to materialize in higher education, it is nonetheless a critical trend to note, as future enrollment growth may also need to come from individuals who haven't recently been in an education setting.

Lastly, there remains much uncertainty about the expiration of Proposition 30. While the sales tax portion will expire on December 31, 2016, the current forecast illustrates that this portion of Proposition 30 should not have a major impact on education spending. On the other hand, the economy would have to remain steady in order to avoid drastic reductions

upon the expiration of the personal income tax portion of Proposition 30. Negotiations are underway for a modified proposal that extends these both taxes.

League Analysis

As we have seen in previous years, the LAO revenue estimates are generally higher than those used by the Governor and Department of Finance in crafting the Governor's January proposal or those adopted in the Annual Budget Act. The *Fiscal Outlook* serves as a preview of the upcoming budget discussions.

The availability of one-time resources, estimated at about \$200 million in 2016-17, provides an opportunity to think strategically about programmatic needs both in technology infrastructure and in curriculum and resources development. Colleges can view the prospect of one-time funds as start-up monies for programmatic improvements and/or look for ways to use one-time funds to accelerate implementation of new or current initiatives to increase student success. The system is poised to utilize one-time funds on new efforts such as the implementation of the Strong Workforce Task Force recommendations. It is important to note that anticipated new funds for community colleges of about \$396 million are significantly lower than the 2016-17 System Budget Proposal which requested \$968.5 million.

Over the next several years, colleges will need to continue to focus on long-term cost pressures. The League's primary analysis is to be cautious of the state's heavy reliance on personal income tax, especially since much of the growth comes from Bay Area technology industries. Based on the forecasted economic conditions and long-term cost pressures, the League advises districts to exercise optimistic restraint.