2015-16
May Revision

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Introduction

Since the January Budget, the state's economy has strengthened and revenues have surged upward, driven by increased capital gains and other income from high-wage earners.

Despite these stronger revenues, the budget remains precariously balanced and faces the prospect of deficits in succeeding years. The state has 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. In this budget, under Proposition 2, spikes in capital gains will be used to prepare for the inevitable next recession by saving money and paying down these debts and liabilities.

Overall, the May Revision reflects a $6.7 billion increase in General Fund revenues compared to the January Budget. The Constitution, reflecting the voters' priorities, directs the use of these revenues as follows:

- Proposition 98 increases General Fund spending by $5.5 billion for K-12 schools and community colleges.

- Proposition 2 requires that an additional $633 million be saved in the Rainy Day Fund and an additional $633 million be used to pay down debts and liabilities.

Too often in the past, state government has made ongoing commitments based upon what turned out be temporary spikes in revenues — a mistake this budget attempts to avoid. The May Revision commits new spending in only three additional areas:

- Creating the first-ever California Earned Income Tax Credit to assist the state's lowest-income workers. The credit will provide $380 million in benefits to 2 million Californians. This credit — combined with increased funding for education and health care reform, together with an increased minimum wage — will provide increased state support for California's poorest residents.
- Holding tuition flat at the state's universities for California undergraduate students for two more years by providing increased ongoing funding to California State University and temporary assistance to the University of California to pay down its unfunded pension liability.
- Providing health care and other safety net services to currently undocumented immigrants who gain Permanent Residence Under Color of Law status under the President's executive actions.

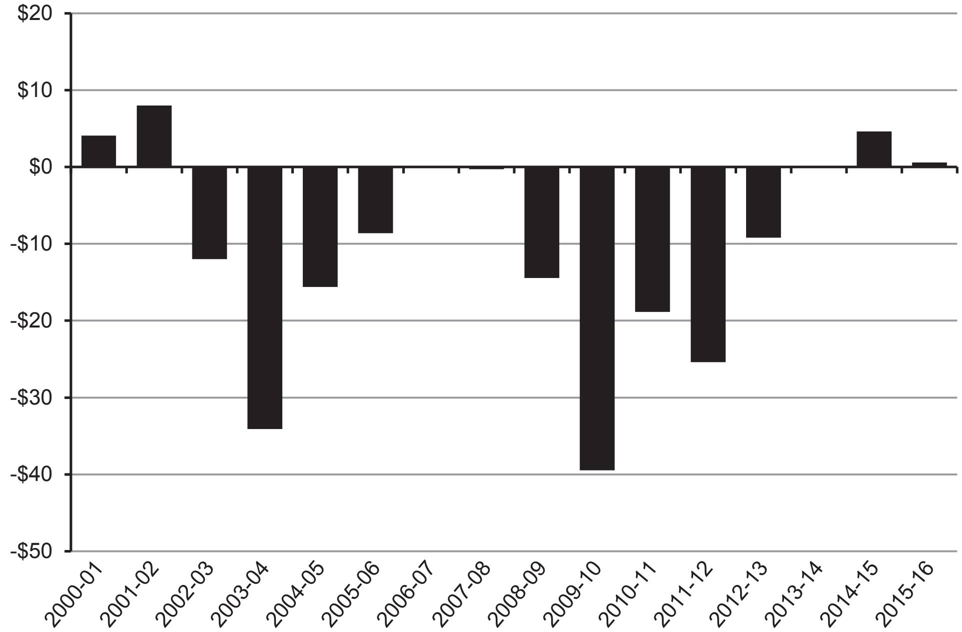
The May Revision continues to focus on the key elements of the January Budget — carrying out the Local Control Funding Formula, federal health care reform, public safety realignment, the Water Action Plan, and the Cap and Trade expenditure plan.

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 deficits. Keeping the budget balanced over time will be a 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.

The Budget assumes the continued expansion of the economy. Yet, as we know, economic expansions do not last. In the post-war period, the average expansion has been about five years, and the current expansion has already exceeded that average by a year. While there are few signs of immediate contraction, another recession is on the way — we just don't know when.

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.

Proposition 2 was designed to help the state save when times are good, such as now. 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 $3.5 billion. As shown in Figure INT-02, the May Revision also pays down an additional $633 million in debts and liabilities (for a total of $1.9 billion) from Proposition 2 funds.

Slowly but surely, the state is climbing out from under the budgetary debts accumulated over the past decade and a half. In the next three months alone, the state will:

- Repay the remaining $1 billion in deferrals to schools and community colleges (which once peaked at $10 billion).
- Make the last payment on the $15 billion in Economic Recovery Bonds that were used to cover budget deficits from as far back as 2002.

Figure INT-02

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2015-16	Governor's Budget Pay Down	Additional May Revision Pay Down
Budgetary Borrowing			
Loans from Special Funds	$3,028	$965	$537
Underfunding of Proposition 98—Settle-Up	1,512	256	0
Unpaid Mandate Claims for Local Governments (prior to 2004-05) [1/]	0	0	0
State Retirement Liabilities			
State Retiree Health	71,773	0	0
State Employee Pensions	43,303	0	0
Teacher Pensions [2/]	72,718	0	0
Judges' Pensions	3,358	0	0
Deferred payments to CalPERS	530	0	0
University of California Retirement Liabilities			
University of California Employee Pensions	7,633	0	96
University of California Retiree Health	14,519	0	0
Total	**$218,374**	**$1,221**	**$633**

1/ Entire liability paid off under the 2014 Budget Act revenue trigger.

2/ The state portion of the unfunded liability for teacher pensions is $14.916 billion.

- Repay local governments the final mandate reimbursements for activities completed in 2004 or earlier (totaling $765 million).

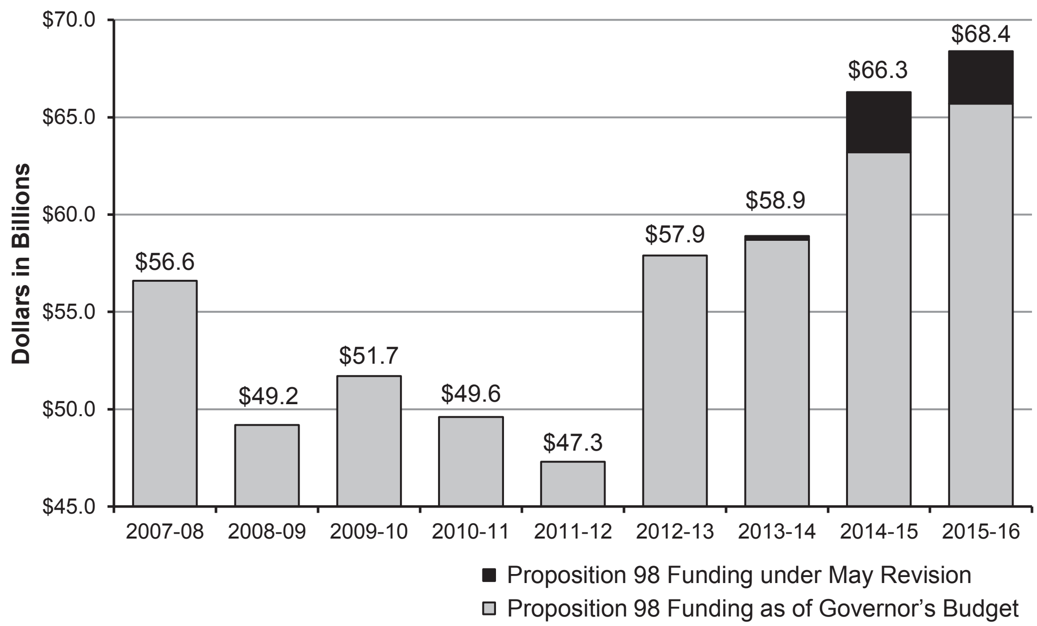
The elimination of all of these budgetary debts and a healthier Rainy Day Fund balance will give the state fiscal capacity when the next recession begins. But these steps alone will not ensure an enduring balanced budget. Already, the commitments that the state made in the past two years are straining the state's finances. Under a projection of current policies, the budget would be upside down by more than $2 billion by 2018-19. While forecasts four years into the future are subject to great uncertainty, it is clear that the state cannot take on new ongoing spending commitments beyond those proposed in the May Revision.

More Money for Schools

The Proposition 30 temporary taxes were premised on the need to increase funding for education. As shown in Figure INT-03, the constitutional guarantee of funding for

Figure INT-03

Proposition 98 Funding
2007-08 to 2015-16



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 $68.4 billion in 2015-16, an increase of $2.7 billion compared to the level expected in January. The Proposition 98 maintenance factor—an indicator of the past cuts made to schools and community colleges—totaled nearly $11 billion as recently as 2011-12. Under the May Revision, this amount is reduced to $772 million.

K-12 Education

For K-12 schools, funding levels will increase by more than $3,000 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 implement 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 May Revision provides $6.1 billion more—with the formula instead allocating $53.1 billion this coming year.

Higher Education

The May Revision also invests in the quality and affordability of the state's higher education system. University tuition almost doubled during the recession, creating a hardship for many students and their families. To maintain affordability, the May Revision holds tuition for California undergraduate students flat through 2016-17. The May Revision commits $38 million in ongoing funding for the California State University (CSU), for a total of $158 million in new funding. As part of an agreement with the University of California (UC), the state will provide temporary funding from Proposition 2 to assist in paying down UC's unfunded pension liability—as UC imposes a pension cap consistent with the state's 2012 reform law.

By focusing on reducing the time it takes a student to successfully complete a degree, rather than just admitting more students, the universities can ensure their systems are financially viable over the long term. The community colleges and the university systems must work together to develop innovative approaches so students can successfully complete their degrees. The May Revision provides new funding for CSU and community colleges to coordinate their provision of basic skills and remedial education.

A clear pathway for students to transfer from community colleges to the state's universities is one of the most important features of California's higher education system. For many years, the requirements for transfer to the state's universities were a confusing overlay of individual campus and department rules. Over the past few years, CSU and the community colleges have greatly simplified and improved the transfer process in implementing statewide associate degrees for transfer under Chapter 428, Statutes of 2010 (SB 1440). Over the next two academic years, UC will identify specific pathways for transfer for its 20 most popular majors. These pathways will be closely aligned to the SB 1440 transfer degrees. This will ease the transfer process for students and contribute to UC admitting at least one transfer for every two freshmen by 2017-18.

Counteracting the Effects of Poverty

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). While the state's economic conditions have improved since the Governor's Budget, much of the gains continue to be made by the state's wealthiest residents.

California has an extensive safety net for its neediest residents who live in poverty, and the state has maintained those core benefits despite the recession. In the past two years, the recovering economy has allowed the state to take even greater steps to assist the state's neediest residents. These efforts are assisting millions of Californians.

- The implementation of health care reform has extended coverage under Medi-Cal to an additional four million Californians in just three years and added new services such as treatment for substance abuse and mental health. The expansion has already increased General Fund costs by approximately more than $1 billion annually and that amount will rise to more than $2 billion by 2017-18 as the federal government begins to reduce its share of costs beginning in 2017. Under the May Revision, coverage will also be provided to immigrants who gain Permanent Residence Under Color of Law status under the President's executive actions. For Medi-Cal and other programs, this will add General Fund costs of an estimated $200 million when the federal changes are fully implemented ($62 million in 2015-16).
- The Local Control Funding Formula is concentrating the greatest school funding — billions more this year alone — to those students who face the greatest challenges.
- 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. General Fund costs to implement these measures will be nearly $250 million by 2016-17.

Despite these steps, millions of Californians remain below the federal poverty line. The Budget takes additional steps to counteract the effects of poverty:

- Establish the state's first Earned Income Tax Credit to help the poorest working families in California. This targeted credit will provide a refundable tax credit for wages and would focus on the lowest-income Californians — households with incomes less than $6,580 if there are no dependents or $13,870 if there are three or more dependents. The proposed credit would match 85 percent of the federal credit at the lowest income levels, providing an average estimated household benefit of $460 annually for 825,000 families (representing 2 million individuals), with a maximum benefit of $2,653.

- Provide $1.4 billion ($150 million more than the Governor's Budget) in funding to support a coordinated framework for adult education, career technical education, workforce investment and apprenticeships.
- Establish an amnesty program for those Californians with past due court-ordered debt from traffic infractions. Participating individuals can reduce their debts by 50 percent, reduce the administrative fees they pay from $300 to $50, and have their drivers' licenses reinstated.

Emergency Drought Response

The State of California has experienced four consecutive years of below-average rain and snow, and is currently facing severe drought conditions in all 58 counties. The most recent surveys recorded the statewide average snowpack, which is the source for one-third of the state's water, at just 2 percent of the normal average. Since the Governor first declared a state of emergency in January 2014, the Administration has worked with the Legislature to appropriate approximately $1.9 billion to assist drought-impacted communities and provide additional resources for critical water infrastructure projects. The state's emergency drought response accelerates several of the key actions in the California Water Action Plan. The May Revision includes an additional $2.2 billion of one-time resources to continue the state's response to drought impacts. The funds will protect and expand local water supplies, conserve water and respond to emergency conditions.