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November 26, 2012

To: Supervisor Zev Yaroslavsky, Chairman
Supervisor Gloria Molina
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From: William T Fujioka
Chief Executive Officer

SACRAMENTO UPDATE – LEGISLATIVE ANALYST'S OFFICE FISCAL OUTLOOK

This memorandum contains a report on the Legislative Analyst's Office California Fiscal Outlook.

Legislative Analyst's Office Fiscal Outlook for California

On November 14, 2012, the Legislative Analyst's Office (LAO) released *"The 2013-14 Budget: California's Fiscal Outlook,"* a report forecasting projections for State General Fund revenues and expenditures through FY 2017-18. While the LAO projects a $1.9 billion State Budget deficit through June 30, 2013, the LAO estimates operating surpluses of over $1.0 billion in FY 2014-15, growing to over $9.0 billion surplus by FY 2017-18. Overall, the LAO notes that the State Budget situation has improved sharply and the forecast differs dramatically from the severe operating deficits that have been forecasted by the LAO over the past decade.

FY 2012-13 State Budget Deficit

The Legislative Analyst's Office projects a $1.9 billion State Budget deficit through the end of FY 2012-13, which represents a significantly smaller budget problem compared to recent years. The deficit is attributable to a number of factors, such as lower-than-expected savings related to the dissolution of redevelopment agencies (RDAs) and an operating deficit of $936.0 million attributed to the difference between current-law revenues and projected expenditures in FY 2013-14.

In addition to the projected $936.0 million operating deficit, the FY 2012-13 State Budget Act assumed a year end reserve of $948.0 million. Now, the LAO projects that the State General Fund will end the current fiscal year with a $943.0 million deficit, due to: 1) $625.0 million of lower revenues in FY 2011-12 and FY 2012-13 combined; 2) $2.7 billion in higher expenditures (including $1.8 billion in lower-than-budgeted savings related to the dissolution of RDAs); and 3) a $1.4 billion positive adjustment in FY 2010-11 because of a higher than anticipated fund balance.

Operating Surpluses Projected Over the Next Few Years

The Legislative Analyst's Office projects that State revenues will grow more rapidly than expenditures due to the Education Protection Account created by Proposition 30 and given LAO's analysis of current State law and policies. In addition, a contributing factor to the surpluses beginning in FY 2016-17 is the financing mechanism used for the 2004 Economic Recovery Bonds (ERBs). Specifically, once the ERBs are retired, the State General Fund will benefit by realizing approximately $1.6 billion in additional revenue annually. The retirement of the ERBs will result in higher local funding for school districts, which ultimately leads to lower State contributions to fund schools.

Uncertainties: Caution is Appropriate despite Projected Operating Surpluses

The Legislative Analyst's Office bases its multi-year forecast upon several economic, policy and budgetary assumptions including:

1) steady growth of the economy and stock prices over the next several years (e.g. assumptions fueled by recent data of the State's housing market and income trends);

2) Federal actions to avoid the near-term economic problems associated with the "Fiscal Cliff" (e.g. if all major near-term effects of the Fiscal Cliff cannot be avoided, the economy could enter into a recession in 2013, which would delay potential or future State operating surpluses);

3) no transfers to the Budget Stabilization Account (BSA), the State reserve account, provided by Proposition 58 of 2004, which requires 3 percent of estimated State General Fund revenues to be transferred each year to the BSA under specific circumstances. The State has made such transfers in the past, but suspended the required annual payment since FY 2008-09 due to the State's persistent budget problems; and

4) no cost-of-living or inflation adjustments for most State employees.

The Legislative Analyst's Office indicates that any changes to the aforementioned assumptions may significantly reduce or even eliminate projected operating surpluses.

While there are many ways in which the State may use potential surpluses, the LAO advises the State to start building the reserve envisioned by Proposition 58 as soon as possible. Secondly, the State should strategize to address outstanding liabilities that will have to be paid (unfunded retirement liabilities and outstanding loans from the State's special funds to the General Fund). Finally, the LAO recommends for the State to selectively restore some of the recent program cuts.

The Legislative Analyst's Office complete report is available at: www.lao.ca.gov.

We will continue to keep you advised.

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MR:KL:lm

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