California Business Roundtable

ISSUE: Prop. 55. Tax Extension to Fund Education and Healthcare. Initiative Constitutional Amendment.

Measure Summary

Extends by 12 years the temporary personal income tax increases enacted in 2012 on earnings over $250,000 (for single filers; over $500,000 for joint filers; over $340,000 for heads of household). Allocates these tax revenues 89% to K-12 schools and 11% to California Community Colleges. Allocates up to $2 billion per year in certain years for healthcare programs. Bars use of education revenues for administrative costs, but provides local school governing boards discretion to decide, in open meetings and subject to annual audit, how revenues are to be spent.

Current Law

Prop. 30 was adopted by voters in 2012 by 55.4% - 44.6% to provide a temporary increase in taxes to help the state cope with a budget deficit estimated at $15.7 billion and to repair state finances that had become increasingly burdened by budgetary debt. To encourage support for passing the temporary tax increases, the adopted budget withheld $5.951 billion in "trigger reductions" to be restored only after Prop. 30 passed. $5.353 billion of the triggers were for Prop. 98 education, with another $500 million for UC and CSU. Prop. 30 was a merger of measures previously proposed separately by Governor Brown and by California Federation of Teachers.

A competing measure backed by Molly Munger would have increased personal income tax over a broader range of tax brackets for a longer, 12-year period. Prop. 38 would have raised about $10 billion a year with 60% distributed directly to local schools, 30% to repay state debt, and 10% for early childhood programs for the first 4 years, and an 85-15 split for schools and early childhood in the remaining years. Unlike Prop. 30, the Prop. 38 revenues to schools would not have been subject to the Prop. 98 calculations or to Legislative allocation, and would have represented a far more significant increase in education funding levels. This measure was rejected 28.7% - 71.3%.

Prop. 30:

- Enacted constitutional guarantees to local agencies for the 2011 Realignment funding for public safety and additional social welfare programs transferred to the local level.
- Increased state portion of the sales tax rate by a quarter cent for calendar years 2013 to 2016.
- Increased marginal income tax rates by 1%, 2%, and 3% for the highest income brackets retroactively for 2012 and proactively for calendar years 2013 to 2018. The affected income brackets are adjusted annually for inflation.

Medi-Cal is California's program to implement federal Medicaid. Medi-Cal is administered primarily through Department of Health Care Services (DHCS), with enrollment and caseload management conducted by the counties. Until recently, eligibility for Medi-Cal consisted of the following: low-income families with children, seniors and persons with disabilities (SPDs), and pregnant women. Beginning in 2014, the state expanded eligibility under the Affordable Care Act (ACA) to include additional low-income populations earning up to 138% of the Federal Poverty Level (FPL), primarily childless adults. Other expansions have included the ACA-required coverage of former foster care youth from age 18 to 26. The Legislature has continued to expand eligibility to other groups, primarily funded through state resources.

Eligibility for Medi-Cal varies by age, family size, income level, Medi-Cal program being applied for, immigration/residency status, and a variety of other factors. A "simplified" flowchart developed by a consumer group just to help determine initial eligibility runs 12 pages. Whether an individual is eligible for no-cost Medi-Cal or is subject to a co-pay is generally determined by how much family income (as adjusted by various factors) differs from the applicable FPL.

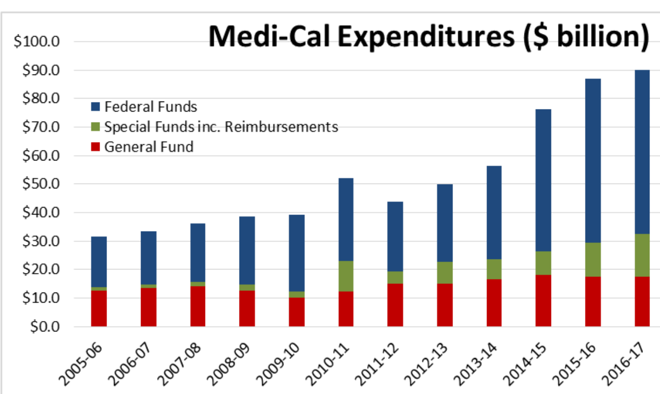
Medi-Cal provides services through two main systems:

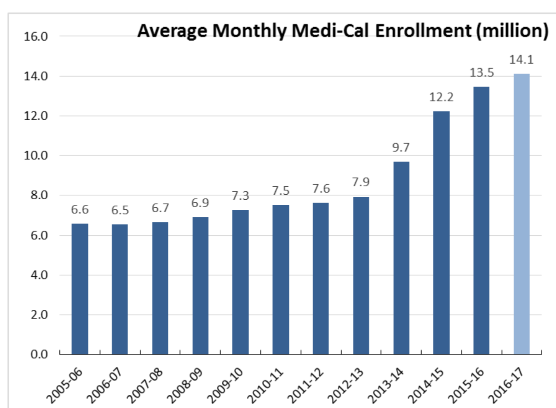
- Fee-for-Service is the traditional mode under which DHCS determines provider rates and pays for services as provided. These are done under either a cost-based reimbursement primarily for long-term care facilities and federally qualified health centers, or under an extensive fee schedule.

- Managed Care has become the dominant mode, covering about 80% of the caseload in the current budget year. Based on actuarial determinations, the state pays a fixed rate per enrollee per month, known as the "capitated rate" determined for each health plan.

The federal match in general is the 50% minimum for states, although individual components have varying rates. The key area of difference is for the Affordable Care Act optional expansion. From 2014 to 2016, federal funds covered 100% of the costs, but the required state match begins in 2017 and grows to 10% by 2020. The half-year of cost sharing in the adopted budget will require $385 million general fund, growing another $1.7 billion by 2020 or essentially an amount equivalent to the potential allocation under Prop. 55.

Based on the preliminary budget numbers, total growth in Medi-Cal funding along with the overall caseload are summarized in the following charts.





Adoption of the revised MCO tax this year provides $1.7 billion to Medi-Cal, while preserving federal funding and achieving a $1.1 general fund savings.

The 2011-12 Budget incorporated various Medi-Cal savings, including a 10% reduction in payments to providers ("AB 97 reductions"). The subsequent lawsuits seeking to overturn this action produced a federal court injunction until June 2013 when it was lifted and allowed implementation of the reductions both prospectively and retroactively. The Administration has applied this authority unevenly, exempting some providers and services from ongoing reductions and/or retroactive recoupments while leaving some of these savings in place.

Even prior to 10% cuts, however, California's program was marked by relatively low reimbursement rates compared to other states. As one metric, the Medicaid-to-Medicare fee index measures each state's physician fees relative to the allowable Medicare fees. The most recent data from 2012 shows California at 47th and 48th lowest state for 3 of the 4 health care categories. Another indication of California's low reimbursement rates is the number of physicians refusing to accept new Medi-Cal patients. A 2013 study by CDC showed that only 54.2% of office-based physicians were willing to accept new Medicaid patients, the second lowest rate behind only New Jersey. By comparison, 77.2% of California physicians were willing to accept new Medicare patients, and 76.6% were willing to accept new privately insured patients.

Analysis

Prop. 55 would enact the following provisions:

- Extend Prop. 30's higher income tax rates another 12 years, effective through 2030. The effective tax rates using the tax brackets in effect for 2015 are shown in the following table. Note that the Mental Health Surcharge adds another 1% to that portion of taxable incomes over $1 million (whether single or joint filer), making the highest rate 13.3%, the highest in the nation. Oregon is the second highest at 9.9%.

		Marginal Tax Rate[b]		
		Through 2018	2019 and Later	2019-2030
Single Filer's Taxable Income[a]	Joint Filers' Taxable Income[a]	With Proposition 30 Still in Effect	If Proposition 30 Expires as Scheduled	If This Proposal Is Approved by Voters
$0-$7,850	$0-$15,700	1.0%	1.0%	1.0%
7,850-18,610	15,700-37,220	2.0	2.0	2.0
18,610-29,372	37,220-58,744	4.0	4.0	4.0
29,372-40,773	58,744-81,546	6.0	6.0	6.0
40,773-51,530	81,546-103,060	8.0	8.0	8.0
51,530-263,222	103,060-526,444	9.3	9.3	9.3
263,222-315,866	526,444-631,732	10.3	9.3	10.3
315,866-526,443	631,732-1,052,886	11.3	9.3	11.3
Over 526,443	Over 1,052,886	12.3	9.3	12.3

- Provide additional revenue for Medi-Cal as calculated annually by Department of Finance from the following factors: (1) calculate revenues raised by the proposition, (2) subtract estimated costs of providing specified services to more people being provided with state funded services, and (3) allocate the lesser of half the result or $2 billion to Medi-Cal. During a Prop. 2-declared emergency, the allocation would be reduced proportionally as overall general fund expenditures.

- The measure's revenues would be subject to Prop. 98 K-14 minimum funding calculations, Prop. 2 rainy day reserve, and Prop. 4 Gann Spending Limit. However, the adopted budget still shows a Gann surplus of $7.8 billion, and while this number has been narrowing, it is unlikely it will become relevant to budget decisions for several years giving the slowing growth in overall revenues.

Prop. 30 was a revenue solution adopted during budgetary lows, but it has by no means been the only or largest component of the sustained growth in state revenues. As shown in the table below:

- Increased special funds has been an even larger source of budget backfill, begun the year prior in 2010-2011. Compared to 2007-08, special fund revenues have been increased $20.6 billion.

- The economic recovery has produced significant recovery and expansion in overall general fund revenues. Compared to 2007-08, non-Prop. 30 general fund revenues have grown $16.1 billion. And although the pace is expected to slow down, the most recent Department of Finance projections show continued growth of about $5 billion a year over the next 3 years. No projections are available for the special funds.

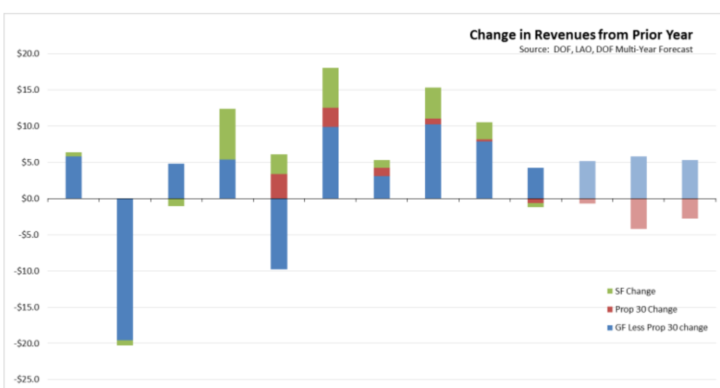
- Overall, general and special fund revenue has grown $44.3 billion since 2007-08, and $64.6 billion since the recessionary low of 2008-09.

Revenues ($ billion)

Source: LAO, DOF, DOF Multi-Year Forecast

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Prop. 30					3.4	6.1	7.2	8.0	8.3	7.7	7.0	2.8	0.0
Other General Fund	101.3	81.7	86.6	92.0	82.2	92.0	95.1	105.3	113.2	117.4	122.5	128.3	133.6
Total General Fund	101.3	81.7	86.6	92.0	85.6	98.1	102.3	113.3	121.5	125.1	129.5	131.1	133.6
Special Funds	25.3	24.6	23.5	30.5	33.2	38.7	39.8	44.2	46.5	45.9	n/a	n/a	n/a
Total State Funds	126.6	106.3	110.1	122.5	118.8	136.8	142.1	157.4	167.9	170.9			

These points are further shown in the following chart illustrating the components of revenue change since 2007-08. While Prop. 30 revenues are scheduled to ramp down by the end of the 2019-20 budget year, DOF is currently projecting that they will more than be covered by continued—although slower—growth of the other general fund sources. Note that the projections cover only general fund, not special funds.



DOF, however, is also now projecting a deficit in the out years. As shown in the table below, expenditures are projected to outpace revenues. Revenues are projected to be short of expenditures by $1.1 billion in 2018-19 but will be covered by transfers from the previous year. A larger shortfall of $3.2 billion is projected the following year that cannot be covered by transfers after the BSA transfer occurs.

General Fund Multi-Year Projection
Source: Department of Finance

	2015-16	2016-17	2017-18	2018-19	2019-20
RESOURCES:					
Prior Year Balance	3.4	4.9	2.7	3.2	1.1
Revenues/Transfers	118.8	123.6	127.9	129.0	133.3
Transfer to the Budget Stabilization Account	(1.8)	(3.3)	(1.1)	(1.0)	(1.0)
Total Resources	120.4	125.2	129.5	131.2	133.4
EXPENDITURES:					
Proposition 98	49.7	51.1	52.7	52.1	53.2
Non-Proposition 98	65.8	71.4	73.6	78.0	83.3
Total Expenditures	115.6	122.5	126.3	130.1	136.5
FUND BALANCES:	4.9	2.7	3.2	1.1	(3.2)
Reserve for Encumbrances	1.0	1.0	1.0	1.0	1.0
Special Fund for Economic Uncertainties	3.9	1.8	2.2	0.1	(4.2)
Budget Stabilization Account/Rainy Day Fund	3.4	6.7	7.9	8.8	9.8
Operating Surplus/Deficit with BSA Transfer	1.4	(2.2)	0.5	(2.1)	(4.3)

These deficits, however, disappear if economic growth is only slightly higher. The LAO multi-year projections from May are based on average jobs growth of 2.25% over the next two years vs. 1.85% for DOF, with slowing growth in the years after. This small difference, however, is enough to project revenues that exceed base expenditures through the end of Prop. 30, with a significant fund balance to tempt even more new spending.

General Fund Multi-Year Projection
Source: LAO

	2015-16	2016-17	2017-18	2018-19	2019-20
RESOURCES:					
Prior Year Balance	3.4	4.2	1.9	5.5	9.3
Revenues/Transfers	118.8	123.5	130.0	132.6	135.4
Transfer to the Budget Stabilization Account	(2.6)	(3.6)	(1.8)	(1.3)	(1.0)
Total Resources	119.6	124.2	130.1	136.8	143.6
EXPENDITURES:					
Proposition 98	49.6	50.9	52.5	52.8	53.3
Non-Proposition 98	65.8	71.3	72.2	74.7	79.2
Total Expenditures	115.5	122.2	124.7	127.5	132.5
FUND BALANCES:	4.2	1.9	5.5	9.3	11.1
Reserve for Encumbrances	1.0	1.0	1.0	1.0	1.0
Special Fund for Economic Uncertainties	3.2	1.0	4.5	8.3	10.1
Budget Stabilization Account/Rainy Day Fund	4.2	7.8	9.6	10.9	11.9
Operating Surplus/Deficit with BSA Transfer	0.7	(2.2)	3.5	3.8	1.8

As indicated above, DOF's projected deficits are not a revenue issue; general fund revenues continue to show significant growth. Overall state revenue taking into account special funds is likely to be stronger still.

The issue is more the extent of new spending commitments. While prior budget years showed strong commitments to fiscal prudence and a focus on debt reduction and creation of a budget reserve, this year has signaled a return to long-term spending commitments on the belief that revenues will continue growing either on their own or through voter approval. A deficit is becoming likely because the Legislature is creating one:

- At full implementation, the $15 minimum wage will cost an additional $3.4 billion for the general fund and $10 billion for all funds.

- Comparing 2016-17 to 2011-12, salaries for the Executive Branch have increased $1.5 billion (10%) while the number of employees has dropped by 19,400 (9%). Including all state employees including UC and CSU, salaries have increased $4.2 billion (17%) while the number of employees has gone down 3,800 (1%). Unions continue to negotiate additional raises this year, and will be pushing for more as the minimum wage increases produce salary compaction.

- State pension payments (not including UC) have increased $3.4 billion to a total of $8.1 billion. Health benefits—both current and retired employees—has increased $1.1 billion to a total of $5.1 billion. While the state's STRS payments are not scheduled to accelerate at the same pace as for school districts, CalPERS' were scheduled to keep increasing even before the latest $8 billion loss.

- More current data on school districts is not yet available, but comparing 2014-15 to 2011-12, districts and county offices have used a significant amount of their new resources for salary increases. Total salaries increased $3.6 billion (11.2%) while the number of teachers increased only 12,000 (4.2%). STRS and PERS payments increased $1.2 billion to a total of $4 billion, and are scheduled to continue rising significantly (additional $3 billion) as a result of the STRS changes adopted by the Legislature. Average teacher salary increased 8.1% from 68,531 to $74,090.

- The January Budget identified an additional $3.8 billion in social/welfare program increases already locked into the base.

- The optional Medicaid expansion is costing $385 million general fund as the first half year of cost sharing kicks in. Full cost sharing will cost an additional $1.7 billion under the current caseload assumptions.

Fiscal Impact

From the DOF/LAO fiscal impact analysis:

- Increased state revenues annually from 2019 through 2030-likely in the $5 billion to $11 billion range initially-with amounts varying based on stock market and economic trends.

- Increased revenues would be allocated under constitutional formulas to schools and community colleges, budget reserves and debt payments, and health programs, with remaining funds available for these or other state purposes.

Consistency with CBRT Draft Strategic Policies

Relevant strategies:

VII.1 Oppose New Tax Increases that Harm Middle Class Wage Job Creation

VII.2 Simplify Corporate Income Tax & Reduce the Overall Rate

Enact tax simplification that allows revenue-neutral reduction of rates closer to the national average. Consideration should also be given to the effects of California's high personal income tax rates on capital formation and employment rates in the growing portion of the state's businesses that are organized as pass-through forms of business.

CBRT was neutral on Prop. 30.

Arguments Pro

Arguments contained on the Yes on 55 web site:

- California public school funding was cut to the bone during the recession, forcing more than 30,000 teacher layoffs, huge class sizes, and the elimination of programs like music and art that make our kids well-rounded. Public schools and colleges are just starting to come back from these cuts, and unless we pass Prop. 55 to maintain the current income tax rates on the wealthiest Californians, our schools will lose $4 billion a year.

- Furthermore, California is facing a severe teacher shortage. There is a need to hire more than 22,000 teachers next year alone, and there is still a need to hire education support professionals like library aides, bus drivers and custodians.

- California chronically underfunds health care, and Prop. 55 provides up to $2 billion per year to give low- income families with kids increased access to care. This measure helps low-income families with children access the care they need, especially preventative care, which keeps kids healthier and saves California money in the long run. Proposition 55 will help low-income children come to school healthy and ready to learn – because everyone deserves access to quality healthcare, not just the wealthiest Californians.

Arguments Con

Prop. 30 was pushed as a temporary tax measure designed to help the state rebalance its fiscal picture. By and large, these revenues were used for that purpose. Extending the temporary taxes another 12 years essentially will make them permanent by supporting even further expansion of spending commitments over and above the $30+ billion identified above.

The state revenue structure is already at a historical high point of volatility and this measure will push it even further as the budget increases its reliance on the highest income earners. As proponents rely on this extension plus additional revenues from measures such as oil severance, split roll, and others to push for even higher base spending, this growing volatility will require even deeper cuts in the next downturn.

Department of Finance already projects required spending cuts of up to $55 billion in even a moderate downturn. If this "temporary" measure is extended now, the cuts will be even deeper and a further temporary increase will no longer be available to help guide the state through this next crisis.

The proposed increases are not just expecting the wealthy to pay their "fair share." It is a business tax. An increasing number of businesses within the state are being formed as pass-through tax entities such as sole proprietorships, partnerships, LLCs, Subchapter S, and comparable forms. Increasing the tax rate will further dampen the current low level of new venture formation and reduce resources available to these companies to finance expansions and efficiency improvements through internal capital formation.

A significant portion of new revenues—including Prop. 30—have gone to increasing the cost of government rather than to expanding services, including improving the quality of education in the state. Adding resources will further this trend.

The comparison of the DOF and LAO projections show that even a small increase in the current historically low-level of economic expansion will provide more than adequate resources for the current expenditure structure. As a business tax, this measure will run counter to this approach. More broadly, there are no counterbalancing measures seeking to improve jobs and incomes growth, only continued efforts to increase both the cost of living and the cost of doing business in the state.

Support

The recent IGS poll showed strong support for extending the temporary income tax rates of Prop. 30: 65.2% support – 34.8% oppose. The April PPIC poll shows 62% support – 35% oppose – 2% don't know. Neither poll asked specifically about Prop. 55.

Secretary of State shows the support committee has raised $50.4 million, with primary funding from California Association of Hospitals and Health Systems ($33.5 million), CTA ($14.0 million), and various SEIU ($1.7 million). The only significant individual contribution to date is $25,000 from Eli Broad. Listed endorsements (among many others) include:

- Lt. Gov. Gavin Newsom
- Controller Betty Yee
- Treasurer John Chiang
- Commissioner Dave Jones
- Superintendent Tom Torlakson
- Delaine Easton
- Jack O'Connell
- Senators De Leon, Hall, Lara, Mitchell
- Assemblymembers Rendon, Alejo, Arambula, Bonilla, Chiu, Gipson, Gonzalez, Lopez, Low, Medina, O'Donnell, Thurmond
- Various superintendents and local officials
- Various unions
- AFSCME
- Asian American Business Women Association
- Asian Americans in Commercial Real Estate
- Association of California Health Districts
- Association of California School Administrators
- Blue Shield of California
- Association of California Health Districts
- Association of California School Administrators

- Blue Shield of California
- California Alliance of Retired Americans
- California Black Chamber of Commerce
- California Democratic Party
- California Federation of Teachers
- California Hospital Association
- California Labor Federation
- California League of Conservation Voters
- California Medical Association
- California Professional Firefighters
- California School Boards Association
- California State Firefighters' Association
- California Teachers Association
- League of Women Voters of California
- SEIU California State Council
- SEIU Local 1000

Opposition

Secretary of State reports no committee opposed to this measure, although Dave Kersten has formed California's Future PAC but has not raised any funds into it. Announced opposition includes:

- Senator Moorlach
- California Republican Party
- California Chamber of Commerce
- California NFIB
- Howard Jarvis Taxpayers Association
- Cal-Tax

The Governor has not indicated his position on this measure, stating "I am prepared to manage without it . . . I am prepared to manage with it."

Executive Committee Recommended Position

Position: Neutral
Proposed Statement: "As California struggled to recover from the worst recession since the Great Depression, Prop. 30 in 2012 provided the temporary emergency resources to help pay down massive state debt and help maintain funding for critically important priorities such as education and health care. While we support continued funding for those priorities, we observe that the state is also increasing spending in non-priority areas and has yet to address other unmet needs such as roads and other infrastructure. The California Business Roundtable believes that a comprehensive agreement on broader revenue, budget and jobs reforms will serve the interests of long-term budget stability far better. Due to its highly volatile revenue, we believe that a measure such as Prop. 55 is better policy if it is reserved for economic emergencies, as was Prop. 30."