Chancellor's Budget Workshop State Economic and Fiscal Forecast

July 28 and July 30, 2014

Presented By:
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School Services of California, Inc.

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ECONOMICS AND POLICY

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The National Economy

- The national recovery is fragile, but continuing
  - The national economy shrank in the first quarter due to weather disruptions and weak demand abroad
  - Softer sales at retailers suggest U.S. consumer spending remains on a trajectory of modest growth
    - Sluggish consumer spending could hold back gross domestic product (GDP) growth
  - However, there are signs of economic improvement
    - American factories gained momentum in the second quarter, recording four consecutive months of improvement on the Manufacturing Purchasing Managers' Index
    - Many economists are predicting increases in wage growth in coming months

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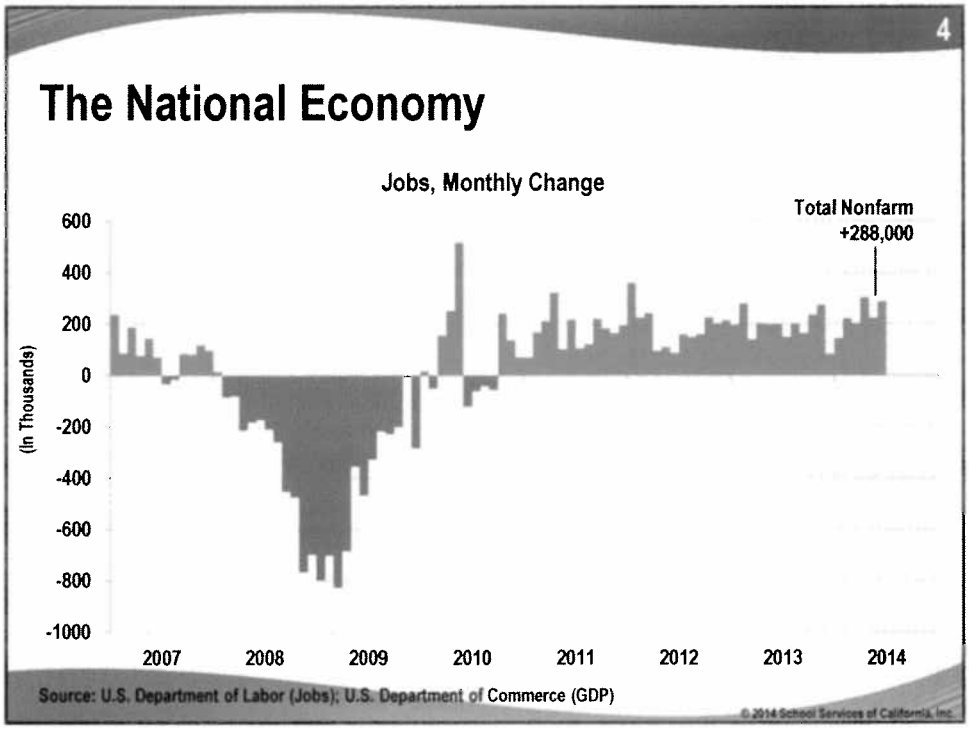
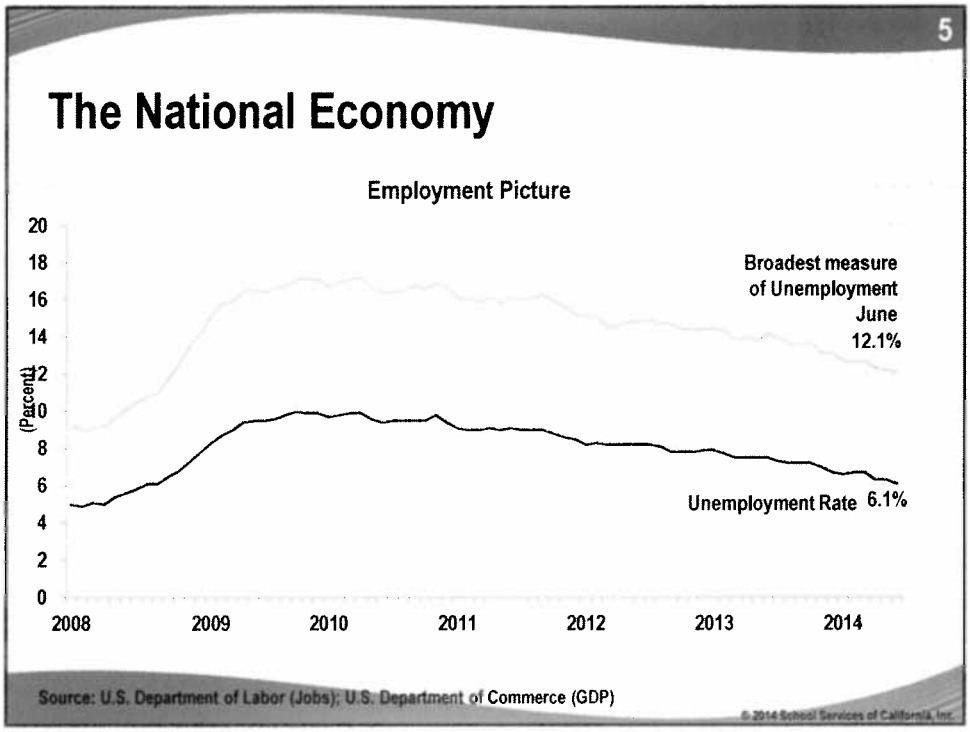
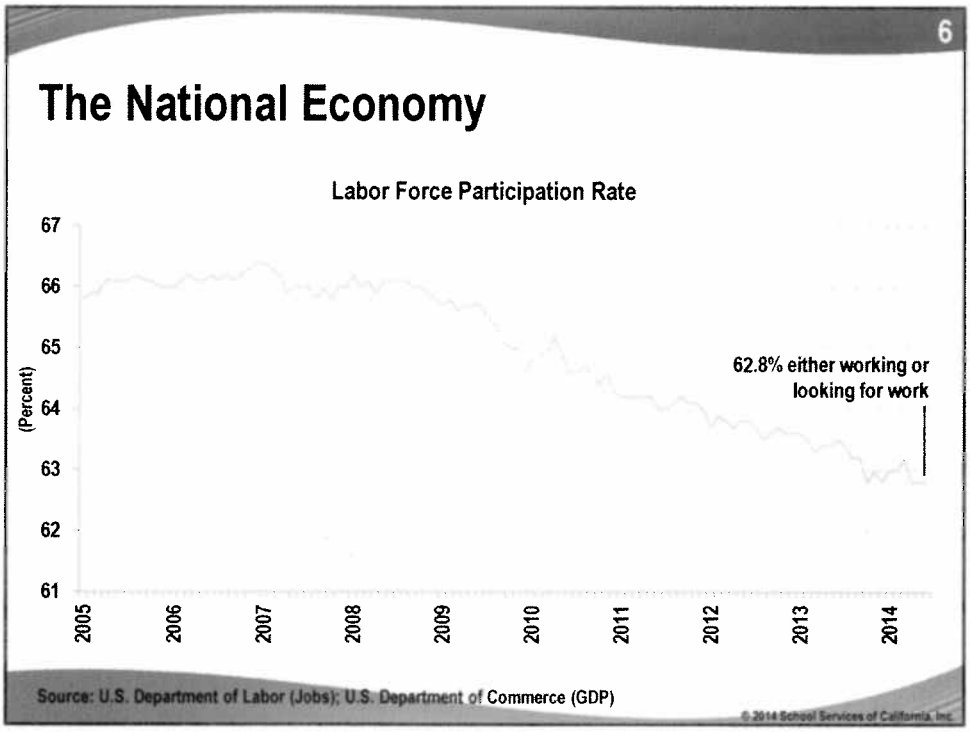
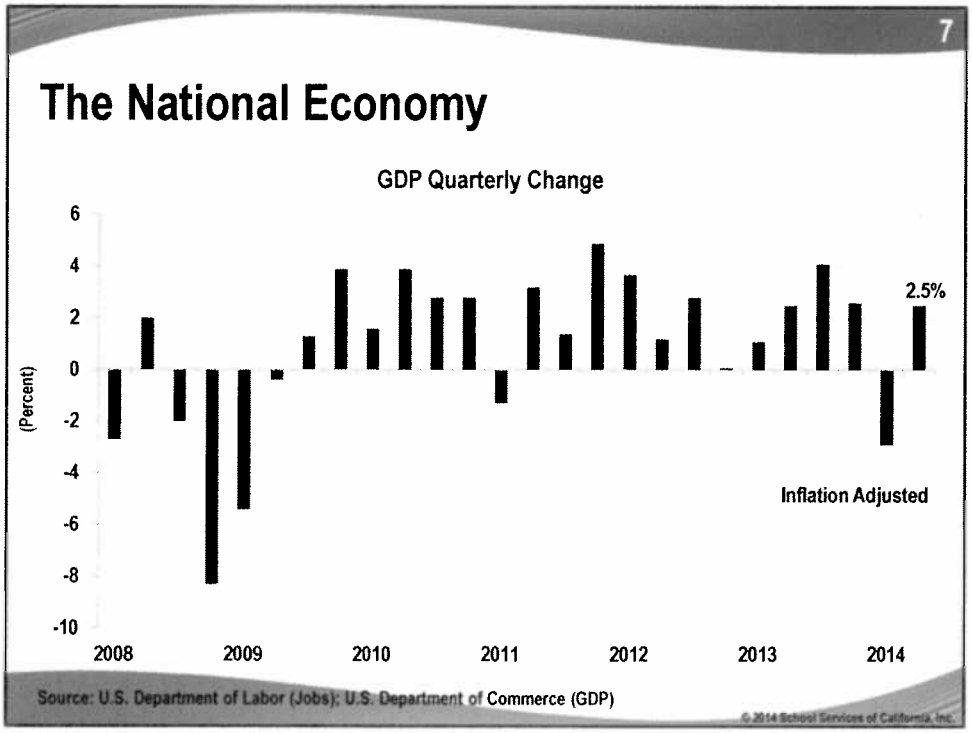
The National Economy

- Additional encouraging economic signs:
  - Employers added 288,000 jobs in June
    - That is the fifth month in a row that hiring has topped the 200,000 mark
    - Nationally, job gains were across the spectrum of professions
      - This is a marked difference from the exclusively low-wage job increases seen earlier
  - Inflation is still relatively low, with prices up 2.1% from a year ago
  - The Federal Reserve nudged up projections for short-term interest rates, signaling confidence in the economy over the next couple years









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The California Economy

- California has shown some encouraging developments recently on the economic front
  - Job growth has begun to outpace most of the nation, with significant gains in educational and health services professions
  - In the June Finance Bulletin, the Department of Finance (DOF) reported that the state has regained all but about 25,000 of the jobs lost during the recession
    - California manufacturing is still an area lacking improvement
      - None of the recent employment gains appear to be in this important area of the economy
  - Still, with a 2.1% increase in payroll growth, the improving employment picture can only help improve our communities, many of which have followed an uneven path to economic recovery

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The California Economy

- The most recent UCLA Economic forecast indicates overall flat growth in new home sales combined with increased pricing, pointing to a normalization of the housing market
  - Construction patterns are still not uniform throughout the state
- The median home price in the state – at approximately $449,000 – is at its highest since December 2007
- Foreclosures have plummeted to less than 7% of the housing market
- Multifamily unit demand is increasing, resulting in greater construction
- UCLA estimates inflation adjusted personal income growth at 3.1% in 2014 and 4.1% in 2015
- Through 2014, the California unemployment rate is expected to fall to 7.7%

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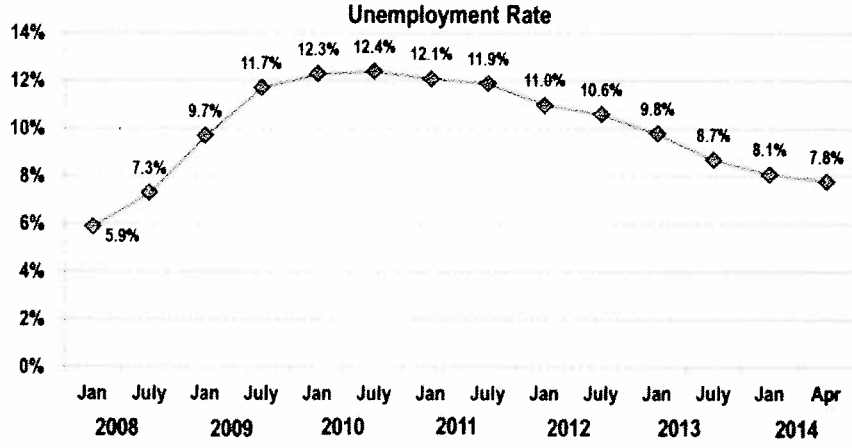
California's Unemployment Rate



Source: DOF Bulletin 2014

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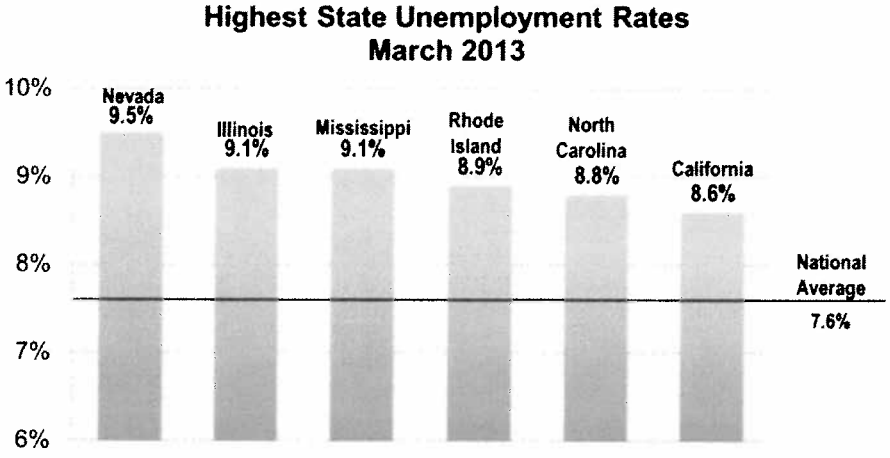
California's Unemployment Rate vs. Other States – Where We Were



Source: Bureau of Labor Statistics, March 2013

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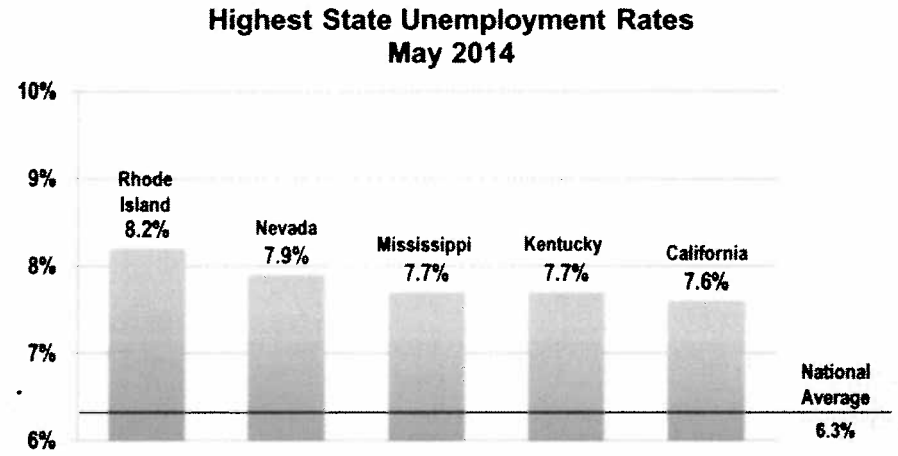
California's Unemployment Rate vs. Other States – Where We Are



Source: Bureau of Labor Statistics, June 2014

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Competing State Revenue Forecasts

- Like last year, the Administration's revenue forecast was lower than the forecast of the Legislative Analyst's Office (LAO), the Legislature's fiscal advisor
  - For 2013-14 and 2014-15 combined, the LAO forecast was $2.8 billion in additional revenues
  - Both houses of the Legislature initially assumed the higher LAO forecast and augmented 2014-15 expenditures accordingly
  - Ultimately, however, the Budget Conference Committee adopted the Administration's revenue forecast and sent Governor Brown a Budget based largely on his May Revision expenditure plan
- Postscript to 2013-14 revenues – in the end, the LAO's forecast was closer than the Administration's, with revenues coming in roughly $5 billion more than budgeted

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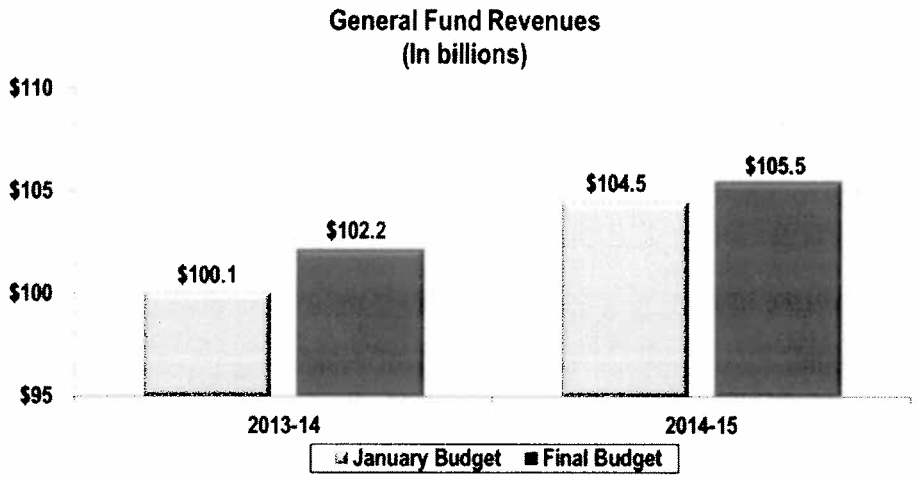
General Fund Revenues in 2014-15



Source: 2014-15 State Budget Summary, page 14 and 2014-15 State Budget, page 10

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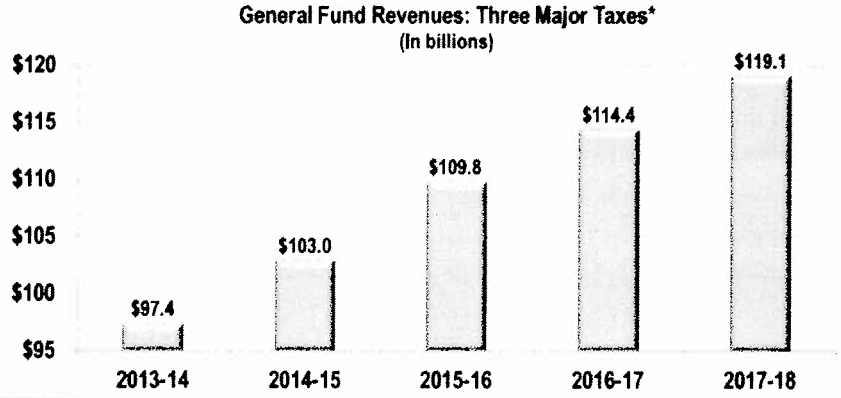
Long-Term Revenue Forecast

- From 2013-14 through 2017-18, the Administration's DOF forecasts moderate growth in General Fund revenues, reflecting an improving overall economy



Source: Governor's May Revision, Page 77
* Personal income tax, sales and use tax, and corporation tax

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Proposition 30 Taxes Are Temporary

- Proposition 30, approved by voters in November 2012, temporarily increased the state sales tax and income tax rates for high-income earners to address state revenue shortfalls stemming from the Great Recession
- The higher rates boosted revenues $7.1 billion in 2013-14 and are forecast to provide $7.4 billion in 2014-15
- Unless extended by the voters, these higher taxes will expire as follows:
  - The 0.25% sales tax increase expires in 2016 (i.e., the 2016-17 fiscal year)
  - The personal income tax increase expires in 2018 (i.e., the 2018-19 fiscal year)

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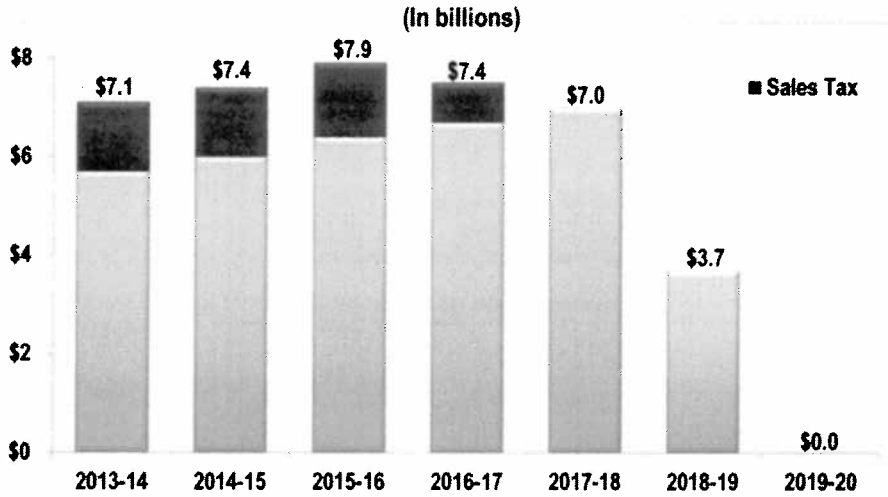
Proposition 30 Revenue Gain and Loss



Source: 2014-15 May Revision and SSC analysis

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PROPOSITION 98 AND THE LOCAL CONTROL FUNDING FORMULA

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Proposition 98 Funding

- Proposition 98, the constitutional minimum funding guarantee for K-14 education, adjusts total funding for increases in:
  - Workload – K-12 average daily attendance (ADA) change
  - Inflation –
    - Test 1: percentage share of General Fund revenues
    - Test 2: per-capita personal income growth
    - Test 3: per-capita General Fund revenue growth
- For 2014-15, Proposition 98 is based on Test 1 and will provide $60.9 billion ($44.5 billion from the state's General Fund and $16.4 billion from local property taxes
  - An increase of $2.6 billion, or 4.5%, from the revised 2013-14 level

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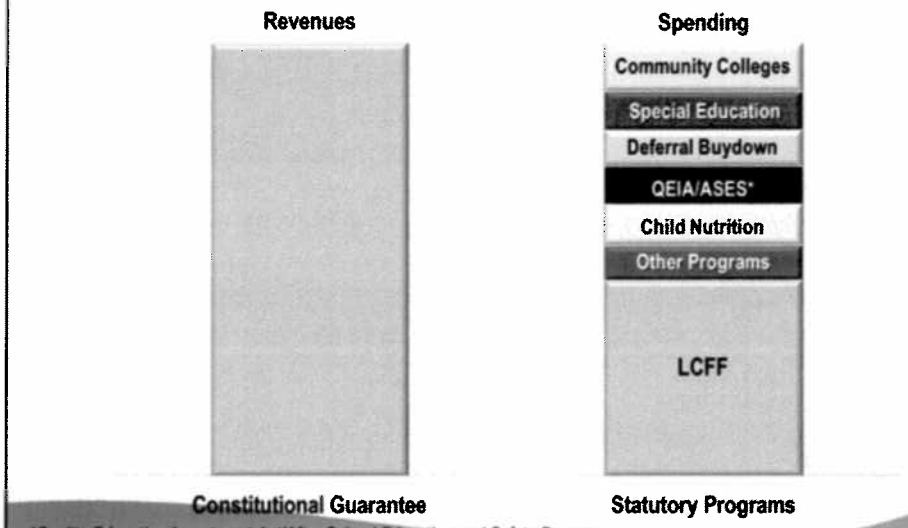
Proposition 98 Revenues and Spending



*Quality Education Investment Act/After School Education and Safety Program

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Proposition 98 Upside Potential?

- Last year, the State Budget was based on the Administration's revenue forecast, which ultimately turned out to be $5 billion lower than actual revenue collections
  - The additional revenues boosted Proposition 98 funding, which was used to buy down deferrals and reduce other past liabilities
- The LAO's 2014-15 General Fund revenue forecast is $2.2 billion higher than the DOF's, but the Governor ultimately prevailed in negotiations with the Legislature, and the State Budget is based on the lower DOF forecast
- If General Fund tax receipts exceed the budgeted level and because Proposition 98 is funded based on Test 1, funding would increase for this fiscal year
  - K-14 education could receive an additional $880 million if the LAO's forecast proves correct

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"Rainy Day Fund"

- In conjunction with the 2014-15 Budget Act, the Legislature and the Governor agreed to place a proposition before state voters to amend the existing Budget Stabilization Account (BSA) –"Rainy Day Fund" – enacted by Proposition 58 under Governor Schwarzenegger
- Proposition 44 would amend the existing requirements as follows effective beginning in 2015-16:
  - Reduce annual contributions to the Fund from 3% to 1.5% of General Fund revenues
  - To address revenue volatility, require contributions to the Fund equal to the amount of capital gains revenue in excess of 8% of General Fund revenue
  - Limit the Fund to 10% of General Fund revenue
  - Require 50% of contributions to the Fund to be used to repay prior years' obligations
  - Require legislation to suspend contributions to the Fund

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Proposition 98 Reserve

- In addition to amending the state-level Rainy Day Reserve, Proposition 44 would establish a Proposition 98 Reserve (officially called the Public School System Stabilization Account) effective beginning in 2015-16
- Establishment of the reserve would not affect the calculation of the Proposition 98 minimum guarantee
- Transfers to the reserve would be based on capital gains collections and would only occur if specified conditions are met
  - The Proposition 98 Maintenance Factor as of June 30, 2014, which is estimated at $6.6 billion, is fully repaid
  - Proposition 98 funding is based on Test 1
  - Full funding for enrollment growth and cost-of-living adjustment (COLA) are provided
- Transfers out of the Proposition 98 Reserve would be made during years in which the growth in the minimum funding guarantee is insufficient to fund projected enrollment growth and inflationary adjustments

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Cap on Local Reserves

- In a controversial, last-minute proposal advanced by the Governor, the Legislature adopted severe limits on LEAs' local reserves
- Senate Bill (SB) 858, the omnibus education trailer bill, requires the following:
  - If a district adopts a budget with an ending fund balance in excess of the minimum reserve specified in State Board of Education (SBE) regulations (1% to 5%, based on district size), the district must:
    - Identify the minimum reserve level applicable to the district
    - Identify the amount in excess of the minimum
    - Prepare a statement that substantiates the need for the excess
      - These needs could include one-time expenditures for infrastructure, maintenance and repair, technology, contributions to unfunded liabilities such as Other Post Employment Benefits (OPEB), or other needs as determined by the local board

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Cap on Local Reserves

  - Provided that (1) state voters enact Proposition 44, the proposed "Rainy Day Fund" in November 2014 and (2) the state makes a contribution to the Proposition 98 Reserve created by that proposition, in the year following:
    - District reserves would be limited to two times the SBE minimum, and three times for Los Angeles Unified School District (i.e., 3%)
    - County offices of education (COEs) are authorized to provide an exemption to the reserve limit under "extraordinary fiscal circumstances"
      - This exemption is limited to two consecutive fiscal years in a three-year period
      - COEs are exempt from the cap on reserves
- In testimony before the Budget Conference Committee, the Administration's DOF asserted that the need for local reserves would diminish because the state's Proposition 98 reserve would cushion the loss of funds during a downturn

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