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, temporary taxes from Proposition 30, and a solid economic recovery.

As the state's economy has recovered, the past three budgets have restored some previous budget cuts and expanded services, such as extending health care coverage to millions of Californians, creating the state's first earned income tax credit, and spending multiple hundreds of millions of dollars for movie tax credits and child care. 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 making major improvements to the state's water system.

A strengthening state economy is continuing to push revenues higher. The state's unemployment rate is below 6 percent for the first time since 2007. In 2015, capital gains — the state's most volatile revenue source — reached an all-time high. Despite the increase in one-time revenues, the Budget remains precariously balanced for the long term after paying for existing obligations and the Proposition 30 temporary tax revenues expire.

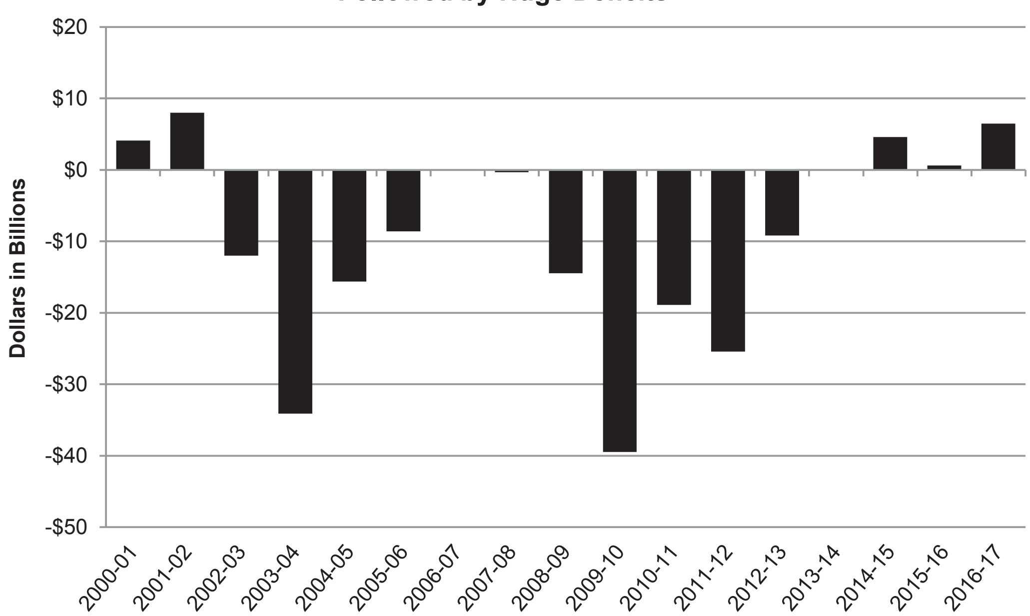
The economy is finishing its seventh year of expansion, already two years longer than the average recovery. While the timing is uncertain, the next recession is getting closer, and the state must begin to plan for it. If new ongoing commitments are made now, then the severity of cuts will be far greater—even devastating—when the recession begins.

Without question, the best way to protect against future cuts is to build up the state's Rainy Day Fund. Today, the fund is at 37 percent of its constitutional target (10 percent of General Fund tax revenues). The Budget proposes to bring its balance to 65 percent. The state must also take this opportunity to address its long-term liabilities—restoring and upgrading the state's infrastructure and creating a sustainable path for state worker retiree health benefits.

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 budget deficits. 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. In fact, the sum of all the deficits during this period is seven times greater than the sum of all the surpluses.

Figure INT-01
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]



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

With California's complicated budget, there will continue to be year-to-year fluctuations, risks and cost pressures, including from the federal government and ballot initiatives. The current fiscal year is the last one with the full revenues of Proposition 30. 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 $224 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$220 billion—are related to retirement costs of state and University of California employees. For 15 years, Proposition 2 provides a dedicated funding source to help address these liabilities, but that funding alone will not eliminate the liabilities.

Figure INT-02

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2016-17	Proposed Use of 2016-17 Pay Down
Budgetary Borrowing		
Loans from Special Funds	$1,806	$955
Underfunding of Proposition 98—Settle-Up	1,232	257
Repayment of pre-Proposition 42 Transportation Loans	879	173
State Retirement Liabilities		
State Retiree Health	71,773	0
State Employee Pensions	43,291	0
Teacher Pensions [1/]	72,718	0
Judges' Pensions	3,358	0
Deferred payments to CalPERS	570	0
University of California Retirement Liabilities		
University of California Employee Pensions	10,786	171
University of California Retiree Health	17,270	0
Total	**$223,683**	**$1,556**

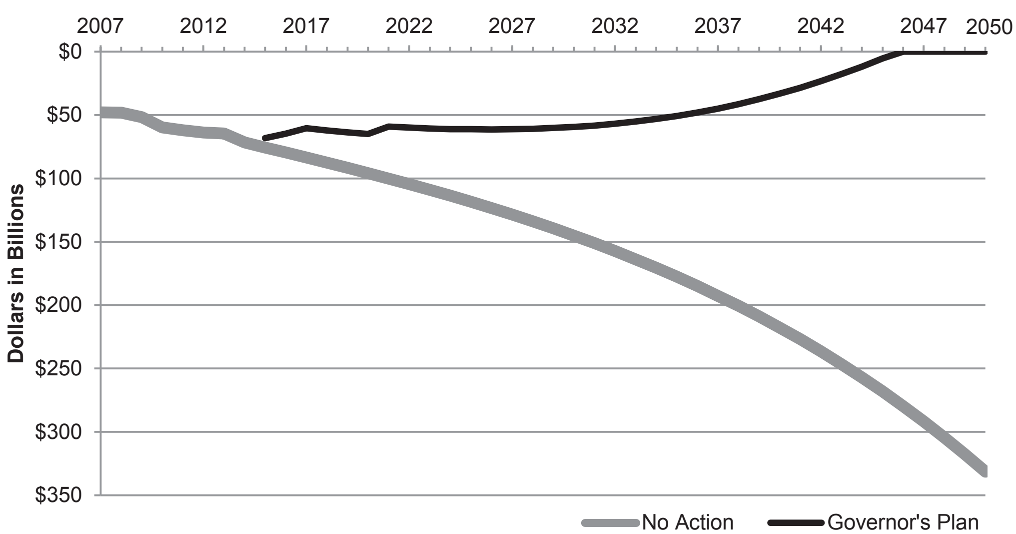
1/ The state portion of the unfunded liability for teacher pensions is $14.916 billion.

Eliminating the Retiree Health Unfunded Liability

Over the past several years, the Governor and Legislature have taken significant steps to address the long-term costs of pensions. In 2012, the California Public Employees' Pension Reform Act was enacted to save billions of taxpayer dollars by capping benefits, increasing the retirement age, stopping abusive practices and requiring employees to pay at least half of their pension costs. In 2014, a funding plan was implemented to restore fiscal solvency to the state's teacher pension system over three decades. The state must now turn its attention to the $72 billion unfunded liability that exists for retiree health care benefits.

The state's pay-as-you-go system for retiree health benefits is not working. The costs 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 1.7 percent ($2 billion). As shown in Figure INT-03, without action, the state's unfunded liability will grow from $72 billion to $100 billion by 2020-21 and $300 billion by 2047-48.

Figure INT-03
Eliminating Unfunded Liability for Retiree Health Care



Even though the private sector is eliminating these types of benefits, the state can preserve retiree health benefits for career workers. Last year's state agreement with Bargaining Unit 9 (professional engineers), combined with the statutory protection of the funds, lays out the approach. The state and its employees share equally in the prefunding of retiree health benefits, similar to the new pension-funding standard. 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 over three decades.

The Administration will be negotiating with its other bargaining units this year to implement this critical, cost-sharing agreement as part of labor contracts. Over the next 50 years, this approach will save $240 billion statewide. The Budget sets aside $300 million General Fund to pay for potential increases in employee compensation as part of these good faith negotiations.

Planning for the Next Recession

The passage of Proposition 2 in 2014 gives the state an opportunity to mitigate 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 primarily 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. Proposition 2 establishes a constitutional goal of having 10 percent of tax revenues in the Rainy Day Fund.

Capital gains are at an all-time high in 2015. As a result, by the end of 2015-16, the state's Rainy Day Fund will have a total balance of $4.5 billion (37 percent of the target). Based on recent history, however, we know that capital gains will dive downward at some point (see Figure INT-04).

The Budget assumes the continued expansion of the economy. Yet, economic expansions do not last forever. In the post-war period, the average expansion has been about five years. As shown in Figure INT-05, the current expansion has already exceeded the average by nearly two years.

While there are few signs of immediate contraction, another recession is inevitable and should be planned for. To that end, the Department of Finance has modeled a recession of average magnitude to occur in 2017-18. As shown in Figure INT-06, revenues from the state's "big three" taxes—the personal income, sales, and corporation taxes—drop a total of $55 billion from the start of the recession through 2019-20. The state's financial obligation under Proposition 98, the funding formula for K-14 education, would also drop. Under such a model, the state would be left with a $29 billion General Fund deficit by

Figure INT-04
Unpredictable Capital Gains
(Dollars in Billions)

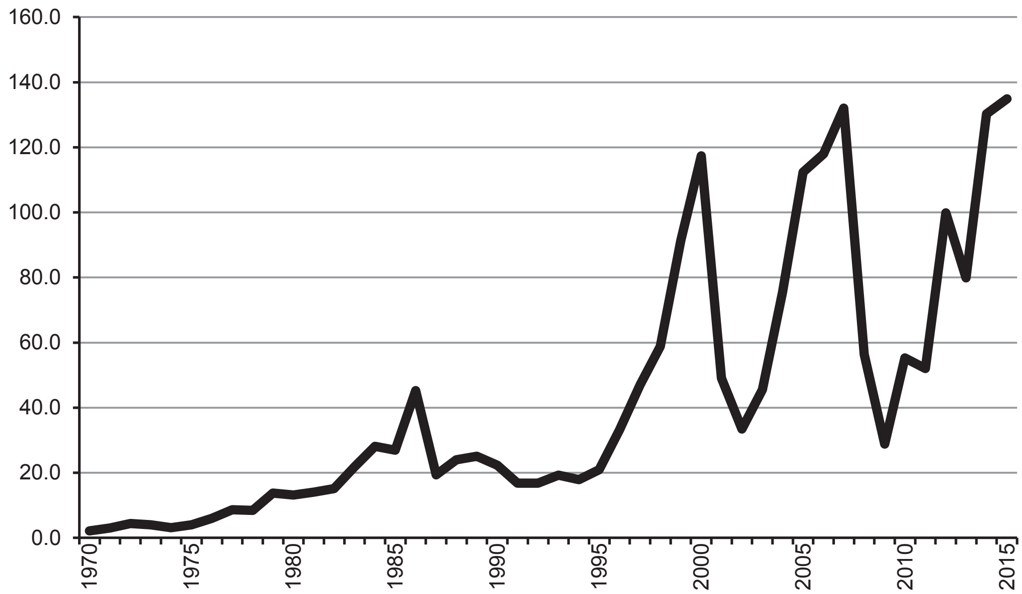


Figure INT-05
Current Recovery Already Two Years Longer Than Average

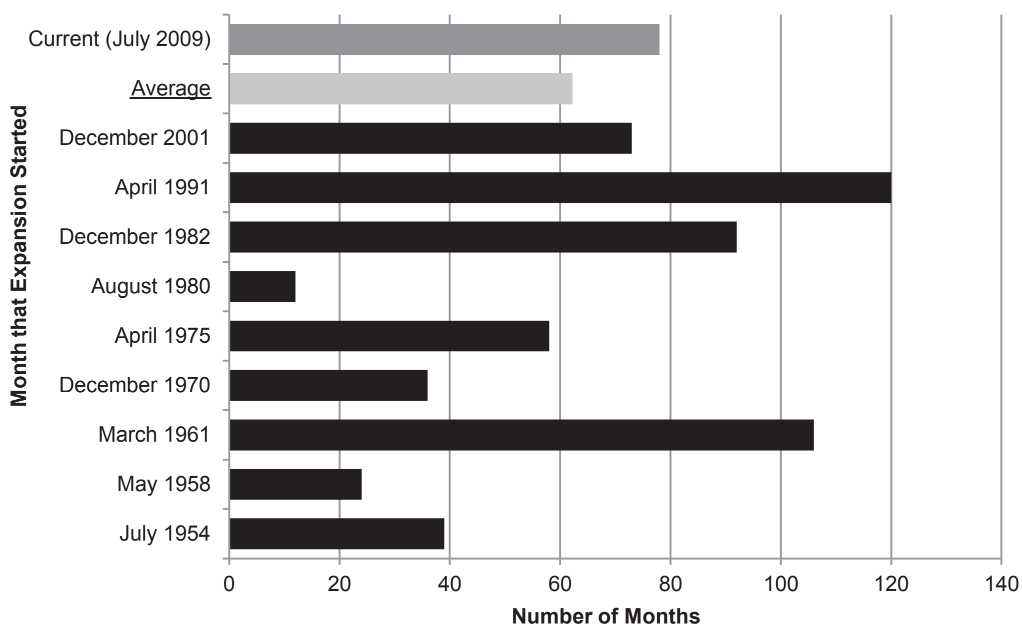
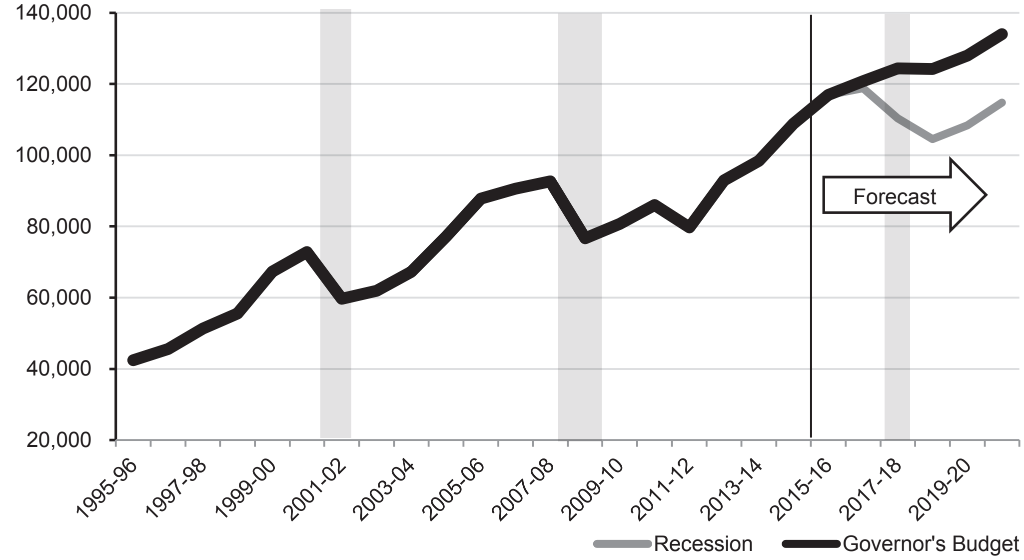


Figure INT-06
Recession Could Cause Loss of $55 Billion in Revenues by 2019-20
(Dollars in Millions)



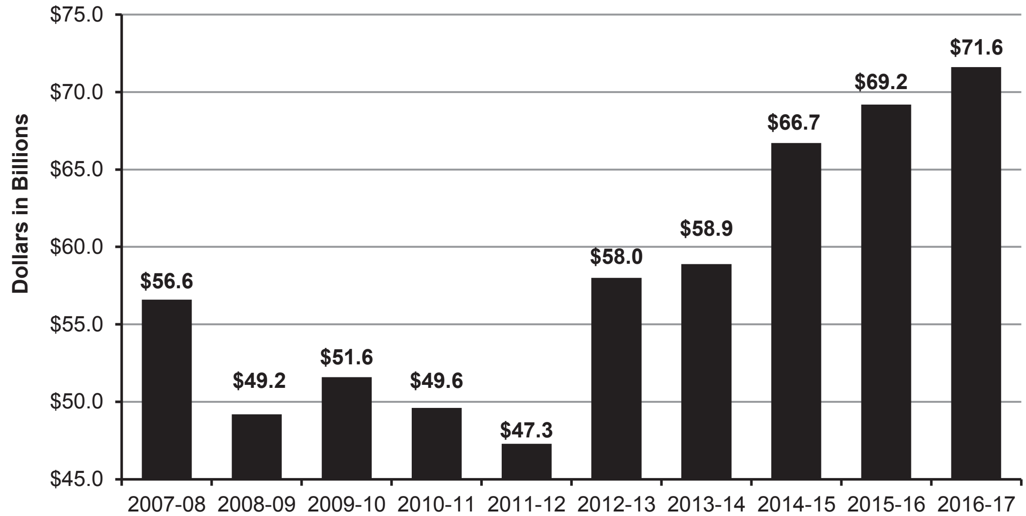
2019-20 under the Governor's approach—even without accounting for higher safety net program spending caused by the recession. If, however, the budget embarks on higher <u>ongoing</u> spending this year, rather than the <u>one-time</u> purposes as proposed by the Governor, the deficit would grow to more than $43 billion by 2019-20.

In the short term, fully filling the Rainy Day Fund by the time the next recession begins should be the primary fiscal goal of the state. Under Proposition 2, its balance would grow to $6 billion, or 48 percent of its full amount in 2016-17. The Budget proposes to make an additional $2 billion deposit, bringing the Rainy Day Fund to $8 billion, or 65 percent of the target. While a full Rainy Day Fund might not eliminate the need for some spending reductions in case of a recession, saving now would allow the state to spend from its Rainy Day Fund later to soften the magnitude and length of any necessary cuts.

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-07, 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

Figure INT-07
Proposition 98 Funding
2007-08 to 2016-17



recent low, funding has been at all-time highs since 2012-13 and is expected to grow to $71.6 billion in 2016-17, an increase of $24.3 billion in five years (51 percent).

K-12 Education

For K-12 schools, funding levels will increase by nearly $3,600 per student in 2016-17 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. The Budget provides $2.8 billion in new funding, bringing the formula's implementation to 95 percent complete.

The Budget seeks to extend the goals of the Local Control Funding Formula to the state's early education programs. The Budget proposes a $1.6 billion early education block grant by combining three existing programs to promote local flexibility, focusing on disadvantaged students and improved accountability.

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. The Budget keeps tuition at 2011-12 levels. By focusing on reducing the time it takes a student to successfully complete a degree or certificate, colleges and universities can ensure their systems are financially viable over the long term. Increased funding must be used to get students their degrees in a timely manner, not just admit more students.

The Administration's higher education efforts—keeping student costs low, promoting new technology and innovation, rethinking remediation practices, easing the transfer process from community colleges to universities, and improving graduation rates—will support students' success in achieving their educational goals. Proposed funding will maintain affordability and strengthen pathways through education and into the workforce.

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 infrastructure demands continue to grow.

The deferred maintenance on existing state infrastructure is staggering—estimated to total $77 billion. The state's largest deferred maintenance is on its highways, roads and bridges. Annual maintenance and repairs are billions of dollars more than can be funded annually within existing revenues. The state must address deferred maintenance in its transportation system through expanded and ongoing funding sources. The Budget reflects the Governor's transportation package first outlined last summer that would provide $36 billion over the next decade to improve the maintenance of highways and roads, expand public transit, and improve critical trade routes. The proposal includes an $879 million commitment from the General Fund to accelerate the repayment of loans to transportation projects. The increased funding would be coupled with Caltrans efficiencies, streamlined project delivery, and accountability measures.

The Budget also includes $807 million ($500 million General Fund) for critical deferred maintenance at levees, state parks, universities, community colleges, prisons, state hospitals, and other state facilities. The Budget supports a major investment in renovating Sacramento's aged and inadequate state office infrastructure. A study of state offices completed in 2015 documented serious deficiencies with state office buildings that will require their replacement or renovation. The Budget proposes a $1.5 billion General Fund down payment to begin that work for three buildings, including the State Capitol Annex.

California needs a new school facilities program that provides enhanced local flexibility and reflects the major changes in demographics and lower local bond authorization thresholds of recent years. A proposed $9 billion school bond for the November 2016 ballot makes no changes to the existing program. It would add an additional $500 million a year in General Fund debt service (on top of the over $2 billion annually already committed to school bonds). The Administration intends to continue a dialogue with the Legislature to shape a state program that focuses on districts with the greatest needs, while providing substantial new flexibility for districts to raise the necessary resources for their facilities.

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 14.8 percent. The Census Bureau's supplemental measure of poverty, which considers broader measures of income and the cost of living, reflects an even higher poverty rate. While the state's economic condition has improved since the Great Recession, much of the gains are 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 three 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 5 million Californians in just four years. The Local Control Funding Formula is concentrating the greatest school funding to those students with the greatest needs. The state guaranteed that 6.5 million workers are eligible for sick leave. The 2015 Budget Act created California's first earned income tax credit to help the poorest working families in California and encourage more families to claim the existing federal credit. The Budget proposes the first state cost-of-living increase for Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients since 2006.

Raising the Minimum Wage

In 2013, the Governor signed legislation to raise the state minimum wage by 25 percent, from $8 an hour to $10 an hour in two steps. The second increase to $10 an hour just went into effect on January 1, 2016. On an inflation-adjusted basis, the new level is the highest minimum wage in California since 1979. The higher minimum wage will raise the income of an estimated 2.2 million workers. However, higher minimum wage laws are not free. They raise the operating costs of many businesses, and the state must shoulder higher wages in its programs, particularly In-Home Supportive Services and developmental services. For example, the increase to $10 an hour has raised General Fund costs by over $250 million annually.

Already, there are proposals to raise the minimum wage further. At $15 an hour, as two ballot measures propose, the General Fund would face major increased costs, estimated at more than $4 billion annually by 2021. Based on current projections, such a change would return the state budget to annual deficits—even assuming a continued economic expansion. Yet under the measures, one or more increases would likely occur at the same time that California is experiencing a recession. Such an increase would require deeper cuts to the budget and exacerbate the recession by raising businesses' costs, resulting in more lost jobs.

Further raising the minimum wage is a noble goal but it must be done responsibly. Any further increases in the state minimum wage should be implemented on timelines that allow the budget to absorb their costs and have appropriate off-ramps in case the economy is experiencing a recession.

Addressing Climate Change

The California Global Warming Solutions Act of 2006 (AB 32) set greenhouse gas emission reduction goals for 2020. Last year, California adopted its climate change goals beyond 2020 with several ambitious and sweeping policies. The Budget supports these efforts with a $3.1 billion Cap and Trade expenditure plan that will reduce greenhouse gas emissions through programs that support clean transportation, reduce short-lived climate pollutants, protect natural ecosystems, and benefit disadvantaged communities.

In addition to reducing emissions, the state also is taking actions to mitigate the impacts of climate change. These impacts, such as increased fires, floods, severe storms and heat waves, will in unpredictable ways become more frequent and more damaging. California has experienced four consecutive years of below-average rain and snow and unprecedented drought. The Budget includes a total of $719 million in new General Fund resources to pay for the costs of wildfires and for other effects of the drought.