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California's fiscal condition is improving. A year ago, the state faced an immediate \$26.6 billion shortfall and future estimated annual budget gaps of \$20 billion. This year, the state faces a \$9.2 billion budget problem and future annual budget gaps of \$5 billion or less.

The on-time 2011 Budget Act balanced the budget by cutting billions of dollars in spending and realigning state programs. This year, the Governor's Budget proposes a balanced solution by cutting more deeply into spending while also increasing revenues. The Governor will ask voters in November to approve a Constitutional Amendment to prevent deep cuts to education and guarantee funding for public safety at the local level.

The Budget builds on last year's progress by continuing to move government closer to the people, protect education and public safety programs from the worst of the cuts, improve government efficiency, and pay down debt. The balanced budget will provide fiscal stability, make California more attractive for business and investment, and accelerate the state's economic recovery.

SUBSTANTIAL PROGRESS HAS BEEN MADE

The enacted 2011 Budget made substantial progress in stabilizing California's finances. It rejected the past approach of over-relying on one-time solutions and instead substantially shrank the ongoing deficit.

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The accomplishments of the 2011 Budget include:

- Passing an on-time budget that avoided the gimmicks of prior budgets.
- Closing three-quarters of the state's chronic structural budget gap. A year ago, the gap stood at about \$20 billion and is now \$5 billion or less.
- Adopting an historic realignment of public safety that brings government closer to the people.
- Protecting education, public safety, and other core state services to the extent possible, absent adoption of the proposed tax extensions.
- Eliminating redevelopment agencies to increase funding for schools, police, fire, and other core local services.
- Reducing the state's cash-flow borrowing from \$10 billion to \$5.4 billion and saving hundreds of millions of dollars in short and long-term borrowing costs.
- Improving management of the state's infrastructure projects by committing available cash to shovel-ready projects and avoiding unnecessary debt.
- Shrinking state government and making it more efficient by reducing the state workforce by more than 15,000 positions and eliminating 20 boards, commissions, task forces, offices, and departments.

MAINTAINING A BALANCED BUDGET IS AN ONGOING CHALLENGE

While the passage of the 2011 Budget made substantial progress in restoring fiscal stability to the state, major challenges and threats remain. Achieving savings and controlling costs, especially in the areas of health and human services and corrections, are particularly challenging.

Last year, the Governor and the Legislature agreed to about \$5 billion in cuts to health and human services programs. Many of these cuts—such as reducing CalWORKs grants to below their 1987 level—have already been implemented. Other cuts, however, have been blocked by the courts. For example, a portion of the Medi-Cal provider rate reductions has been enjoined. In other instances, the federal government has rejected or delayed timely implementation—both copayment requirements for Medi-Cal beneficiaries and expanding the sales tax to personal care services have yet to

be approved. Each cut that cannot go into effect further strains the state's budget and requires deeper cuts.

In corrections, federal courts control many aspects of spending, including medical, mental health, and dental care, as well as disability access. The Administration continues to work to demonstrate compliance with legal requirements and return control to the state. 2011 Realignment is the cornerstone of achieving compliance with a U.S. Supreme Court decision ordering California to reduce state prison overcrowding. It will help end the costly revolving door of lower-level offenders and parole violators through the state's prisons. This reform will reduce the Department of Corrections and Rehabilitation's budget by 18 percent—\$1.1 billion in 2012-13—and yield higher savings in the future. To achieve the budget target, Corrections will need to stay on track with its savings plan and overcome legal and other impediments as they materialize.

THE STATE'S BUDGET PROBLEM

SLOW ECONOMIC RECOVERY CONTINUES

At the time of the 2011 May Revision, the state's economy was picking up steam, reflected in rising revenue collections. Since then, two events have slowed that progress—the federal debt limit debate and the European fiscal crisis. Consequently, the Budget forecasts that the economic recovery from the recession will continue at a slow pace.

The employment bounceback from this very severe recession has been so weak that the state's job level will not reach its pre-recession level until 2016. This slow jobs recovery, due in part to a housing market that remains mired in a slump, continues to take its toll on state revenues.

Baseline General Fund revenues are projected to total \$89 billion in 2012-13. Five years after the recession, state revenues are below their peak and tens of billions of dollars below the level expected prior to the recession. General Fund revenues are not projected to return to their 2007-08 level until 2014-15.

UNCERTAINTY AND SIGNIFICANT RISKS REMAIN

Risks to the Budget remain. The state faces a “wall of debt,” pension liabilities, other increasing annual obligations, and potential cost increases associated with the federal deficit.

While budget estimates are always subject to some change, accurately forecasting revenues and expenditures is particularly challenging now, given the level of economic uncertainty. In particular, forecasting income for high income tax payers is difficult. During the economic recovery, income among top earners has grown at a much faster rate than income among all other groups. In 1980, the top one percent of taxpayers had about 10.5 percent of total income. This percentage has ebbed and flowed over time, but the trend has been upward. For 2010, data suggest that this group had over 22 percent of total state income. The Budget forecasts that income for top earners will continue to recover and grow at a faster rate than the income of all other earners. Differences in projections for wage growth are one reason why the Legislative Analyst’s Office forecasts revenues \$3 billion lower in 2012-13 than the budget estimate.

Actions at the federal level and demographic trends threaten to increase costs. Efforts to close the federal budget deficit will likely increase state costs and may reduce revenues. The population over the age of 65 is growing at approximately three times the rate of growth of the working population and seven times the rate of growth of the school and college-age group. At the same time, the income and assets of retirees and those nearing retirement are declining and becoming more uncertain. Reduced income levels of seniors will further increase the demand for government services—particularly health and human services programs.

DEFINING THE BUDGET GAP

At the time Governor Brown signed the 2011 Budget, it was expected that the state would face a budget problem of less than \$5 billion in 2012-13. A major contributor to this budget gap was the reduction in sales tax and vehicle license fee rates that went into effect on July 1, 2011.

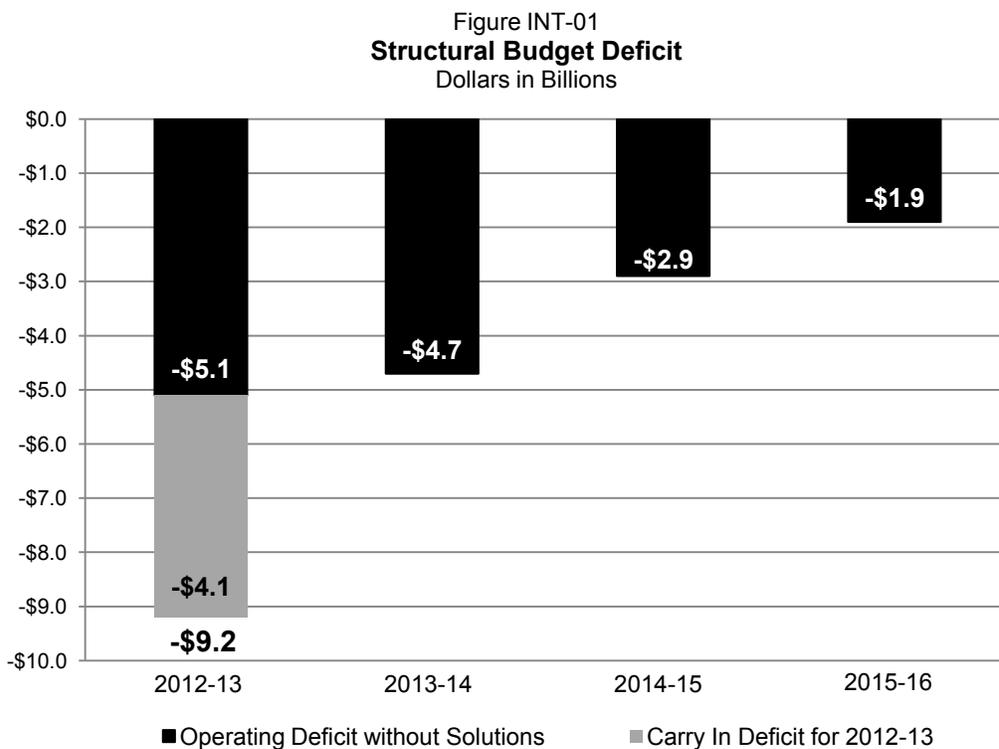
The Budget projects a 2012-13 budget problem of \$9.2 billion. This is the result of several developments:

- The problem left over from the prior year is \$1.9 billion worse than expected in June of 2011.

- Court orders and delayed federal approval related to several budget-balancing cuts in the health and human services area have increased costs by nearly \$2 billion.
- National and international economic developments have pulled state revenues downward for 2011-12. This revenue loss is partially offset by lower costs for Proposition 98 and the implementation of “trigger” spending reductions in the current year.
- The elimination of redevelopment agencies, recently validated by the California Supreme Court, results in less General Fund savings in 2011-12 but significantly greater savings going forward, beginning in 2012-13.

The Budget projects that the state will end 2011-12 with a deficit of \$4.1 billion. Absent corrective actions, it is projected that the state would spend \$5.1 billion more than it takes in during 2012-13. Combined, the state faces a \$9.2 billion budget problem.

The 2011 Budget was primarily comprised of ongoing solutions. Consequently, the size of the state’s structural budget deficit has been reduced significantly, from roughly \$20 billion annually to \$5 billion or less each year. Figure INT-01 shows the current size of the budget problem through 2015-16.



CLOSING THE BUDGET GAP

The Budget proposes a total of \$10.3 billion in cuts and revenues to balance and to rebuild a \$1.1 billion reserve. These proposals, summarized in Figure INT-02, are estimated to eliminate future budget problems throughout the forecast period under current projections.

Figure INT-02
Budget Balancing Proposals
 (Dollars in Millions)

| | |
|---|---------------------------------|
| Expenditure Reductions | |
| <u>Health and Human Services</u> | |
| CalWORKs | \$946.2 |
| Medi-Cal | 842.3 |
| In-Home Supportive Services | 163.8 |
| Other Health and Human Services Programs | 86.9 |
| <u>Education</u> | |
| Proposition 98 | 544.4 |
| Child Care | 446.9 |
| Cal Grant Program | 301.7 |
| Other Education | 28.0 |
| <u>All Other Reductions</u> | |
| State Mandates | 828.3 |
| Other Reductions | 27.3 |
| Total Expenditure Reductions | <u>\$4,215.8</u> |
| Revenues | |
| <u>General Fund Revenues</u> | |
| Temporary Taxes | \$4,400.8 |
| Other General Fund Revenues | 88.8 |
| <u>Special Fund Revenues</u> | |
| Gross Premiums Insurance Tax on Medi-Cal Managed Care Plans | 161.8 |
| Total Revenues | <u>\$4,651.4</u> |
| Other | |
| Loan Repayment Extensions | \$630.5 |
| Unemployment Insurance Interest Payment | 417.0 |
| Additional Weight Fee Revenues | 349.5 |
| Suspend County Share of Child Support Collections | 34.5 |
| Total Other | <u>\$1,431.5</u> |
| Total Solutions | <u><u>\$10,298.7</u></u> |

ADDITIONAL DIFFICULT SPENDING CUTS

The 2011 Budget cut General Fund spending as a share of the economy to its lowest level since 1972-73. State Supplementary Payment grants were reduced to the level in effect in 1983. CalWORKs grants were reduced to below the level in effect in 1987. State support for its universities and courts was cut by about 25 percent and 20 percent, respectively. The Adult Day Health Care program, redevelopment agencies, Williamson Act subventions, Home-to-School Transportation, and the refundable child care and dependent tax credit were all eliminated. The Department of Corrections and Rehabilitation's expenditures will be reduced by approximately 18 percent once realignment is fully implemented. K-14 education funding remains \$9 billion below the funding level in 2007-08.

The Governor is seeking additional tax revenues to mitigate the need for the deepest of cuts. However, these revenues will not be sufficient to close the entire budget gap. Among the difficult actions necessary to balance the Budget are:

- Refocusing CalWORKs and subsidized child care by increasing income support to working families and reducing assistance to families who are not meeting work requirements. (Savings of \$1.4 billion)
- Merging service delivery for those who are eligible for both Medi-Cal and Medicare. This will reduce costs and improve the coordination of services. Additional savings will be achieved by other changes. (Savings of \$842 million)
- Eliminating domestic and related In-Home Supportive Services for recipients in shared living arrangements. (Savings of \$164 million)
- Eliminating supplemental funding for schools associated with the elimination of the sales tax on gasoline and making other Proposition 98 adjustments. (Savings of \$544 million)
- Reducing grant amounts for students who attend private institutions and making other reductions to the Cal Grant program. (Savings of \$302 million)
- Repealing, making permissive, or suspending many state mandates on local governments that are unnecessary and burdensome. (Savings of \$828 million)
- Expanding the alternative custody program for female inmates. This will allow the state to further reduce its prison population and focus more dollars on services. (Savings of millions of dollars in future years)

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Implementing many of these proposals will require months of lead time to generate budget savings. If they were adopted on July 1, less than a full year of savings would be generated in 2012-13, and additional cuts would be needed. Similar to last year, the Budget assumes that a portion of its proposals will be adopted by the Legislature by March 1, 2012.

Other budget proposals include the continuation of the use of weight fees to offset future General Fund costs connected with transportation expenses (savings of \$350 million). In addition, funds will be borrowed from the Unemployment Compensation Disability Fund to pay the federal government for interest costs on the outstanding Unemployment Insurance loan. In future years, these interest costs will be paid from a proposed surcharge on employers.

TEMPORARY TAXES TO PROTECT EDUCATION AND PUBLIC SAFETY

The Budget assumes the passage of the Governor's proposed initiative at the November election. This measure temporarily increases the personal income tax on the state's wealthiest taxpayers and temporarily increases the sales tax by one-half percent. The measure guarantees these new revenues to schools and constitutionally protects the 2011 Realignment funds for local public safety. It will generate an estimated \$6.9 billion through 2012-13. After accounting for the increased Proposition 98 minimum guarantee, it will provide \$4.4 billion in net benefit to the General Fund budget. The measure will prevent deeper cuts to schools, protect local public safety funding, and assist in balancing the budget. The revenues will allow the state to invest in higher education and to pay off the \$33 billion in outstanding budgetary borrowing and deferrals by 2015-16.

ALTERNATIVE TO TAXES IS EVEN DEEPER CUTS

The California Constitution requires that the annual state budget be balanced. To pay the state's bills on time, the budget must be credible and financeable. The Budget proposes a backup plan if the ballot measure is not approved. The plan specifies \$5.4 billion in cuts affecting education and public safety—the areas protected by the Governor's initiative. These ballot trigger cuts, summarized in Figure INT-03, would go into effect on January 1, 2013:

- Funding for schools and community colleges would be reduced by \$4.8 billion. A reduction of this magnitude would result in a funding decrease equivalent to more than the cost of three weeks of instruction. It would also continue to provide

20 percent of program funds a year in arrears. The savings would be achieved through the reduction in the Proposition 98 minimum guarantee that would result from the loss of the revenues. The costs of general obligation bond debt service for K-14 facilities would be shifted into the guarantee, thereby reducing other General Fund costs.

- The University of California and California State University would each be reduced by \$200 million.
- The courts would be reduced by \$125 million, the equivalent of court closures of three days per month.
- The number of the state’s public safety officers in the departments of Parks and Recreation (park rangers) and Fish and Game (wardens) would be reduced, and the state would no longer staff its beaches with lifeguards.
- The Department of Forestry and Fire Protection’s firefighting capabilities would be reduced substantially. The emergency air response program would be reduced, and fire stations would be closed.
- Flood control programs in the Department of Water Resources would be cut, which would reduce channel and levee maintenance and floodplain mapping.
- The Department of Justice’s law enforcement programs would be reduced.

Figure INT-03
Ballot Trigger Reductions
Effective January 1, 2013
(Dollars in Millions)

| | 2012-13 |
|--|------------------|
| Expenditure Reductions | |
| Proposition 98 | \$4,836.9 |
| University of California ^{1/} | 200.0 |
| California State University ^{1/} | 200.0 |
| Courts | 125.0 |
| Department of Forestry and Fire Protection | 15.0 |
| Flood Control | 6.6 |
| Fish and Game: Non-Warden Programs | 2.5 |
| Fish and Game: Wardens | 1.0 |
| Park Rangers | 1.0 |
| Park Lifeguards | 1.0 |
| Department of Justice | 1.0 |
| Total Ballot Trigger Reductions | \$5,390.0 |

^{1/} This level of savings may be offset by Cal Grant increases if the universities raise tuition.

MOVING GOVERNMENT CLOSER TO THE PEOPLE

The 2011 Realignment shifted various public safety programs closer to the people and provided an ongoing funding source for these programs. Because counties can better serve lower-level offenders at a lesser cost, the state has begun a major reduction in the size of the state prison system. In 2012-13, state correctional costs will be reduced by \$1.1 billion to reflect the smaller prison population. Further reductions will occur

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in future years. The Budget proposes a permanent structure and revenue allocation mechanism for realignment.

The Budget provides local schools with enhanced flexibility to manage their finances and gives greater control to local decision-makers. Specifically, for K-12 schools, almost all funding (excluding federally-required programs, such as special education) would be allocated on a single formula that takes into account a school's number of students and the concentration of English learners and pupils eligible for free and reduced-price lunches. This funding approach will give school districts a significant new tool to target limited resources without being hampered by numerous rules and regulations. This flexibility, coupled with local accountability measures, will enhance transparency and support improved educational outcomes.

Several proposals in the Budget lay the foundation for further realignment. For example, the CalWORKs and child care restructuring emphasizes support for those individuals who meet federal work requirements. Counties will be the leaders in implementing these changes. As the state implements federal health care reform, there will be a natural shift of health care costs from the county indigent health system to Medi-Cal. In the future, it will make sense for the state to assume more responsibility for health care funding, while shifting other programs to the local level.

MEETING LONG-TERM CHALLENGES

In addition to balancing the Budget, the Governor's plan sets forth a path to meet California's long-term fiscal challenges.

REFORMING PENSIONS

Retirement costs for state and local government employees and retirees threaten the long-term viability of government finances. Specifically, the state faces unfunded pension obligations of \$45.2 billion and unfunded retiree health obligations of \$59.9 billion. In October, the Governor unveiled a 12-point pension reform plan to put the state on a more sustainable path to providing public retirement benefits. When fully implemented, these reforms will cut roughly in half the cost to taxpayers for providing pension benefits to state employees. It will also dramatically reduce the risk for future pension debts.

SHRINKING STATE GOVERNMENT

The 2011 Budget eliminated 20 entities as a first step in making state government smaller, more efficient, and more focused on core activities. The Budget reflects the Governor's continuing efforts in this area by proposing the elimination and consolidation of 48 boards, commissions, programs, and departments. In addition, the Budget proposes a major reorganization of remaining entities. By making government's organization more sensible, the state can better provide services to the public.

PAYING DOWN THE WALL OF DEBT

The state's current budget problem is exacerbated by an unprecedented level of debts, deferrals, and budgetary obligations. At the time of the 2011 May Revision, a total of \$34.7 billion in budgetary borrowing was identified. By the end of 2011-12, this amount will total \$33 billion, as shown in Figure INT-04. The state also has large outstanding bond balances.

Figure INT-04

Outstanding Budgetary Borrowing (Dollars in Billions)

| | |
|---|---------------|
| Deferred payments to schools and community colleges | \$10.4 |
| Economic Recovery Bonds | 6.3 |
| Loans from special funds | 3.4 |
| Unpaid costs to local governments, schools, and community colleges for state mandates | 4.5 |
| Underfunding of Proposition 98 | 3.4 |
| Borrowing from local government (Proposition 1A) | 2.1 |
| Deferred Medi-Cal costs | 1.3 |
| Deferral of state payroll costs from June to July | 0.8 |
| Deferred payments to CalPERS | 0.5 |
| Borrowing from transportation funds (Proposition 42) | 0.3 |
| Total | \$33.0 |

In addition, the state faces major payment obligations that will eventually increase state spending annually by \$13 billion. The largest such obligation—the Proposition 98 maintenance factor—will ensure that school funding over time returns to its

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pre-recession level. Debt service on authorized but unissued bonds will eventually add \$3 billion in annual budget costs.

Under the Budget and current projections, for the first time in the past decade, the budget would be balanced on an ongoing basis. To restore fiscal order and support the state's economic recovery, the Budget proposes to pay off the \$33 billion in outstanding budgetary borrowing and deferrals by 2015-16.

CHANGING THE BUDGET PROCESS

In December, the Governor issued an executive order that will alter state budgeting processes to make better use of existing tools—such as zero-based budgeting, performance measures, strategic planning, audits, cost-benefit analyses, and program reviews—to focus on achieving performance goals and increasing efficiency. That order requires the Department of Finance to develop a plan by early March. The Budget begins the type of evaluations and reviews envisioned under the executive order. The departments of Corrections and Rehabilitation, General Services, Mental Health, Technology, and Transportation have completed or will undertake comprehensive reviews of their operations to reduce costs.

CONTAINING HEALTH CARE COSTS

Actions proposed to reduce the federal budget deficit could drive higher costs. For example, the federal government has been exploring options to shift health care costs to states. These would be in addition to the future costs California will incur under federal health care reform.

The current Medicaid funding formula encourages spending and does not promote efficiency or cost containment. In addition, California receives relatively low Medicaid funding, as the federal formula fails to recognize the large number of Californians living in poverty. In conjunction with other states, California will pursue changes to the way the federal government funds health care programs to reward efficiency and to allow states to keep a portion of savings generated through cost-effective management. This reform will reduce the federal deficit without increasing costs to states. The changes could help contain overall health care costs and assist states in the implementation of health care reform.

INVESTING IN CALIFORNIA'S FUTURE

The Budget lays the foundation for critical investments in California's future.

STABILIZING FUNDING FOR EDUCATION

From its peak of \$56.6 billion in 2007-08, Proposition 98 funding for K-14 education fell by \$9 billion, or 16 percent, to \$47.6 billion in 2011-12. The Governor is pursuing new tax revenues to prevent deeper cuts in school funding. Under the Budget, Proposition 98 funding will increase to \$52.5 billion. This funding will be provided with fewer rules and regulations but greater accountability. The Budget eliminates school funding associated with the gas tax swap and applies a consistent approach to accounting for the various Proposition 98 programmatic adjustments that have been made.

INVESTING IN OUR UNIVERSITIES

The higher education system is critical to the state's long-term economic growth, but General Fund spending on higher education has dropped substantially. The Governor's proposed initiative protects higher education from further reductions. Given concerns about growing student debt and to halt the trend of double-digit tuition increases, the Budget provides at least 4-percent annual General Fund growth beginning in 2013-14.

SUPPORTING JOB CREATION

The resulting stability from a balanced budget will give businesses the certainty and the reassurance they need to invest in California. In addition, the Administration will propose legislation to reform the enterprise zone program and move to a mandatory single sales factor for apportioning multistate business income. Such changes will allow the state to afford investments in manufacturing, business incentives, and other tax relief.

REDUCING GREENHOUSE GAS EMISSIONS

California has been an international leader in the effort to reduce air pollution and develop clean energy. The Budget reflects the first year of implementation of the AB 32 cap and trade program. Through a market approach, the program will create fiscal incentives for businesses to reduce their greenhouse gas emissions. The proceeds generated from

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the program, potentially \$1 billion in the first year, will be used to invest in clean energy, low-carbon transportation, natural resource protection, and sustainable infrastructure.

BUILDING HIGH-SPEED RAIL

High-speed rail will be an important asset of the state's infrastructure. It will meet Californians' future travel needs in an efficient manner and reduce greenhouse gas emissions. The Budget includes funding requests to continue the basic functions of the High-Speed Rail Authority. The Authority's funding plan is under review by the Department of Finance. After the review, the Administration will propose a plan for the initial train segment.

MEETING WATER NEEDS

Balancing the state's water needs with environmental protection remains a long-term challenge. The Delta Habitat Conservation and Conveyance Program is currently developing a plan to promote the recovery of endangered, threatened, and sensitive fish and wildlife and their habitats in the Sacramento-San Joaquin Delta in a manner that will also ensure water supply reliability. When completed, the plan will provide the basis for issuing permits for the operation of state and federal water projects. The Budget proposes \$25 million and 135 positions to complete preliminary engineering work. Future funding requests to address the state's water needs will be necessary.