League Analysis of the *2017-18*
California's Fiscal Outlook

Background

On November 16, 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 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. This *Fiscal Outlook* provides scenarios for economic growth and a scenario for a mild recession.

Economic Conditions

The *Fiscal Outlook* acknowledges that California's economic expansion continues and is currently in its 89th month. In California, income is up by 4 percent and job growth is up by 2.3 percent, however the percentage of those needing supplemental assistance as a result of high living-costs remains higher than the rest of the country. The *Fiscal Outlook* again warns about the uncertainty of an economic slowdown. The bulk of the economic expansion has been driven by the Bay Area (San Franciscio, Oakland, and San Jose) which has shown strong job growth and the largest per capita personal income tax in the state. State revenue growth is primarily driven by personal income, a volatile economic indicator which comprises 70 percent of the General Fund. 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.

The *Fiscal Outlook* acknowledges that forecasters are not good at projecting the end of economic expansions, therefore they provide indicators of looming recessions. These include reaching "full employment" combined with inflation, or major public policy change.

State Budget Outlook

The LAO predicts a positive outlook for the 2017-18 budget. The report illustrates that the state is better prepared to handle mild recessions than in past years. This optimistic outlook is based on the assumption that current state policies continue and no new budget commitments are made. Provided those conditions are met, the LAO anticipates the state would end fiscal year 2017-18 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 $2.8 billion, down from $4.3 billion last year. The LAO warns that if the Legislature were to make new funding commitments in the 2017-18 budget, it will likely face difficult choices by the end of the five-year forecast of 2020-21.

Current Year 2016-17
The 2016-17 Budget Act assumed revenue at $122.5 billion. The *Fiscal Outlook* indicates that revenue for 2015-16 and 2016-17 are down $1.7 billion. Final reserves are estimated at $7.5 billion levels, down $1 billion from budget assumptions. The decrease is due primarily to lower than projected sales taxes and corporate taxes.

Budget Year 2017-18
The *Fiscal Outlook* predicts that revenues will increase $8.1 billion, or 5.4 percent, in 2017-18. The growth is driven by a 6.9percent increase in personal income tax (PIT). The LAO estimates that, under current law, General Fund spending will grow by $4.1 billion in 2017-18. Increased spending is due to the Prop 98 guarantee and commitments to health and human services programs.

Proposition 98 Outlook
From 2017-18 through 2020-21 of the LAO forecast, Test 2 of Proposition 98 is operative. Generally, Test 2 is operative when there are changes in K-12 attendance and per capita personal income. For 2017-18, the LAO estimates the statutory COLA at about 1 percent.

One-Time Resources
The LAO indicates that the Proposition 98 Guarantee for 2015-16 and 2016-17 combined is down by $388 million. The *Fiscal Outlook* estimates that 2015-16 spending exceeded revenue by $351 million. The state will likely apply that as a payment towards it settle-up obligations of $1 billion. As a result, one-time funding will be limited for the 2017-18 budget. In addition, the state will have no outstanding maintenance factor payment for the first time since 2005-06.

New Proposition 98 Funds Available in 2017-18
The LAO projects the Proposition 98 guarantee will increase 3.6 percent, ($2.6 billion) from $71.9 billion (the adjusted guarantee) in 2016-17 to $74.5 billion in 2017-18. Combined with $496 million that was allocated as one-time money in 2016-17, the *Fiscal Outlook* estimates a $2.8 billion increase for K-14 education priorities for 2017-18. Using the approximate 11 percent statutory split between K-12 and community colleges, colleges could receive an estimated $308 million in on-going increases for the 2016-17 fiscal year.

Further, the LAO predicts that the 2017-18 Proposition 98 guarantee is "modestly sensitive" to General Fund revenue declines. Revenue could increase up to about $5.5 billion before having any effect on the minimum guarantee.

2016-17		
On-Going Funds Allocated in Budget Act	$71.7 billion	
2017-18		
LAO Estimated Prop 98 Guarantee	$74.5 billion	
	New Prop 98 Funds	$2.8 billion
LAO Estimated CCC 2017-18 Split	**$308 million**	

Out-Year Projections

This year, the LAO provided two hypothetical economic scenarios cautioning how the minimum guarantee would respond to either moderate growth or a mild recession beginning in the middle of 2018. Both scenarios include revenue for the passage of Proposition 55. Additionally, Proposition 51 does not affect the minimum guarantee but does provide community colleges with $2 billion in bonds for building and renovations of facilities.

Growth Scenario	Mild Recession Scenario
• Increases from $71.9 billion in 2016-17 to $83.5 billion in 2020-21. • Average annual growth rate under this scenario is 3.8%. • Under this scenario, the state creates little new maintenance factor, • By 2020-21, only $200 million in outstanding maintenance factor obligation.	• From 2017-18 to 2018-19 the guarantee declines by $1.4 billion (1.9%). • By 2020-21the guarantee grows from $71.9 billion in 2016-17 to $78.1 billion, an average annual growth rate of 2.1%. • In 2018-19, the state creates more than $4 billion in new maintenance factor. • State ends the period with $3.1 billion in outstanding maintenance factor obligation.

Overall, the LAO notes a number of significant issues in K-14 that impact the five-year forecast period including the full phase-in of K-12's new Local Control Funding Formula and the increased costs associated with CalSTRS contributions.

Local Property Tax Assumptions.

The LAO forecasts local property tax revenues to grow steadily during the forecast period, indicating that property tax revenue grows from $20.9 billion in 2016-17 to $25.6 billion by 2020-21. Both scenarios present a cautionary tale for community colleges. Community colleges do not receive an automatic backfill if Property tax revenue projections are lower than the assumptions in the Budget Act. The fact that much of the growth in the minimum guarantee is dependent on Property tax revenue (40 percent under the growth scenario and about 65 percent under the recession scenario) indicates that funding could dramatically change if assumptions do not materialized.

Higher Education Issues
Growing pension costs continue to be a primary concern for community colleges. District contribution rates for CalSTRS will increase from 12.5 percent of payroll in 2016-17 to 18.1 percent by 2019-20. CalPERS contributions will increase 13 percent to 19.9 percent by 2019-20. For the 2017-18 fiscal year, the CalSTRS and CalPERS contribution rates are as follows:

Year	STRS	PERS
2017-18	14.43%	16.6%

The LAO illustrates two possible economic scenarios for pension impacts. Under a growth scenario, costs represent about 25percent of the $24 billion cumulative funding increase districts would receive by 2020-21. In a recession scenario, costs represent about 33percent of the $19 billion cumulative increase in Proposition 98 funding.

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, while the sales tax portion of Proposition 30 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 reductions.

League Analysis
In past years, the LAO revenue estimates have generally been 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.

It is important to note that anticipated new funds for community colleges of about $308 million are significantly lower than the 2017-18 System Budget Proposal which requested $752 million. Additionally, as we learned from the 2016-17 budget, while ongoing funds may be available in the Proposition 98 guarantee, the Governor has the discretion to allocate the resources as one-time funds.

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 caution but to maintain focus on current ongoing initiatives like Student Success and Support Programs (SSSP) and Equity.