

INTRODUCTION

California has struggled with massive budget deficits for most of the past decade. These recurring deficits have been largely the result of a reliance on one-time solutions, borrowing, accounting maneuvers, and cuts or revenues that were illusory and therefore did not materialize. Short-term spikes in revenues were repeatedly used to justify permanent increases in spending and costly tax breaks. Making matters much worse, the Great Recession reduced the state's revenue base by 30 percent.

When Governor Brown took office, California's immediate and long-term fiscal problems were immense. A \$25.4 billion budget deficit for 2011-12 and an annual structural deficit of up to \$21.5 billion was projected into the future. The Governor's Budget not only closed the budget deficit in 2011-12, but it addressed the state's ongoing fiscal problems. It did so by reducing spending and increasing revenues, returning authority to local governments, and reducing state government.

In March, most of the Governor's spending cuts were adopted by the Legislature, dramatically reducing the size of the budget deficit and improving the state's fiscal outlook.

Nevertheless, a sizable budget deficit remains.

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California's economy is beginning to recover and revenues have increased though it is uncertain how long this uptick will continue. The increased revenues have made it possible to reduce the proposed temporary tax estimations by \$2.9 billion and provide enhanced support to education and public safety. They also help to avoid additional borrowing previously needed to pay for cancelling the short sighted sale of state buildings.

The bottom line is, the state still has a large ongoing budget problem and massive liabilities for the long term. Based on updated projections, California will need to adopt over \$10 billion in ongoing cuts and revenues to balance the budget and make inroads in reducing its substantial long-term debt.

The May Revision keeps the Governor's Budget framework by moving government services closer to the people, and streamlining state government. Under the May Revision, the state's budget would be balanced into the future—setting the groundwork for a strong economic recovery.

THE STATE'S BUDGET PROBLEM

ADOPTED SOLUTIONS MADE SIGNIFICANT PROGRESS IN BALANCING THE BUDGET

The Governor's Budget identified a \$25.4 billion gap between revenues and spending and proposed to bridge the gap through a balanced combination of spending cuts and tax extensions. In February, the Governor cancelled the sale of state buildings that had been set in motion in 2009, as it would have cost the state \$6 billion over the long run. As a result, the 2011-12 budget gap grew to \$26.6 billion.

In March, the Legislature passed the Governor's proposed package of bills that substantially cut government spending. In addition to the \$11 billion in cuts and other solutions that the Governor signed, the budget bill adopted by the Legislature contains \$2.4 billion in solutions. Figure INT-01 summarizes the total of the \$13.4 billion in solutions already adopted. These include the following:

- Reducing the State Supplementary Payment (SSP) grants to below the level in effect in 1983.
- Reducing CalWORKs grants to below the 1987 level.
- Reducing California Department of Corrections and Rehabilitation's (CDCR) inmate population by 39,750, or 24.5 percent, once realignment is fully implemented.

Introduction (Figure INT-01)

Adopted Solutions Reduce Spending
(Dollars in Millions)

	2-Year Total
<u>EXPENDITURE REDUCTIONS</u>	
<u>Health and Human Services Programs</u>	
Medi-Cal	\$1,518.8
Proposition 10 Funds to Maintain Health Services	1,000.0
CalWORKs	983.8
Proposition 63 Community Mental Health Services	861.2
Developmental Services	567.2
In-Home Supportive Services (IHSS)	420.1
Supplemental Security Income/State Supplementary Payment Grants	178.4
<u>Education</u>	
UC and CSU	1,076.5
Cal Grant Program	153.0
<u>All Other Reductions</u>	
Transportation Debt Service	1,130.2
Employee Compensation and State Operations	440.8
Other Reductions	1,628.4
Subtotal, Expenditure Reductions	\$9,958.4
<u>REVENUES</u>	
Revenue Proposals	\$531.1
<u>OTHER</u>	
Loans and Transfers from Special Funds, including Loan Repayment Deferrals	\$2,212.0
Other Solutions	688.8
Subtotal, Other	\$2,900.8
Total	\$13,390.3

- Requiring recipients of Medi-Cal health benefits to pay a share of the cost for doctor visits and other services.
- Requiring almost all state employees to pay at least 3 percent more of their salary for their retirement costs.
- Eliminating the Adult Day Health Care program, Williamson Act subventions, and the refundable child care and dependent tax credit.
- Closing up to 70 state parks.
- Reducing the state's workforce by approximately 5,500 positions.

REVISED REVENUE AND SPENDING FORECASTS

The May Revision reflects the positive economic data of the early months of 2011. However, the pace of California's economic recovery remains uncertain.

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Higher-than-anticipated cash receipts have resulted in an upward revision to the current-year tax revenue forecast of \$2.8 billion from the level reflected in the Governor's Budget. For the budget year, the tax revenue forecast has increased by \$3.5 billion. Other minor revenue adjustments result in a two-year total change of \$6.6 billion.

Offsetting the \$6.6 billion revenue gain, the May Revision also reflects other changes including required increased spending and adjustments made since January to keep this budget plan honest, accurate and balanced. Specifically:

- State funding for K-12 education and community colleges will increase by \$1.6 billion General Fund pursuant to Proposition 98 to account for the higher revenues
- Last year's budget underfunded the costs for both the Department of Corrections and Rehabilitation and the Department of Mental Health. The May Revision contains funding—\$415 million and up to \$50 million respectively—so these departments can pay their bills.
- The \$11 billion in budget solutions were adopted by the Legislature one month later than the Governor's Budget anticipated. The May Revision reflects a lower amount of savings due to delayed implementation.
- While the Legislature adopted the Governor's proposal to shift \$1 billion in Proposition 10 dollars to fund health services for children, the May Revision does not reflect these savings due to ongoing litigation.

The May Revision adjusts proposed solutions by \$3.6 billion—reduced tax extensions and reduced borrowing—made possible by the higher revenues. These changes are discussed later in this chapter.

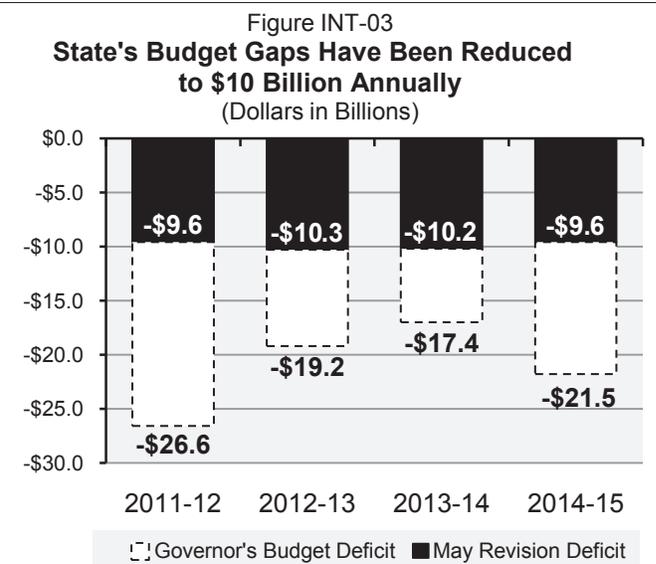
THE REMAINING SHORT-TERM BUDGET PROBLEM

After accounting for the solutions already adopted by the Legislature, higher revenues, and updated spending projections, the state's \$26.6 billion budget problem has been reduced to \$9.6 billion. The remaining \$9.6 billion problem is composed of a carry-in deficit of \$4.8 billion from 2010-11 and an operating shortfall of \$4.8 billion in 2011-12. The projected operating shortfall increased to \$10 billion and remains at that level into the future. To balance the budget, \$10.8 billion in solutions must be adopted to erase the deficit and rebuild a modest \$1.2 billion reserve. Figure INT-02 illustrates that even with this improvement, the size of the state's budget shortfall is still \$10.8 billion, representing about 11 percent of expected General Fund revenues.

Figure INT-02
Updated 2011-12 Budget Problem—May Revision
 (in Billions)

Original Problem Statement	\$26.6
Solutions Already Enacted	-11.0
Higher Revenues	-6.6
Higher Spending	2.0
Proposition 10 Litigation	1.0
Deficit Under Current Law	12.0
Solutions Adopted by the Legislature in Pending Legislation	-2.4
Remaining May Revision Problem	9.6
Build Reserve	1.2
May Revision Solutions Needed	\$10.8

Without decisive action, the state’s chronic budget problems will persist, and continue to harm economic recovery and job growth. As shown in Figure INT-03, the Department of Finance projects that the state would face at least a \$10 billion budget gap through at least 2014-15 if long-term solutions are not adopted.



BUDGETARY BORROWING CREATES LONG-TERM PROBLEMS

Over the past decade, the state has strayed from the principle that government should only spend what it takes in. The state’s current budget problem is exacerbated by an unprecedented level of debts, deferrals and budgetary obligations. These liabilities take many different forms.

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Future Annual Payment Obligations — As summarized in Figure INT-04, three major eventual payment obligations will increase state spending by \$13.6 billion annually. The state will need to increase Proposition 98 spending by \$10 billion annually as the “maintenance factor” created by the recession is paid off and base funding is increased. The state’s Unemployment Insurance Fund is more than \$10 billion in debt to the federal government, requiring annual interest payments from the General Fund in excess of \$500 million. In addition assuming that all previously authorized bonds are eventually sold, \$48.2 billion in not yet issued general obligation and lease revenue bonds, will require an increase in spending of more than \$3 billion annually at today’s interest rates.

Figure INT-04

Future Annual Payment Obligations

	(\$ in Billions)
Proposition 98 Maintenance Factor	\$9.9
Interest on Unemployment Insurance Debt	0.5
Debt Service on Authorized but Unissued Bonds	3.2
Total	\$13.6

Outstanding Budgetary Borrowing — Debt accumulated over the past decade totals \$35 billion. See Figure INT-05. The state increasingly deferred required payments to K-12 schools and community colleges from one year to the next. As a result, they receive more than \$10 billion in funding the year after they have incurred the costs. In addition, the state owes schools \$3 billion in “settle-up” payments from years in which it failed to fully fund the Proposition 98 minimum guarantee. The state still owes \$7 billion of the \$15 billion in Economic Recovery Bonds authorized by the voters in 2004 and the General Fund has taken out \$5 billion in loans from a variety of state special funds. Finally, a variety of accounting maneuvers have pushed spending from one year to the next. For example, in 2009, the state’s payroll was shifted one day—from June 30 to July 1—to push one month of employee costs into a future fiscal year.

Figure INT-05

Outstanding Budgetary Borrowing
Based on Senate Bill 69 and implementing legislation

	(\$ in Billions)
Deferred payments to schools and community colleges	\$10.4
Economic Recovery Bonds	7.1
Loans from Special Funds	5.1
Unpaid costs to local governments, schools and community colleges for state mandates	4.3
Underfunding of Proposition 98	3.0
Borrowing from local government (Proposition 1A)	1.9
Deferred Medi-Cal Costs	1.2
Deferral of state payroll costs from June to July	0.8
Deferred payments to CalPERS	0.5
Borrowing from transportation funds (Proposition 42)	0.4
Total	\$34.7

This borrowing totals \$35 billion which contributes to the state’s current budget problem and creates a drag on the state’s economy. Under current law, a total of \$2.5 billion in 2011-12 General Fund resources is needed to service this debt. Over the next few years, the state would spend a total of \$15 billion and will still end 2014-15 with nearly \$20 billion in outstanding budgetary borrowing.

Retirement Liabilities — The state faces other long-term fiscal challenges. Unfunded liabilities in the state’s retirement system are more than \$100 billion for pensions and retiree health. Retirement systems for University of California employees and teachers have accumulated tens of billions of additional liabilities (See Figure INT-06).

Lastly, the state has \$81.1 billion in outstanding general obligation and lease revenue bonds.

All of these liabilities prevent the state from being able to afford wise investments in programs and services to enhance the quality of life in California. As described below, the May Revision enables the state to pay off more of its debts now and continue to do so in the coming years, encouraging an economic recovery.

Given the limited options available to close the then-projected \$26.6 billion shortfall, the Governor’s Budget included two borrowing proposals—\$2.2 billion in new Proposition 98 deferrals and \$2.9 billion in additional special fund borrowing (much of which was proposed to reverse the costly sale of state buildings). The May Revision reverses much of this borrowing.

Figure INT-06
Retirement Liabilities

	(\$ in Billions)
Unfunded Obligations for Retiree Health	\$59.9
Unfunded Pension Liability for State Employees	48.6
Unfunded Pension Liability for Teachers	56
Unfunded Pension Liability for Employees of the University of California	12.9
Unfunded Pension Liability for Judges	3.6
Total	\$181.0

INVESTING IN CALIFORNIA’S FUTURE

Building on the Governor’s January Budget, the May Revision reflects a multi-pronged approach to invest in California’s future. The proposals include:

- Reducing state government.
- Protecting education and public safety by extending current taxes and funding a historic realignment of responsibility to local governments.
- Paying off the state’s debts.
- Creating incentives for businesses to locate and expand in California.

FOCUSING ON CORE SERVICES AND REDUCING STATE GOVERNMENT

The May Revision reflects the Governor's continuing efforts to make state government smaller, more efficient and focused on core responsibilities. Details about the specific proposals can be found later in this publication. Among the highlights are:

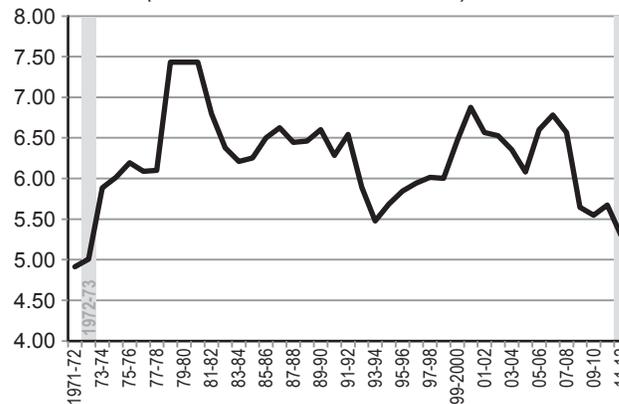
- Eliminating 43 boards, commissions, task forces, offices, and departments, including the California Medical Assistance Commission, the California Postsecondary Education Commission, the Managed Risk Medical Insurance Board and the Unemployment Insurance Appeals Board.
- Reducing state administration as functions are realigned to local authorities, thereby eliminating the Departments of Mental Health and Alcohol and Drug Programs and reducing state personnel by at least 25 percent for affected programs.
- Improving management of the state's infrastructure bond proceeds. Currently, over \$11 billion of cash from bond sales have accumulated in department accounts, which costs taxpayers more than \$700 million a year in debt service payments for projects that have yet to be completed.
- Selling nonessential or under-utilized state properties such as the Los Angeles Coliseum, properties owned and managed by the Capitol Area Development Authority in Sacramento, the Ramirez Canyon property in Southern California, and the Montclair Golf Course in Oakland.
- Merging the Healthy Families Program into the Medi-Cal Program to reduce costs and create a single health care program for low-income families.

These efficiencies are in addition to a number of executive actions to reduce state operations costs, such as cutting the number of cell phones, banning non-essential travel, and reducing the size of the state's vehicle fleet.

PROTECTING EDUCATION AND PUBLIC SAFETY

The rise in General Fund revenues in the first part of this year is a hopeful sign that the state's recovery is underway. But the state still faces a \$10 billion deficit and must adopt \$11 billion in new solutions to rebuild a modest reserve. State spending has been reduced to focus on core services, and under the May Revision those core services will be scaled back even further. As shown in Figure INT-07, General Fund spending as a share of the economy will be at its lowest level since 1972-73 under the May Revision.

Figure INT-07
**General Fund Spending
 Would Drop to 1972-73 Level**
 (Per \$100 of Personal Income)



Further, the May Revision reduces state personnel by approximately 5,500 from 2010-11 to 2011-12.

Consistent with the Governor’s Budget framework, the May Revision includes \$10.8 billion in solutions. The May Revision includes a total of \$655 million in new proposals to further lower state spending. Figure INT-08 shows that, under the plan, expenditure reductions would represent 48 percent, revenues 42 percent, and other solutions 9 percent of the total solutions.

Figure INT-08
Closing the Budget Gap Under the May Revision
 (In Millions)

	Adopted ^{1/}	May Revision	Total	%
Expenditure Reductions	\$8,958	\$2,259	\$11,217	48.3
Revenues	531	9,321	9,852	42.4
Other	2,901	-745	2,156	9.3
Total	\$12,390	\$10,835	\$23,225	

^{1/} Excludes the \$1 billion attributable to Proposition 10 due to litigation.

The May Revision proposes that the Legislature implement and the voters ratify a plan that preserves core services, including a reduced safety net. Current sales tax and vehicle license fee rates and the dependent credit exemption level would be extended for five years. Given the current revenue situation, the May Revision does not seek a 2011 personal income surcharge, but would reinstate it for the 2012 through 2015 tax years in order to fund core services. Even with these extensions, State revenues, per \$100 of personal income, would remain billions below the average level of the past three decades. These revenues would be used for two purposes:

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- Funding a major realignment of public safety programs. The Governor's Budget proposed a major realignment of public safety programs from the state to local governments. This realignment assigns program and fiscal responsibility to the level of government that can best provide the service, eliminating duplication of effort, generating savings, and increasing flexibility. The implementation of the Community Corrections Grant Program authorized by AB 109 will end the costly revolving door of lower-level offenders and parole violators through the state's prisons. A Constitutional Amendment passed by the voters will guarantee that local governments receive the necessary funding to make realignment successful.
- Protecting education funding. Schools have borne a disproportionate share of past spending cuts. These revenues will allow a reinvestment in education. Even under the May Revision's increased funding for education, support for schools and community colleges will remain more than \$4 billion below the 2007-08 funding level.

Based on current projections, the mix of spending reductions and revenue extensions reflected in the May Revision would balance the budget in 2011-12 and into the future. The state would operate a slim surplus in each of the next four years.

PAYING OFF THE STATE'S DEBTS

As described above, the state is burdened by \$35 billion in debt from a decade of borrowing and poor fiscal decisions. While the state cannot reverse a decade of these decisions in a single year, the May Revision begins the process of paying down budgetary borrowing:

- The \$3 billion in increased Proposition 98 spending is dedicated to reversing the deferrals of payments into future years. These deferrals require schools to dedicate scarce resources to borrowing money to get through the year, rather than on classroom investments.
- Borrowing from state special funds will be reduced by \$744 million.

Paying off the remainder of this budgetary borrowing should be the top priority of any new revenue received in the coming years. The Administration looks forward to working with the Legislature in the coming weeks to devise a mechanism to ensure that revenue growth above what is needed to fund current programs will be dedicated to paying off debts. New Proposition 98 funds should be used to erase all of the deferrals and pay off owed mandate claims. Increased General Fund dollars should be used to reverse the borrowing and accounting maneuvers of the past. Under the Governor's approach, at least \$29 billion in deferrals and debt would be paid off by 2014-15, twice as much as under current law.

In March, the Governor announced a framework to reform public employee retirement systems. The Administration looks forward to working with the Legislature to adopt comprehensive and fair reforms that reduce and stabilize taxpayer costs and curb abuses.

CREATING ECONOMIC INCENTIVES

The May Revision reflects the Governor's continued commitment to help grow the economy and increase jobs by creating a long-term, balanced state budget that preserves critical levels of government services. The resulting stability from a balanced budget will give businesses the certainty and reassurance they need to invest in California.

The May Revision removes disincentives to investment in California by reforming job creation incentives and adding a new incentive to invest in manufacturing equipment in California. The Governor stands ready to work towards effective ways of reforming our regulatory programs to achieve better outcomes with less cost to business.

- In 2009, the state adopted a tax policy that allows multistate businesses to choose how their income will be apportioned. As a result, wholly in-state businesses are put at a competitive disadvantage. The May Revision maintains the Governor's proposal to move to a mandatory single sales factor.
- The May Revision proposes to use a portion of the revenues created by the mandatory single sales factor to encourage manufacturing investment by creating a sales tax exclusion for business equipment purchases beginning in 2012-13. The exclusion will encourage investments in equipment and provide the most benefit—a full exclusion from the state sales tax (5 percent)—to those businesses just starting out.

In addition, the state can make better use of two existing economic development programs to better target dollars to encourage job creation.

- As part of the 2009 budget package, a tax credit for hiring was created. The credit was intended as a short-term stimulus to spur economic recovery, but little of the \$400 million in credits has been claimed. The May Revision proposes to increase the size of the credit, and to expand it to firms with up to 50 employees.
- The Governor's Budget proposed the elimination of enterprise zones, as they have not proven their effectiveness. The May Revision instead retains these zones but proposes to implement a series of reforms to help ensure that the zones are creating incentives for new jobs, rather than reward businesses for decisions they have already made.

Because redevelopment of specific areas is a local economic responsibility, rather than the state's, the May Revision maintains the Governor's Budget proposal to eliminate redevelopment agencies. Redevelopment costs the state more than \$2 billion annually in lost school property taxes, and its effectiveness on a statewide basis is questionable. By eliminating the agencies, more funds can be returned to cities, counties, special districts, and schools to invest in core services such as hiring police officers, firefighters, and teachers.

STATE FACES CRITICAL DECISIONS

California faces a critical decision point regarding the level of services that it will provide and the kind of state it will be. The Governor's Budget proposed substantial spending reductions and revenue extensions to close the deficit. Based on this plan, in March, the state made billions of dollars in spending reductions—eliminating programs and reducing core services. As a share of personal income, General Fund spending will drop to its lowest level since 1972-73.

Absent the balanced approach proposed by the Governor, the options are either an "all cuts" budget or a combination of gimmicks and cuts. Described below are the types of reductions that would be necessary in an "all cuts" budget. The levels of reductions by program area are similar to those identified by the Legislative Analyst's Office earlier this year. The choices outlined avoid the failed and unachievable solutions of the past.

IMPACT ON EDUCATION

Schools have borne a disproportionate share of cuts in the past. In 2007-08, General Fund and property tax revenues to support K-12 schools and community colleges totaled \$56.6 billion. In 2010-11, funding decreased to \$49.7 billion.

Because Proposition 98 represents more than 40 percent of General Fund spending, K-12 schools and community colleges would need to bear a heavy share of any "all cuts" budget. An "all cuts" budget would require a suspension of the Proposition 98 minimum guarantee and deep reductions. To remain in balance in future years, the minimum guarantee would likely need to be suspended in subsequent years. Such an approach would drive future maintenance factor payment requirements—already at \$10 billion—significantly higher.

A \$5 billion reduction to Proposition 98 funding is equivalent to eliminating 4 weeks of the K-12 school year and 52,000 community college courses. Alternatively, it equates to laying off 51,000 teachers, raising K-12 class sizes from an average of 25 students to 30 students, and raising community college fees from \$36 to \$125 per unit. In whatever

way such reductions were implemented, such a funding drop would require a major downsizing of the state's education system.

The University of California and California State University have already each been cut by \$500 million. An "all cuts" budget would require another cut of \$500 million for each university systems. The systems have reported that fee increases likely exceeding 30 percent would be necessary if additional cuts of this size were made. Reductions of this magnitude would significantly impair the universities' critical role in training the state's workforce and encouraging innovation.

IMPACT ON PUBLIC SAFETY

In the area of criminal justice, implementing the recently enacted AB 109 would remain a priority for the administration and an even greater necessity under an "all cuts" framework. This realignment will make the state's correctional system operate more efficiently with better outcomes. Given the pending ruling by the U.S. Supreme Court in the three-judge panel case and the potential of a prisoner release order, these changes are critical.

Without the tax extensions and with additional cuts required, other aspects of public safety would be affected. The state could no longer afford the supervision of non-serious, non-violent parolees. Nor could it afford to have these parolees incarcerated for violations unless they committed a new crime. The state could not afford some state public safety programs administered by the Department of Justice and other state agencies. An additional cut of \$150 million to the court system would be necessary—likely leading to court closures twice each month. Fire prevention and protection would also be reduced.

IMPACT ON HEALTH AND HUMAN SERVICES

Health and human service programs were significantly reduced in March—cutting grants, requiring co-pays for health care services, eliminating adult day health services, and reducing services for the developmentally disabled. An "all cuts" budget would mean further reductions in CalWORKs grants (which are already at their 1987 level), eliminating domestic and related services for many IHSS recipients, increasing the costs of AIDS drugs, capping Medi-Cal coverage for prescriptions and other medical supplies, and making deeper reductions to developmental services. In addition, the state would no longer have a dedicated funding stream for the Governor's realignment of public safety programs. Some of these programs, such as Adult Protective Services, would be eliminated instead.

OTHER IMPACTS

In other areas of the budget, deep cuts would also be needed. The state would need to reach out to state employees to renegotiate their recently signed contracts to generate hundreds of millions of dollars in further savings. Water quality programs, parks, food and agricultural protection, and veterans services would all face further cuts. The state would need to freeze issuance of any new general obligation bonds in order to contain rising debt service costs, delaying key infrastructure projects.

INVESTING IN CALIFORNIA'S FUTURE

The May Revision reflects the Governor's belief that a budget full of gimmicks or one embracing "all cuts" is damaging to California. The preferred—and responsible—alternative is to invest in California's future by reducing state government, protecting education and public safety through tax extensions, paying down the state's debt and adopting powerful economic incentives.