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MEMORANDUM

To: **Mayor Libby Schaaf**

Council President Larry Reid and Members of the City Council

From: Townsend Public Affairs, Inc.

Date: February 21, 2017

Subject: **Ongoing update of the 2017-2018 State & Federal Budgets**

As we reported, on the morning of January 10th the Governor released his proposed budget for the 2017-18 Fiscal Year. The proposed budget anticipates that the overall state economy, which has been growing steadily for the last several years, will grow at a much slower pace in the upcoming year. According to the Administration's forecast, if corrective action is not taken, the FY 2017-18 budget would have a $1.6 billion budget deficit, as well as deficits of $1 to $2 billion in the following three budgets. Overall, the Governor's January Budget proposes General Fund spending of $122.5 billion in FY 2017-18, which is $200 million lower than FY 2016-17.

Last month we provided a detailed assessment of the State Budget and will not rehash our last memo but the overview includes:

In order to address the potential budget deficit in FY 2017-18, the Administration is proposing $3.2 billion in corrective actions. If the Legislature adopts these actions then the budget will contain a $1.6 billion reserve in FY 2017-18 and will be balanced into the future. The key components of the corrective actions proposed by the Administration include:

- Adjust the spending level of Proposition 98 – The Proposition 98 funding level is determined based on the level of State revenue and the Governors' budget proposes funding only the minimum Proposition 98 guarantee. This action, while still resulting in an overall growth in Proposition 98 spending, will result in $1.7 billion in savings in FY 2017-18.

- Recapture unspent one-time funds – The FY 2016-17 budget contained significant levels of one-time spending, and many of these one-time allocations have not yet been spent. The Administration proposes savings of $900 million by recapturing some of these one-time allocations. The two largest of these allocations is the *$400 million in affordable housing money that was to accompany the Governor's "by-right" housing proposal* and the $300 million that was allocated for modernization of state office buildings in Sacramento.

- Limit spending growth – The Governor's budget proposal calls for limits on spending for programs that would otherwise be funded, if the General Fund was in a stronger position.

The Administration anticipates that it can save $600 million by limiting spending on programs. The Governor is proposing to pause rate increases for child care, as well as to phase out the Middle Class Scholarship program by not extending the scholarship to any new students.

In addition to the corrective actions outlined above, the Governor's January Budget proposal contains numerous policy proposals and funding adjustments. A few brief items to highlight include:

- Cap and Trade – The Governor's January Budget proposes spending $2.2 billion in cap and trade proceeds on various programs. However, the Administration acknowledges that the cap and trade auction proceeds for the past several auctions has been well below forecasted levels. The Administration believes that this, in part, is due to the uncertainty surrounding the future of the cap and trade program. In order to address this issue, the Administration will be putting forth legislation, which will require a 2/3 vote, to extend the cap and trade program beyond its current 2020 sunset date. The Administration has indicated that it will not appropriate the $2.2 billion in proposed cap and trade spending until the Legislature has acted on the cap and trade extension legislation.

The Governor is proposing substantially the same transportation funding proposal from last year's budget proposal, totaling roughly $4.2 billion per year, or almost $43 billion over the next decade. The proposal includes the following funding sources:

- $2.1 billion from a Road Improvement Charge of $65 on all vehicles (including hybrid and electric vehicles)
- $1.1 billion from setting the gasoline excise tax at 21.5 cents per gallon and then adjusting annually for inflation
- $425 million from increasing the diesel excise tax by 11 cents per gallon
- $500 million from additional cap and trade revenues
- $100 million from efficiencies at Caltrans
- $706 million in loan repayments of transportation funds

Federal Uncertainties – The Governor's Budget acknowledges that there are numerous uncertainties that accompany the change in Administration in Washington DC. These uncertainties could have a significant impact on California and the State budget. For example, the FY 2017-18 budget contains $800 million for the State's portion of Medi-Cal expansion from the Affordable Care Act. This $800 million assumes that the federal government will continue to provide a 95% funding level, as was set forth in the ACA. Should Congress act in a way that modifies the funding provisions of the ACA, then California could be responsible for a significantly higher level of funding. The Governor's budget acknowledges these federal uncertainties, but does not include specific provisions to deal with these uncertainties. Instead, Governor Brown has indicated that he will wait until the May Revise to evaluate what actions, if any, have been taken in Washington DC, and how those may impact the State budget.

Now that the Governor has released his proposed budget, the Legislature will begin the task of gathering information and evaluating the proposals contained within the Governor's budget. The Assembly and Senate Budget committees will conduct informational hearings where the Department of Finance will provide an overview of the proposed budget. Afterwards, the Assembly and Senate Budget Sub-committees will hold a series of hearings over the coming weeks to evaluate specific proposals within the budget. In mid-May the Governor will introduce his May Revise, which will contain updated revenue and expenditure forecasts for the Legislature to evaluate and act on by June 15th. Sub-committee hearings have not yet started.

Federal Budget & Appropriations Overview

- At the federal level, the **budget** is a non-binding, broad outline of spending that is recommended but not required, which is followed by appropriations bills that fund all federal government agencies.
- **Appropriations bills**, which fund the federal government, are traditionally adopted in twelve individual bills pertaining to the various federal departments and agencies. These bills may also advance in the form of a:
  - **Continuing Resolution (CR):** Extension of federal funding for a set amount of time at the same level as previously negotiated
  - **Omnibus:** Full-year funding, all in one bill
  - **Minibus:** Full-year funding, but for several departments at a time
  - **CRomnibus:** Combination CR and omnibus, which negotiates new funding levels for some areas of government and simply extends federal funding at same levels for other areas of government
- In a typical legislative year, Congress begins crafting their annual funding bills after the president submits his proposal in February, followed by appropriation committee hearings in early spring, appropriation bill mark-ups in late spring, floor debate and passage in summer, conference committee negotiations in early fall and final approval by the House and Senate before the September 30 end of the fiscal year.
- However, for the past several years, Congress has been unable to pass all twelve bills in time, and has relied in a series of CRs or omnibus bills.
- An omnibus (and sometimes minibuses) can be unwieldy and under-scrutinized compared to the individual twelve bills, but ultimately, they fund the government in the same way individual appropriation bills would.

Federal Budget

Budget Director Confirmed: President Trump's nominee to lead the Office of Management and Budget (OMB), Mick Mulvaney, was confirmed on February 16, 2017, with a Senate vote of 51 to 49. Up until last week, Mulvaney was a sitting congressman from South Carolina and a member of the conservative House Freedom Caucus. Now that an OMB director has been confirmed, the outlook for the budget and appropriations timeline seems slightly sunnier. With leadership at the top, it is more likely that OMB and the administration at large will be able to meet deadlines and possibly make up for lost time.

However, the same lack of staffing that plagues the rest of the Trump administration is no different in OMB. Despite Mulvaney taking the helm as the agency's director, many subordinates are taking on multiple roles as staffing positions remain empty. This may ultimately result in the same or more delays than we were previously predicting.

Fiscal Year 2017 Budget Resolution: Congress passed a Fiscal Year 2017 budget resolution with only top-line amounts in January, meant to serve as a vehicle to repeal the Affordable Care Act (ACA) via reconciliation (thus, bypassing the filibuster). The FY17 budget resolution directed the relevant committees to report reconciliation measures by January 27, but committees have not yet reported them out.

Fiscal Year 2018 Budget Resolution: While April 15 is traditionally the deadline for Congress to pass its annual budget resolution, there is no penalty for failing to do so. Senate Majority Leader Mitch McConnell stated that he is hoping to pass a FY18 budget resolution by August, and hopes to use reconciliation measures this year to pass tax reform.

Federal Appropriations

Overview: The federal government is currently operating under a continuing resolution (CR) that funds all government programs through April 28, 2017 at the same levels as FY2016 funding. Congress will have to pass appropriations bills (or another CR) by April 28, 2017 to keep the government funded through the end of the federal fiscal year, September 30, 2017.

Fiscal Year 2017 Appropriations: Funding for the remainder of FY17 will likely take the form of a Continuing Resolution (CR)-Omnibus hybrid, colloquially referred to as a "CRomnibus." A CRomnibus allows members to renegotiate funding levels for the areas of government where both parties can find consensus, while extending the funding for more controversial areas at current levels. This CRomnibus would feature a limited number of anomalies, or funding level changes. Departments will have to work with OMB and appropriators to figure out what anomalies are viable and permitted, but we do not currently expect change for most areas. Some Departments have confirmed that they have received no direction from OMB.

Fiscal Year 18 Appropriations: The FY18 President's Budget Proposal, which typically kicks off each the fiscal year budget and appropriations timeline, is likely to be published during an 8-week window between April and May. Senior department officials report that they expect the proposal to be a fairly limited document with few new policy details, with the exception of Trump priorities that have been widely discussed.

Fiscal Year 2019 Appropriations: Although funding has not yet been determined for the rest of FY17 (through September 30, 2017) or FY18 (October 1, 2017 – September 30, 2018), federal departments are supposed to begin department-level discussions of their FY19 budget needs in March. However, we expect those to be delayed, especially because of cabinet and sub-cabinet vacancies. For example, according to one administration official, the Department of the Interior has about 125 political appointee positions, and only two have been named and put in place so far. Additionally, those two are likely not in their permanent positions, and their role is likely to change.

Looking Ahead: President Trump missed the deadline to publish his proposed budget in early February, but in the first year of a new administration, this is not uncommon (Presidents Clinton, Bush, and Obama all submitted their proposed budgets in April or May in their first years in office). However, the slow political hiring process is unusual and could result in unusually long budget and appropriations delays.

Despite the delays in the budget and appropriations process, the potential for government shutdowns due to partisan impasses that plagued previous congresses is highly unlikely during the 115th Congress. With Republican control of the House and Senate, as well as the White House, adoption of continuing resolutions, when necessary, should be relatively routine. While there has been no indication that another CR will be required to address the remaining months of FY17 by the April 28 deadline, the sheer volume of budget and appropriations work facing the new administration and congress is daunting. Factoring in difficult decisions on the ACA, border security and looming discussions on infrastructure funding and tax cuts will further complicate matters at both ends of Pennsylvania Avenue.