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HIGHER EDUCATION FINANCE REFORM

Prospects for State General Fund Revenues for Higher Education

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About College Futures Foundation Higher Education Finance Forum

There is a growing consensus in California about the need to increase access and degree attainment among this generation of California residents—but there is no comparable consensus about how to pay for it. College Futures Foundation is sponsoring the Higher Education Finance Forum to provide a neutral, analytically grounded discussion about how to pay for California's public higher education goals.

Current funding trends present one of the biggest barriers to increasing resident student access and baccalaureate degree completion. The Forum's goal is to develop a realistic framework for examining California public higher education finance that both defines the problem *and* identifies options to address it. The Forum will host four invitational conversations among a small group of experts in state budgeting, public higher education finance, demographic trends, social equity, and other facets of the topic. The Forum will synthesize a summary of the proceedings and white papers at the conclusion of the planned work, toward the end of 2016. College Futures Foundation and Forum leadership will then decide whether to transition the conversation into a larger public arena.

College Futures Foundation is a private foundation working statewide to improve baccalaureate degree attainment among California students who are low-income and underrepresented in higher education. College Futures operates on the beliefs that a vibrant future for our state requires more bachelor's degrees, and that every qualified student in California who wishes to should have the opportunity to succeed in college.

Established in 2005, the Foundation supports work in three areas: ensuring successful student transitions along the degree completion pathway; enabling cross-sector, intersegmental, and regional partnerships to drive improvements in bachelor's degree completion; and addressing gaps between policy and practice needed to increase college access and success.

Please see the inside back cover for author information.

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Executive Summary

California's General Fund revenue and expenditure trend lines create an uncertain trajectory that is unlikely to both meet expected costs and provide for significant increase in students for the state's public higher education (California State University and the University of California) systems. The dimensions of the challenge include:

- California's General Fund revenues are increasingly volatile because of the growing share of General Fund revenues that come from income taxes and the reliance on high income taxpayers whose income streams are less predictable than those of middle and lower income wage earners. Fully 68 percent of General Fund revenues are derived from personal income tax receipts. High-income taxpayers—whose personal tax returns reported more than $500,000 in Adjusted Gross Income—comprised 51 percent of California's income tax liability in 2012.[1]

- Volatility aside, the average rate of growth in general purpose revenues has declined significantly. Between 1985 and 2005 general purpose revenues grew by about 6.2 percent annually. Over the past 10 years the annual rate of increase has dropped to some 2.5 percent—a slowdown of major magnitude. While this will likely improve in the next decade, long-term economic and thus revenue growth rates are unlikely to materially exceed cost growth.

California's General Fund revenue and expenditure trend lines create an uncertain trajectory that is unlikely to both meet expected costs and provide for significantly more students.

- The share of General Fund revenues available for discretionary purposes has declined and will likely continue to decline. Over the past two decades, the annual change in discretionary expenditures has flipped from 5.4 percent *growth* between 1995 and 2005 to a 1.7 percent *decline* over the past 10 years. These shifts have hit higher education funding particularly hard—comprising, as it does today, 56 percent of the discretionary budget.

  The largest such restriction is driven by Proposition 98, which mandates that a minimum percentage of the state budget be spent on K-12 education and community colleges. Proposition 98 now controls more than 40 percent of the General Fund budget. Another critical piece of the non-discretionary puzzle is Proposition 2, passed in 2014, which established new reserve and debt payment requirements, further limiting available discretionary funds. Proposition 30, passed in 2012, temporarily raised the state's sales tax and income tax rates on high-income taxpayers for seven years, generating additional revenue. But the impending phase-out of Proposition 30 further complicates California's revenue outlook.

- While post-recession Proposition 98 funding for K-14 has soared, the future outlook is for low growth and substantial internal budget pressures. Other budget demands will add to the challenges posed by revenue volatility and a lack

[1] "Adjusted Gross Income" is the income that is used for income tax purposes at both the state and federal levels and includes capital gains that are realized upon sale. The economic statistic known as "Personal Income" does not include capital gains.

of spending flexibility. In the past several years, funding for K-12 and community colleges has included funding to restore reductions made during the recession through "maintenance factor" allocations required by Proposition 98. About half of growth in Proposition 98 funding after 2015-16 will be absorbed by rising district contributions to teacher and staff retirement plans. There also will be pressure to raise salaries to cover increased employee contributions and make up for years of stagnant or reduced employee compensation. Lawsuits and other factors could drive additional costs. Some school districts could experience negative net funding after these costs are addressed, particularly in 2018-19 and subsequent years. Community college funding, on the other hand, could be a relative bright spot.

Prospects for State General Fund Revenues for Public Higher Education

This paper reviews past and possible future trends affecting General Fund availability for public higher education in California. Although General Fund has declined as a share of institutional revenues, it along with tuition revenue remains the largest source of discretionary revenue to the two 'senior' public university systems in California: the California State University and the University of California. Understanding the dynamics influencing General Fund availability will be key to long-term fiscal planning for these institutions, with strong implications for decisions about tuitions, levels of student access, changes in spending, and other related issues.

Revenue Volatility, Structural Spending Inflexibility, and Competing Budget Demands: Trends and Considerations

1 California's General Fund revenues are highly volatile, creating problems for higher education enrollment, program, and tuition planning.

The revenues available to the state's General Fund have shifted substantially in recent decades—to personal income tax (68 percent) and to high-income taxpayers. Personal income tax returns reporting more than $500,000 in Adjusted Gross Income comprised fully 51 percent of California's income tax liability in 2012.

The income earned by these taxpayers often reflects capital gains or business profits. This income is highly volatile. Profits are more variable than other components of income—and capital market and investor behavior can be even more unpredictable.

The revenues available to the state's General Fund have shifted substantially in recent decades—to personal income tax and to high-income taxpayers.

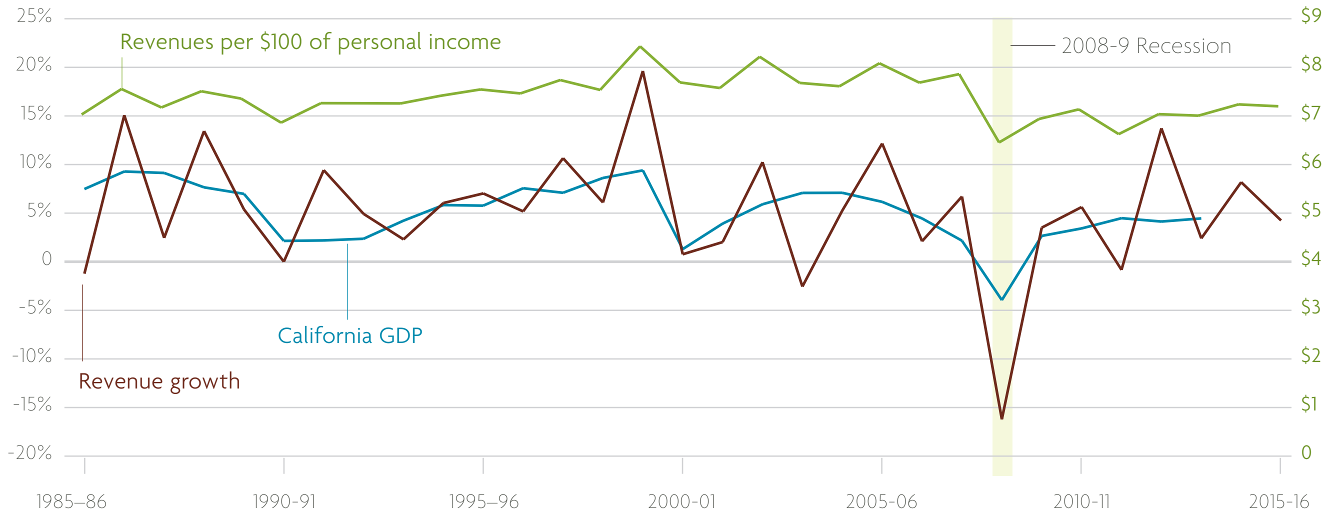
Some California tax policy analysts have recommended consideration of long-term revenue restructuring, to reduce income tax dependency on the highest and most volatile income categories. But it is difficult to raise rates on the more stable incomes of low- and middle-income earners when their earnings have been growing little, if at all. In recent years, most of the growth of personal income has been in the highest income groups—a trend largely independent of the Great Recession and subsequent recovery.

Figure 1 *(next)* shows annual percent changes in California's Gross Domestic Product (GDP) and general purpose revenues. For the purposes of this analysis, general purpose state revenues include state General Fund revenues and taxes that became dedicated by the state to specific purposes but could have been general purpose revenues (realignment sales taxes, vehicle license fees, and school property tax). The figure also displays general purpose revenues per $100 of personal income.

Figure 1

California's General Purpose Revenue Growth: 1985-2015

Numbers in right axis refer to revenues per $100 of personal income, reflected in the green graph line.



Source: Author's analysis of state revenue data maintained by the Legislative Analyst, GDP and personal income data maintained by Department of Finance.

As can been seen, revenues are far more volatile than California's economy, especially to the upside. Because personal income tax—particularly on high-income Californians—is such a large and growing percentage of our revenues, the state's General Fund is disproportionately affected by economic booms and busts in comparison to other states. For instance, in the Great Recession year of 2009, California personal income dropped 3.7 percent and GDP dropped by 4 percent, yet General Fund revenues declined by 19.3 percent and general purpose revenues declined by 16.2 percent.

The changes in the level of revenue per $100 of personal income show that the productivity of the state's tax system contributes significantly to the revenue volatility but does not explain it all. Even with the revenue gain from Proposition 30, we see only a modest recovery from the decline that followed the peaks in 1999-2000 and 2005-2006. This does not bode well for long-term revenue growth rates.

The Great Recession demonstrates that while economic cycles may be less frequent than in the past, due to the efforts of the Federal Reserve, major economic downturns can still be created by structural problems and unusual events. In these years, all revenue sources are depressed. In addition, as recent events caused by economic problems in Greece and China have shown, there can be major disruptions in the stock market even though economic fundamentals remain solid. Capital gains suffer disproportionately in these situations.

Disproportionate growth in income by high-wealth Californians and companies shows no signs of significantly abating. Accordingly, it is likely that California's revenue will become more volatile in the future.

The growing volatility of General Fund revenues has led to arguments in favor of multiyear budgeting or some other mechanism to allow for revenue smoothing over several years. A four- or five-year planning horizon is also needed to reflect policy changes, such as the phase-out of Proposition 30—which temporarily increased the sales tax rate for all taxpayers and the personal income tax rate for upper-income taxpayers—and the additional costs of pension expenditures or Medi-Cal expansion. Proposition 2 requires the Department of Finance to prepare estimates of revenues and expenditures for three years past the budget year; it does not require either the Governor or the Legislature to propose or adopt a plan to balance the out-year budgets.

Volatility aside, the average rate of growth in general purpose revenues has declined significantly. Between 1985 and 2005, general purpose revenues grew by about 6.2 percent annually. Over the past 10 years, the annual rate of increase has dropped to some 2.5 percent—a slowdown of major magnitude. Growth in decades prior to 1985 was even higher. While growth will likely improve in the next decade, long-term economic and thus revenue growth rates are unlikely to materially exceed cost growth.

Volatility aside, the average rate of growth in general purpose revenues has declined significantly.

2 The Department of Finance and the Legislative Analyst's Office budget and revenue projections can vary widely, due to divergent capital gains and spending projections. Despite the impact this can have on budget deliberations, in the long run, the budget is constrained by actual revenues.

California lawmakers build California's General Fund budget by starting with revenue estimates produced by the executive Department of Finance (DOF) or the Legislative Analyst's Office (LAO).

Typically one estimate or the other is adopted as the foundation upon which that year's budget is built. Both the LAO and the DOF base their projections on correlation models for various taxes, adjusted for forecasts of selected economic variables and other factors such as predicted changes in taxpayer behavior due to the effects of tax policy.[2] Estimating error rates decline as estimates become more current; as the budget process proceeds, the final spending blueprint is typically based on May or June revised estimates.

But even January revenue estimates for *the current fiscal year* have been known to be off by billions of dollars when the California economy is changing direction. A

[2] The correlation models DOF and LAO use for most of their projections of future tax revenues are based on statistical relationships between changes in economic and demographic variables that are also predicted by macro-economic models and the performance of the various tax revenue components. These statistical relationships are determined by analyzing prior year data and may change over time, requiring both offices to constantly evaluate their models' performance.

1–3 percent variance to final revenues is not uncommon in the January projections. Accordingly, budget makers try to leave at least 1 percent in reserves on enactment. *(Read a Q&A on Revenue Estimating with Mark Hill online. See page 18 for link.)*

The DOF multiyear estimate published in July 2015, projects modest increases in General Fund revenue through 2019-20. However, the projection shows deficits beginning as early as 2017-18 as costs grow faster than revenues, due to the phase-out of Proposition 30's temporary sales and income tax increases. These deficits could grow by an additional $1 to $2 billion annually if the Managed Care Organization tax is not replaced by 2016-17.

The most recent DOF multiyear estimate, projects modest increases in General Fund revenue through 2019-20 but deficits thereafter. In contrast, the LAO model shows both higher revenues and lower expenditures.

In contrast, as Table 1 reflect, the LAO model shows both higher revenues and lower expenditures. The Legislative Analyst projects a General Reserve of $4.3 billion in 2016-17—a full $3.5 billion more than the Finance Department estimate. This estimate gap grows to $8.4 billion in 2016-17—more than 6.5 percent of total revenues. *See Table 1 (facing page).*

What explains these large discrepancies? The Finance Department assumes capital gains peaked relative to personal income in 2014 and will decline in future years. Conversely, the Legislative Analyst assumes several additional years of capital gains performance above historical levels. The LAO also projects significantly lower ongoing expenditures. This appears to be due, in part, to the LAO's view that higher capital gains will lead to reductions in state payments to the California State Teachers' Retirement System. While current law may provide for such a reduction, in the context of rising district contribution rates, it will be a budget policy choice.

While it is quite possible that there could be several more years of out-performance and then a decline, the LAO forecast of a sustained five-year period of multibillion-dollar revenue increases over costs seems unlikely.

The recipe for such sustained capital gains growth—substantial labor scarcity driving middle income gains, inflation, and corporate profits—is simply not in evidence. Underlying structural trends of globalization and technological progress, combined with Federal Reserve policy, suggest reductions in U.S. labor demand rather than shortages. If the Federal Reserve does not choke off growth in an effort to preclude inflation, and there are effective restrictions on the import of labor, it is possible that in two to five years, something approaching general labor scarcity could exist in the U.S. and possibly other developed countries. If this was allowed to persist and drive some wage-push inflation, longer-term revenue growth trends for California could significantly improve. But this would also drive higher cost growth. Net funding capacity increases would depend to some extent on state and national budget policy choices but conceivably could be positive in the long run. Monetary and fiscal policy changes at the national/international level would be required for this to occur.

Table 1

Department of Finance vs. Legislative Analyst's Office Projections, 2015-2019

	DOF projections[1]				LAO projections[2]				Differences			
	2015–16	2016-17	2017-18	2018-19	2015–16	2016-17	2017-18	2018-19	2015–16	2016-17	2017-18	2018-19
Revenues	$116.9	$121.8	$125.9	$127.6	$119.9	$123.7	$128.0	$132.5	$3.00	$1.90	$2.10	$4.90
Projected expenditures	115.4	120.6	125.5	129.2	116.7	119.7	122.3	125.0	$1.30	-$0.90	-$3.20	-$4.20
General Reserve	1.1	0.8	0.0	-2.6	2.3	4.3	8.4	14.4	**$1.20**	**$3.50**	**$8.40**	**$17.00**
Prop 2 Reserve	3.5	5.0	6.1	7.1	4.2	6.2	7.8	9.3	$0.70	$1.20	$1.70	$2.20
Encumbrances Reserve	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	$0.00	$0.00	$0.00	$0.00

[1] DOF does not assume relief from Proposition 2 in 2018-19 that could occur if the governor requests and Legislature takes action.

[2] LAO 2018-19 projections estimated using LAO 2017-18 growth rates.

Source: DOF Budget Act Projection; LAO May 2015 Revision Projection

3 California's budget has little discretionary funding that can be used for general purposes, including for higher education. Compounding the challenges posed by revenue volatility, California has adopted a combination of constitutional and other restrictions on spending that have reduced flexibility for discretionary spending.

The largest such restriction is driven by Proposition 98, which mandates that a minimum percentage of the state budget be spent on K-12 education and community colleges. Proposition 98 now controls more than 40 percent of the General Fund budget.

About 82 percent of the non-Proposition 98 growth in General Fund spending that is projected by the DOF through 2018-19 is in health and human services programs (approximately 69 percent) and non-Proposition 98 education (approximately 13 percent). Growth rates for non-Proposition 98 education (87 percent of which is higher education) are projected to decline from 7.3 percent in 2015-16 to 3.3 percent by 2018-19 by the DOF. Annual growth rates of 6 to 8 percent are projected for health and human services costs, crowding out other potential increases.

From a longer-term historical perspective, the imposition of Proposition 98 in 1987 and Proposition 13 in 1978 represent the biggest changes to the level of discretion over the state budget available to the Governor and the Legislature.

Figure 3

Discretionary Expenditures as a Percentage of Overall State Spending

Percent of budget

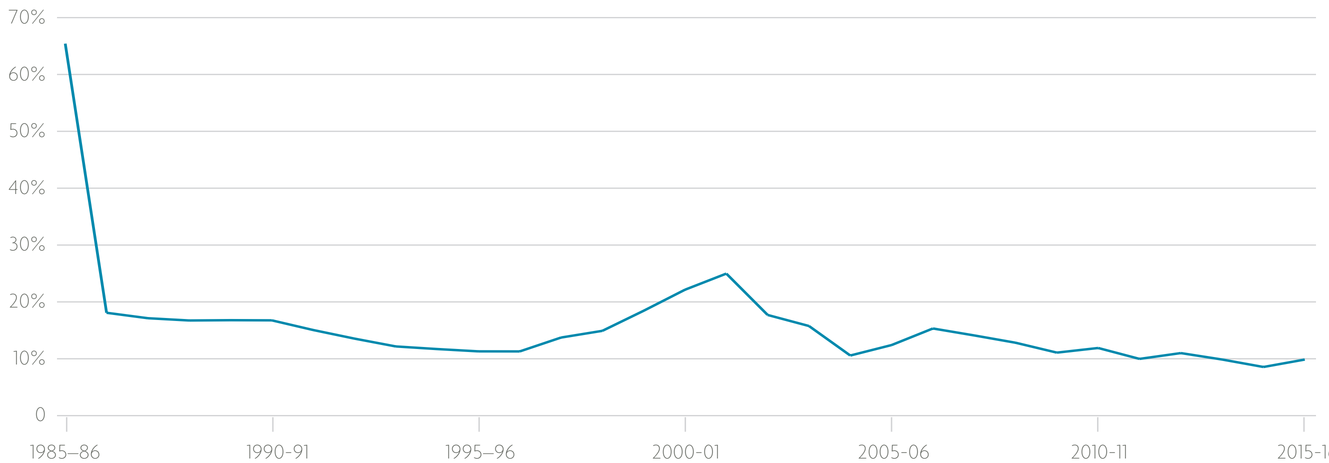


Figure 3 shows that the discretionary share of California's budget derived from general purpose revenues has precipitously dropped from some two-thirds of the budget in 1985-86—before Proposition 98 took effect—to less than 10 percent today. General purpose revenues for purposes of this paper include school property taxes and revenues dedicated to state programs realigned to local government.

Between 1985 and 2005, overall general purpose revenues grew by about 6.2 percent annually. Over the past 10 years, the annual rate of increase dropped to some 2.5 percent. Compounding this decline, annual change in discretionary expenditures has flipped from 5.4 percent *growth* between 1995 and 2005 to a 1.7 percent *decline* over the past 10 years. This shift has hit higher education funding particularly hard—comprising, as it does today, 56 percent of the discretionary budget. For more on budget constraints and the designation of programs with limited discretion for this analysis, see the accompanying discussion of *California's Minimal Budgeting Discretion* *(see page 10)*.

Calculating Discretionary Versus Non-Discretionary Spending: A Note on Methodology

Both the LAO and the DOF have tried to divide the budget into categories with more or less discretion. They have never agreed on a methodology, and the exercise has not been done in recent years. While not every dollar of many of the less discretionary programs are tied down by legal requirements, most of these programs have very little money that the budget can materially affect. In some cases though, like Homeowners Exemption and Debt Service, there are Constitutional pledges for every dollar that would be nearly impossible to change in the short term. While Proposition 98 can be suspended with a two-thirds vote of the Legislature, this has happened only very rarely and has only a one-year effect. Others, such as health care (Medi-Cal primarily), mental health, social services and corrections are constrained by webs of state Constitutional and initiative statute requirements, federal laws, and court rulings. Some, such as STRS and benefits for annuitants are contractual obligations. Thus for long-term planning purposes, it is appropriate to consider these programs to have little discretion to allow funds to be redirected to other uses. For the purposes of this paper, I categorized the expenditures by major program areas as follows:

Less Discretionary Departments, Programs, and Uses

Health Care
Social Services
Mental Health
Developmental Services
Corrections and Rehabilitation
State Teachers' Retirement System (STRS)
Proposition 98
Homeowners Property Tax Exemption
Debt Service
Benefits for Annuitants
Proposition 2 Debt Service and Reserves

More Discretionary Departments, Programs, and Uses

Higher Education
Franchise Tax Board
State Board of Equalization
Judicial Branch
State Legislature
Forestry and Fire Protection (CAL FIRE)
Child Support Services
Veterans Affairs
Everything else not categorized as less discretionary

I used a historical department level expenditure pivot table that LAO maintains and adjusted it to include revenues and expenditures from revenues that once were general purpose (but now there is little or no discretion about their use). Several of the listed program areas have been reorganized and renamed over the years, thus more generic labels are used here. The expanded general purpose totals include Realignment sales taxes and Vehicle License Fees, and school property taxes.

California's Minimal Budgeting Discretion

Many have pointed to California's roller coaster revenues and dependence on high-income taxpayers as a source of its budget woes. This is certainly the cause of much of the unpredictability and volatility. But California also has many self-imposed budget constraints that make balancing the budget in a sustainable way much more difficult than it is in other states. Most of the budget is committed to ongoing programs. Since 1933, California had required a two-thirds vote to pass a budget. The recent repeal of that requirement will ease the process of passing a budget but does nothing to remove other fiscal constraints.

In the 1950s and 1960s, California experienced high population growth from both migration and the baby boom. Industry grew and a tremendous amount of private and public infrastructure was constructed. While this strained local government resources (especially to build schools, roads, water, and waste water systems), the expanded property- and sales-tax base partially offset the costs. The baby boom required a huge expansion of public schools, and successive increases in tax rates for local bonds and for ongoing service costs. In those years, California's state budget was not viewed as a primary funder or guarantor for any of these local services. The state budget was largely at the discretion of the Legislature and the Governor. It was in this context that the Master Plan for Higher Education was adopted in 1960.

The repeated local tax rate increases and rising property assessments increasingly pressured lower-income and fixed-income households, leading to many calls for tax relief. Measures implemented to help homeowners were viewed as insufficient by many voters, leading to the adoption of Proposition 13 in 1978. Proposition 13 reduced property taxes by more than half and fixed rates at 1 percent for services. It also raised the vote threshold for state tax increases to two-thirds. Under long-standing state law, school districts are not authorized an allocation of the local sales tax. This left school funding (amongst other things) at levels that were entirely untenable.

To bolster California's schools, the Legislature enacted a series of laws that reallocated property tax among local agencies to provide sufficient funds to ensure adequate school funding. This left city, county, and special district funding at levels most jurisdictions felt were unacceptable. Fees were adopted or increased to pay for many services that previously had been funded primarily by taxes. Some new fees exceeded the cost of the services they covered. This provoked taxpayer advocates to promote additional limits including the Gann spending limit initiative, which passed in 1979 and Proposition 218 in 1996. The Gann limit was later modified to be less of a constraint on both local and state spending, Proposition 218's limits on fees to no more than costs of service and requirements for voter adoption of taxes, however, has left local government governing bodies, including school boards, with little or no control over their revenues. In most other states, few if any similar constraints exist on local funding, and the local districts retain primary responsibility for school funding.

Successful litigation starting in 1971 by John Serrano and others established that local government taxing capacity variations unfairly deprived some students of equal educational opportunity. The state was required to reallocate state support to equalize per-student funding. These suits and Proposition 13 firmly established the state as the real provider of school funding. This dependence on state funding and the state's more volatile revenues led to calls for a minimum guarantee for state school funding—Proposition 98—adopted by voters in 1988.

California also made decisions in the decades following 1950 to establish relatively generous levels of service and entitlement to social services, mental health, and services to the developmentally disabled. For Medicaid in particular (the largest of these programs by far), once a state establishes an eligibility rule, federal laws prevent the state from reducing it. Thus decisions made in times of plentiful revenue make continued funding in lower revenue years an enormous challenge. Many other states have not increased eligibility because of these federal ratchet–up laws. One might think California's largest-in-the-nation Congressional delegation would provide for generous federal participation levels. Instead, California has the lowest percentage of federal support for Medicaid.

When the economy was growing due to population growth and industrial expansion, middle-class incomes were rising sufficiently to produce substantial state and local revenue increases. General Fund (broadly defined) increases in the 1960s averaged around 12 percent a year (including the effect of some tax increases). In the 1970s growth averaged over 15 percent a year. In the 1980s, however, population growth began to slow and industry—particularly aerospace—shrank due to automation, reduced federal military spending, and foreign competition. As a result, General Fund growth averaged only 8 percent. While the advent of silicon-based computing created a whole new industry in California, its products gradually helped make jobs easier and reduced demand for middle-income labor. Increased automation also allowed firms to seek lower labor prices overseas. This reduced job growth and pay growth—and thus tax growth, especially from sales. By the 1990s, which included several recessions, growth averaged only 5 percent and all of the significant budget constraints were in place. Temporary taxes helped bridge the gap but permanent budget cuts were needed as well.

Since then, average annual growth in General Fund revenues has declined from about 6 percent in 1995–2006 to less than 3 percent in the last 10 years. While some of this is due to the Great Recession, the slow recovery and widespread projections

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California's Minimal Budgeting Discretion

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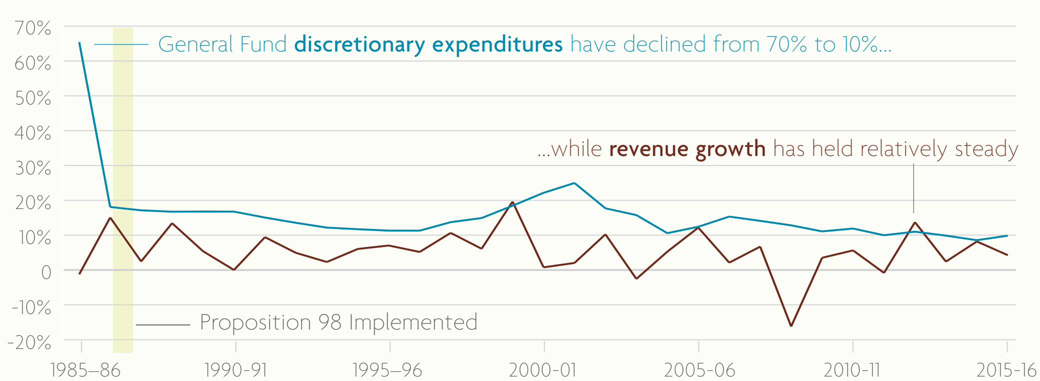
of around 2.5 percent for future economic growth suggest that strong growth in General Fund revenues will be difficult to achieve.

All of these budget constraints and repeated rounds of cuts have led to a budget that has little or no funding for one-time purposes, like capital outlay, and little that can be cut in a shortfall year. Recognizing this, Governor Jerry Brown persuaded voters to adopt Proposition 2, which requires 1.5 percent of General Fund revenues plus capital gains revenues that exceed 8 percent of total revenues to be devoted in most years to restricted-use reserves and debt reduction. The measure reduces budget discretion still further, but also reduces the boom-and-bust budgeting that would otherwise likely continue.

As can be seen in Figure 4, while annual growth in revenues is quite volatile, growth rates are slowly trending down. Discretionary expenditures show a more pronounced decline. Revenues per $100 of California personal income were trending up until the Great Recession but have not recovered fully since then, even with Proposition 30 in place. Bringing revenues from taxes back up to $8 per $100 would provide about $16 billion. It is highly unlikely, however, that natural revenue growth will provide any significant portion of this unless the economy expands sufficiently to materially improve middle class incomes. For that to occur, real full employment must be achieved and sustained. This is very difficult to do when export of jobs and import of labor is relatively easy and technology continues to shrink the numbers and value of middle-class jobs. The long-term increase in state revenues will slow further if not enough college-educated people can be found to fill California's high-tech jobs. While some of the demand can be filled by in-migration, there is already an increasing unmet demand for this labor. This will lead to further outsourcing and even movement of firms to more supportive places.

Figure 4

California Trends in Discretionary vs General Purpose Funding



4 While post-recession Proposition 98 funding for K-14 has soared, the future outlook is for low growth and substantial internal budget pressures.

Other budget demands will add to the challenges posed by revenue volatility and a lack of spending flexibility. In the past several years, funding for K-12 and community colleges has included funding to restore reductions made during the recession. These "maintenance factor" allocations—required by Proposition 98—have boosted K-12 funding by more than $1,400 per student (after recent revenue increases are accounted for)—or 16 percent—over the past two years. Now that these recession-driven funding shortfalls mostly have been restored, the Finance Department is projecting modest growth in K-12 and community college funding, ranging from 3.7 percent in 2015-16 to 1.4 percent in 2018-19.

Other budget demands will add to the challenges posed by revenue volatility and a lack of spending flexibility.

About half of the growth in Proposition 98 funding after 2015-16 will be absorbed by rising district contributions to teacher and staff retirement plans. There also will be pressure to raise salaries to cover increased employee contributions and make up for years of stagnant or reduced employee compensation. For districts that do not benefit as much as others from the Local Control Funding Formula, which targets resources based on the percent of a district's students who are English learners and students eligible for free- and reduced-price lunch, net funding growth after these costs could be negative, particularly in 2018-19 and subsequent years.

5 Projections of low Proposition 98 growth and budget deficits promote consideration of a Proposition 30 extension or expansion.

Many observers are concerned that even without a recession, recent gains could erode and hoped-for increases in programs could evaporate. They also have seen how Proposition 2's direction to use at least 1.5 percent of General Fund revenues for restricted debt payments and reserves has turned a manageable phase-out of Proposition 30 into projected out-year deficits. There may be a 2016 initiative effort to extend or replace a portion or all of Proposition 30's revenues and to reduce the impact of Proposition 2 on the bottom line.

After filling in the budget hole that the DOF projects, an extension of Proposition 30 would likely produce $1 billion in 2019-20 growing to $3.5 billion by 2024-25 in net additional resources for non-Proposition 98 purposes, after Proposition 2 uses. Table 2 *(next page)* estimates this effect.

A revised initiative has also been submitted that appears to be a compromise between school and health care advocates. It also extends the Proposition 30 personal income tax changes but designates 45 percent of any revenue available after funding a "workload budget" to health care, up to $2 billion. The workload budget is defined in existing statute and includes the Proposition 98 guaranteed level of funding for schools. If this version is approved by voters, it would significantly limit any potential benefit for higher education.

Table 2

Estimated Effects of Proposition 30 Extension on Revenues, Expenditures, and Reserves

Multi-year projection with Proposition 30 Extension

	Dollars in billions				
	2015–16	2016-17	2017-18	2018-19	2019–20
Revenues	$116.9	$121.8	$125.9	$132.0	$138.3
Budget Act projected expenditures	115.4	120.6	125.5	129.2	133.1
Expenditure changes (to Budget Act)			-0.3	1.6	4.1
General Reserve	2.0	1.6	1.3	1.3	1.4
Prop 2 Reserve	3.3	4.8	5.9	7.0	8.0
Reserve for encumbrances	1.0	1.0	1.0	1.0	1.0

Source: Author's estimates of Proposition 30 personal income tax extension revenues and Proposition 2 effects on 2015 Budget Act estimates.

6 Overall, long-term prospects for significant ongoing funding improvement for higher education are poor, but community college funding could be a bright spot.

Despite wide political support for higher education, mandatory spending on health care and Propositions 2 and 98 are likely to consume most of the growth in general funds, leaving little left over for public four-year higher education or other discretionary spending. But this could be a time of comfortable revenue growth in the community college sector, which has benefitted proportionately from the recent surge in Proposition 98 spending.

Higher education funding will have to compete with other priorities such as health and child care, law enforcement, courts, and infrastructure.

Even if Proposition 30 is reauthorized and the funds are not restricted to non-higher education purposes, there is no guarantee that any of those "new" funds will result in more funding for higher education. Funding growth for non-Proposition 98 purposes of 5 percent annually is likely if Proposition 30 is extended, with higher growth rates in the first few years. While this may seem like healthy growth, much of it would merely fill the projected budget holes and then fund likely cost increases. Potential for real program growth is likely significantly limited. Improvements in higher education funding will have to compete with desires to increase rates and eligibility for health care services and child care and improve funding for law enforcement, courts, and infrastructure, among other priorities. The budget is still very vulnerable structurally, with little one-time spending that is easy to cut. Thus, in a significant or extended revenue slow-down or reduction, real cuts are likely.

Concluding Comment

When considering prospects for stable long-term increases in funding from the state for higher education, it is important to discount any use of peak revenues to near zero. At best they could be used to build dedicated reserves, pay down higher education retirement debts, and pay for capital costs and thus reduce future operating budget costs. Proposition 2, if it builds a significant reserve, will help reduce the impact of revenue downturns, but probably cannot be a full shield. Thus some consideration of how higher education systems can have a better buffer against revenue volatility is appropriate.

An extension of Proposition 30 (or something of similar magnitude) is probably needed to sustain existing state expenditure levels. Without it, higher education and other areas of the budget face potential cuts. With an extension, while there are not likely to be multibillion-dollar increases in discretionary resources in the near term, there may be some potential for more modest increases in state support.

Afterword

This paper was written in late 2015 to help inform a discussion of potential prospects for state funding of higher education in California. The data mostly reflected the 2015-16 enacted state budget and 2012 tax data. Since that time, more than a year has passed and the most recent complete budget data is from the 2016-17 Budget Act. The Legislative Analyst's Office has recently provided their November 2016 Fiscal Outlook. By the time this is published the 2017-18 Governor's Budget will just have been released. The numbers will change again.

The Department of Finance multi-year forecast of revenues, expenditures and reserves released with the 2016-17 Budget shows a budget that is slightly in operating deficit until the Proposition 30 revenues sunset and then has an ongoing annual deficit exceeding $4 billion starting in 2019-20. This is not significantly different than that projected for this paper in 2015. Now with Proposition 55 in place and the revenue estimates used for this paper, I estimate that the operating deficit will still exist but be reduced to less than $1 billion. While this is manageable with relatively modest budget adjustments, no funds derived from Proposition 55 would likely be available for health care for at least several years (Proposition 55 sets aside 50 percent of any funds not needed for the workload budget to health care, up to $2 billion annually). Thus no more sustainable money may be available for other budget priorities like Higher Education, without cutting some things in the 2016-17 Budget or additional ongoing revenues. The Legislative Analyst projects larger revenues leading to balances sufficient to provide significant funds for new spending.

While many of the numbers in the budget have changed, the overall fiscal outlook in the 2016-17 Budget remains one based on slow to moderate economic growth and very moderate growth in capital gains income, reflecting an end to the recovery from recession and a transition to "normal" economic and profit growth. It appears that while demand in the economy (both in the US and the world) will be insufficient to achieve full employment and significant real wage gains for some extended time, and that marginal productivity increases will be modest at best, some sustained economic growth is still possible. There is a growing debate amongst economists and between members of the Federal Reserve Open Market Committee on what levels of inflation and employment should be targeted. The outcome of this debate may either hasten the next recession or accommodate better growth if underlying economic fundamentals and fiscal policy can drive it. The paper and most other forecasts assume no significant changes in policy.

Early cash counts for 2016-17 and the end of 2015-16 are less than projected in the 2016-17 Budget Act forecast, lending little support for higher revenue forecasts. The Legislative Analyst's higher projections appear to be based on significant increases in capital gains taxes. The 2016-17 Budget funded $300 million in higher education augmentations and added significant additional reserves and one-time spending, which could cushion the budget against any small shortfalls in revenue, but offer relatively little additional protection from recession or ongoing shortfalls.

The 2016 Presidential and Congressional election results could lead to in significant changes in national fiscal and budget policy and have significant economic effects downstream. Effects on California revenues and federal funding impacting state and local budgets may not be known for many months or years. Given the uncertainty, California budget decision-making may be more conservative until federal policy changes and their effects on the state are known.

Need URL, coming soon from Regan

Additional materials to view online:

- Discussion of revenue estimating with author Mark Hill *(see bio at right)*
- Multi-year tables
- Historical revenues data, Legislative Analyst's Office
- Historical expenditures data, Legislative Analyst's Office
- MR DOF + Jun + Prop 30 PIT SF 19R Results.pdf
- MR DOF + Jun + Prop 30 PIT SF 19R MY Detail.pdf

About the author

Mark Hill, Consultant, Former Program Budget Manager for the California Department of Finance

Mark Hill is a consultant on California's budget, with a focus on K-14 (Proposition 98). Mr. Hill has developed an integrated budget model combining estimates of General Fund revenues, expenditures by major program area, Proposition 98, Proposition 2, and the State Appropriations Limit.

Mr. Hill retired from the California Department of Finance in 2013. He was most recently the Program Budget Manager of the unit then responsible for the budgets of the Business, Transportation and Housing Agency and local government, and the Revenue, Demographic, and Economic Research Units of the Department. He also served as the department's lead staff person on—and developed simulation models for—various budget reform proposals. Previously, he served as Assistant Program Budget Manager for the following units: the Education Systems Unit; the Business, Transportation, and Housing Unit; and the Corrections and General Government Unit. In the Education unit, Mr. Hill was responsible for most of the K-12 programs, including Proposition 98 and apportionments.

Mr. Hill holds a B.A. degree from University of the Pacific in Stockton and a Master's of Public Administration degree from the University of Southern California Sacramento campus.

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