Introduction

Since 2011, the State of California's fiscal situation has dramatically turned around. When Governor Brown took office in 2011, the state faced a $26.6 billion immediate budget problem and estimated yearly gaps between spending and revenues of roughly $20 billion. The budget was balanced with permanent spending cuts and temporary taxes from Proposition 30.

As the state's economy has recovered, the past two budgets have restored some previous budget cuts and expanded in some areas, such as extending health care coverage to millions of Californians. In addition, the state has paid down its budgetary borrowing and addressed some long-standing problems—such as implementing a plan to restore fiscal health to teacher pensions and committing to major improvements to the state's water system.

The passage of Proposition 2 in the November election gives the state a critical opportunity to avoid repeating the boom-and-bust cycle of the past two decades. Recent budget shortfalls have been driven by making ongoing commitments based upon temporary spikes in revenues from capital gains. Under Proposition 2, these spikes in capital gains will instead be used to save money for the next recession and to pay down the state's debts and liabilities.

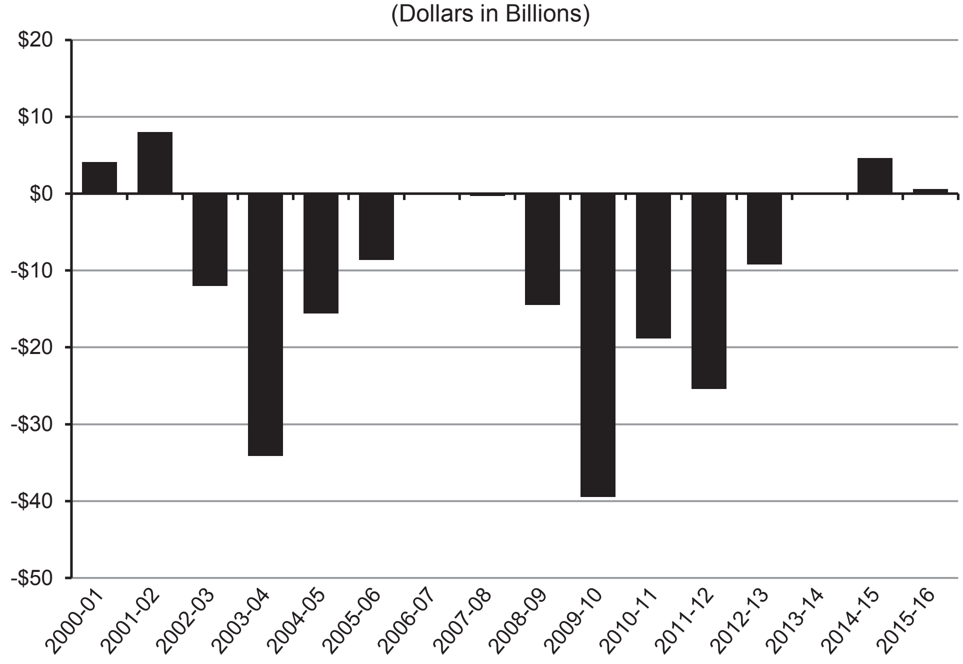
A strengthening state economy is continuing to push revenues higher. Under Proposition 98, most of those revenues are dedicated to K-12 schools and community colleges—allowing the state to invest nearly $8 billion in new funding to better prepare students for college and career. Rising costs from health care reform, wildfires, and the spending imposed by the prison Receiver means that — despite the stronger revenues — the Budget remains precariously balanced after paying for existing obligations.

The state continues to have hundreds of billions of dollars in existing liabilities, such as deferred maintenance on its roads and other infrastructure and its unfunded liability for future retiree health care benefits for state employees and various pension benefits. These existing liabilities must be addressed.

Maintaining Fiscal Balance Is an Ongoing Challenge

The fiscal stability from a balanced budget and a recovering state economy has been a welcome reprieve from the prior decade's massive budget shortfalls. Yet, maintaining a balanced budget for the long term will be an ongoing challenge — requiring fiscal restraint and prudence. As shown in Figure INT-01, since 2000, the state's short periods of balanced budgets have been followed by massive budget shortfalls.

Figure INT-01
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]
(Dollars in Billions)



1/ Budget shortfalls or surplus, measured by the annual Governor's Budget.

The Budget assumes the continued moderate expansion of the economy. Yet, economic expansions do not last forever. In the post-war period, the average expansion has been about five years. The current expansion has already exceeded the average by nine months. While there are few signs of immediate contraction, another recession is inevitable.

With a funding plan that is as complicated as California's budget, there will continue to be year-to-year fluctuations, risks, and cost pressures. The federal government's policies have added hundreds of millions of dollars in costs in the past year alone. Depending on its implementation, changes in federal immigration policy could drive state program costs up by hundreds of millions of dollars more. Responding to the impacts of climate change, such as increasingly severe wildfire seasons, will continue to get more expensive. Rising health care costs could continue to consume a greater and greater share of the budget in Medi-Cal and for state employee and retiree benefits.

This coming year will be the last one with the full revenues of Proposition 30. The quarter-cent sales tax increase under the measure will expire at the end of 2016, and the income tax rates on the state's wealthiest residents will expire at the end of 2018. As it was intended, the measure has provided the state with increased resources on a short-term basis to give the economy time to recover. Under the measure, the state has been able to restore funding for education and the safety net, expand health care coverage, and pay off its budgetary borrowing.

Still, as shown in Figure INT-02, the state has $227 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$222 billion—are related to retirement costs of state and University of California employees. For the next 15 years, Proposition 2 provides a dedicated funding source to help address these liabilities, but that funding alone will not eliminate the liabilities. In addition, the state faces $66 billion more in identified deferred maintenance on its infrastructure.

Already, the commitments that the state made in the past two years are straining the state's finances. Under a projection of current policies, the state would begin to spend more than it receives in annual revenues by 2018-19 (by about $1 billion). While forecasts four years into the future are subject to great uncertainty (and the state would have operating reserves on hand to maintain a balanced budget in that year), it is obvious that the state cannot take on new ongoing spending commitments.

Figure INT-02

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2015-16	Proposed Use of 2015-16 Accelerated Payment
Budgetary Borrowing		
Loans from Special Funds	$3,028	$965
Underfunding of Proposition 98—Settle-Up	1,512	256
Unpaid Mandate Claims for Local Governments (prior to 2004-05) 1/	257	0
State Retirement Liabilities		
State Retiree Health	71,773	0
State Employee Pensions	49,978	0
Teacher Pensions 2/	74,374	0
Judges' Pensions	3,371	0
Deferred payments to CalPERS	530	0
University of California Retirement Liabilities		
University of California Employee Pensions	7,633	0
University of California Retiree Health	14,519	0
Total	**$226,975**	**$1,221**

1/ Amount outstanding reflects $533 million paid under the 2014 Budget Act trigger.

2/ The state portion of the unfunded liability for teacher pensions is $19.932 billion.

Implementing Major Initiatives

Over the past four years, the state has overhauled virtually every area of government. Many of the changes were driven by the need to balance the budget, while others were done to improve services to the public. The changes focus on providing core public services in the most efficient manner possible. The difficult and time-consuming task of making these initiatives successful remains a focus of the Administration.

- Local Control Funding Formula—The 2013 Budget overhauled the state's K-12 school financing system with the Local Control Funding Formula that targets the most new dollars to those districts serving English learners, students from low-income families, and youth in foster care—while giving all districts dramatically more flexibility to achieve their educational goals. The State Board of Education adopted significantly modified accountability procedures at its November 2014 meeting and will continue to review and revise spending regulations as necessary to improve student success.

- Public Safety Realignment—Due to overcrowding, rising costs, and a revolving door of offenders in the state's prisons, 2011 realignment shifted more responsibility for lower-level offenders to counties with an emphasis on improved rehabilitation and reduced recidivism. With upcoming benchmarks to meet the Three Judge Panel's overcrowding order and the implementation of Proposition 47 (passed at the November election), the state's correctional system will continue to undergo major changes in the next year.

- Health Care Reform — Due principally to the implementation of federal health care reform, Medi-Cal caseload has increased from 7.9 million in 2012-13 to an estimated 12.2 million this coming year. The program now covers 32 percent of the state's population. This tremendous expansion of health care coverage for low-income Californians continues to be an administrative and financial challenge. The Budget is covering billions of additional dollars of expenses while computer systems must continue to be upgraded to handle the workload. The state has also greatly expanded its reliance on managed care health plans, including the Coordinated Care Initiative.

- Climate Change — The Budget proposes $1 billion in Cap and Trade expenditures for the state's continuing investments in low carbon transportation, sustainable communities, energy efficiency, urban forests and high-speed rail. The successful implementation of these projects and continued and even steeper reductions in carbon pollutants are necessary to address the ongoing threat posed by climate change.

- Water Action Plan — The Water Action Plan is the Administration's five-year roadmap towards sustainable water management. The Budget includes the first $532 million in expenditures from the Proposition 1 water bond to continue the plan's implementation.

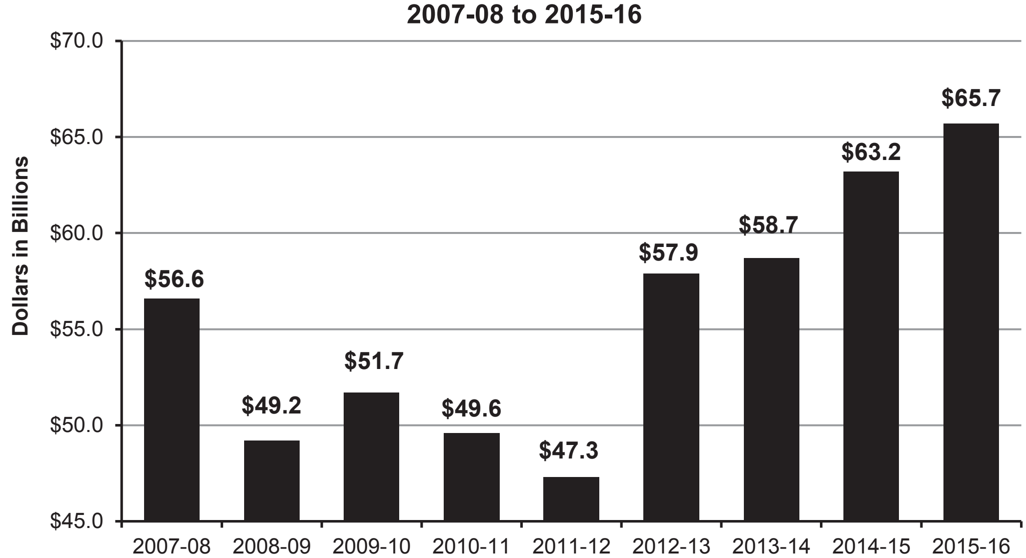
- Redevelopment Dissolution — By the end of the budget year, the elimination of redevelopment agencies will have returned more than $4 billion to cities, counties, and special districts to fund police, fire, and other critical public services. An additional $5 billion will have been returned to K-14 schools. Administering the orderly dissolution of almost 400 redevelopment agencies has been complex and time consuming. Oversight of the dissolution process has progressed to the point where the Budget proposes legislation to streamline the state review process to continue the wind-down activities.

- Pension Reform — Over the past several years, the Administration, Legislature, and public employees have taken significant steps to reform public pension systems — protecting the retirement security of government workers while controlling their costs. In 2012, pension reform increased cost sharing for employees, pushed back retirement ages, and restructured pension formulas. In 2014, the Governor signed a new funding plan to close a $74 billion shortfall for teacher pensions over the next three decades. The Budget includes $1.4 billion ($371 million General Fund) to implement the second year of the teacher pension funding plan.

Continuing to Invest in Education

The Proposition 30 temporary taxes were premised on the need to increase funding for education. As shown in Figure INT-03, the minimum guarantee of funding for K-14 schools was $56.6 billion in 2007-08 and sank to $47.3 billion in 2011-12. From this recent low, funding has been at all-time highs since 2012-13 and is expected to grow to $65.7 billion in 2015-16, an increase of $18.4 billion in four years (39 percent).

Figure INT-03
Proposition 98 Funding
2007-08 to 2015-16



K-12 Education

For K-12 schools, funding levels will increase by more than $2,600 per student in 2015-16 over 2011-12 levels. This reinvestment provides the opportunity to correct historical inequities in school district funding with continued implementation of the Local

Control Funding Formula. Rising state revenues means that the state can continue implementing the formula well ahead of schedule. When the formula was adopted in 2013-14, funding was expected to be $47 billion in 2015-16. The Budget provides almost $4 billion more — with the formula instead allocating $50.7 billion this coming year.

Higher Education

The Budget also invests in the state's higher education system to maintain the quality and affordability of one of California's greatest strengths. By focusing on reducing the time it takes a student to successfully complete a degree, the universities can ensure their systems are financially viable over the long term. Increased funding must be tied to getting students their degrees in a timely manner, not just admitting more students.

The community colleges and the university systems must work together to develop innovative and ambitious approaches so students can successfully complete their degrees. The Budget expands community colleges' recent efforts to improve student success, with a particular focus on achievement in underrepresented student groups.

University tuition almost doubled during the recession, creating a hardship for many students and their families. The Budget commits $762 million to each of the university systems that is directly attributable to the passage of Proposition 30. This increased funding is provided contingent on tuition remaining flat. All cost containment strategies must be explored before asking California families to pay even more for tuition.

Strengthening our Infrastructure

The construction and maintenance of key physical infrastructure is one of the core functions of state government. Infrastructure and capital assets allow for the delivery of public services and the movement of goods across the state — both essential components in fostering the state's long-term economic growth. Despite the investment of tens of billions of dollars over the past decade, the state's identified infrastructure demands continue to grow.

The deferred maintenance on existing state infrastructure, including roads, bridges and facilities is staggering — estimated to total $66 billion. The Budget includes $478 million ($125 million General Fund) for critical deferred maintenance at the universities and community colleges and in state parks, prisons, state hospitals and other state facilities.

The state's largest deferred maintenance is on its highways, roads and bridges. Annual maintenance and repairs are billions more than can be funded annually within existing resources. The state must address deferred maintenance on the state's highways and key freight corridors through expanded and ongoing funding sources.

The Budget also supports improved management of our water resources. The Budget begins implementation of the water bond with funding for safe drinking water, water reliability and groundwater sustainability. It also includes the last $1.1 billion in expenditures from the 2006 flood bond to bolster the state's protection from floods.

Addressing Poverty and Income Inequality

For the last several years, the Census Bureau has reported that about 16 percent of California residents are living in poverty—slightly above the national average of 14.9 percent. The Census Bureau's supplemental measure of poverty, which considers broader measures of income and the cost of living, reflects a poverty rate of 23.4 percent (a three-year average). Additionally, while the state's economic condition has improved since the Great Recession, the increase in wages and salaries has been uneven—with much of the gains being made by the state's wealthiest residents.

California has an extensive safety net for the state's neediest residents who live in poverty, and the state has maintained those core benefits despite the recession. Compared to other states, California provides broader health care coverage to a greater percentage of the population, including in-home care, and guarantees access to services for persons with developmental disabilities. California makes available higher cash assistance to families, continues that assistance to children after their parents lose eligibility, and provides extensive child care to working families with children up to age 13. Finally, the state provides generous financial aid to those seeking higher education.

In the past two years, the recovering economy has allowed the state to take even greater steps to assist the state's neediest residents. The implementation of health care reform has increased coverage under Medi-Cal to an additional 4 million Californians in just three years. The Local Control Funding Formula is concentrating the greatest school funding to those students with the greatest needs. The state increased the minimum wage by 25 percent, to $10 per hour, and guaranteed that 6.5 million workers are eligible for sick leave.

Despite these steps, millions of Californians remain in poverty and more can be done. Educational investments that provide tangible skills desired by employers (such as basic literacy, graduation from high school, certificate programs and college degrees) will increase individuals' earning potential and provide a permanent path out of poverty. The Budget provides over $1.2 billion in funding to support a coordinated framework for adult education, career technical education, workforce investment, and apprenticeships. These funds are intended to provide training and education to workers in California so they can develop the skills they need for self-sufficiency and greater personal advancement.

Saving Money and Paying Down Debts and Liabilities

Proposition 2 was designed to help the state save when times are good. With a stock market that continues to surge, higher revenues from capital gains will both be saved and used to pay down debts. By the end of the year, the state's Rainy Day Fund will have a total balance of $2.8 billion. The Budget spends an additional $1.2 billion from Proposition 2 funds on paying off loans from special funds and past liabilities from Proposition 98.

In addition, the Budget repays the remaining $1 billion in deferrals to schools and community colleges, makes the last payment on the $15 billion in Economic Recovery Bonds that was borrowed to cover budget deficits from as far back as 2002, and repays local governments $533 million in mandate reimbursements.

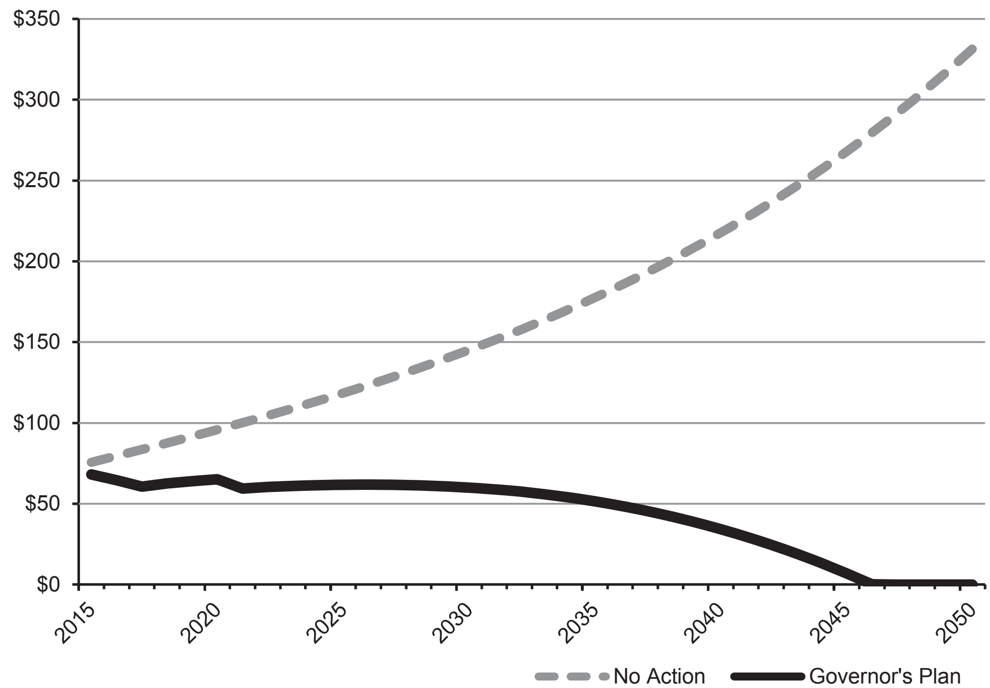
Addressing the Retiree Health Unfunded Liability

The state's largest long-term liabilities are related to retirement costs for government employees. Retirement-related liabilities total $222 billion. As described above, the Governor and Legislature over the past several years have taken significant steps to address the long-term costs of pensions. The state must now turn its attention to the $72 billion unfunded liability that exists for retiree health care benefits.

State health care benefits for retired employees remain one of the fastest growing areas of the state budget. In 2001, retiree health benefits made up 0.6 percent of the General Fund budget ($458 million) but today absorb 1.6 percent ($1.9 billion).

The state's pay-as-you-go system for retiree health benefits is not working. As shown in Figure INT-04, without action, the state's unfunded liability will grow to $100 billion

Figure INT-04
Eliminating Unfunded Liability for Retiree Health Care
(Dollars in Billions)



by 2020-21 and $300 billion by 2047-48. The Budget proposes a plan to make these benefits more affordable by adopting various measures to lower the growth in premium costs. Even though the private sector is eliminating these types of benefits, the plan preserves retiree health benefits for the state's career workers. The Budget calls for the state and its employees to share equally in the prefunding of retiree health benefits, similar to the new pension-funding standard. The Administration will seek to phase in this critical, cost-sharing agreement as labor contracts come up for renewal. Under this plan, investment returns will help pay for future benefits, just as with the state's pension plans, to eventually eliminate the unfunded liability by 2044-45. Over the next 50 years, this approach will save nearly $200 billion.