2017-18 May Revision

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State of California

Introduction

As the state's economy has recovered from the Great Recession, the past four budgets have significantly expanded government spending. The Legislature and the Governor have focused the spending on counteracting the effects of poverty. The May Revision includes funding for:

- The rising state minimum wage, which is scheduled to increase to $11 per hour in 2018 and to $15 per hour over time.
- The expansion of health care coverage to undocumented children and the millions of Californians covered under the federal Affordable Care Act.
- The provision of preventative dental benefits to adults covered by Medi-Cal.
- The first cost-of-living adjustment for Supplemental Security Income/State Supplementary Payment (SSI/SSP) recipients since 2005.
- The repeal of the maximum family grant rule in CalWORKs, which denied aid to children who were born while their parents were receiving aid.
- California's first-ever Earned Income Tax Credit to help the state's poorest working families.

The state has also paid down its budgetary borrowing and addressed some long-standing problems—such as restoring fiscal health to its retirement benefit plans and making major improvements to the state's water system.

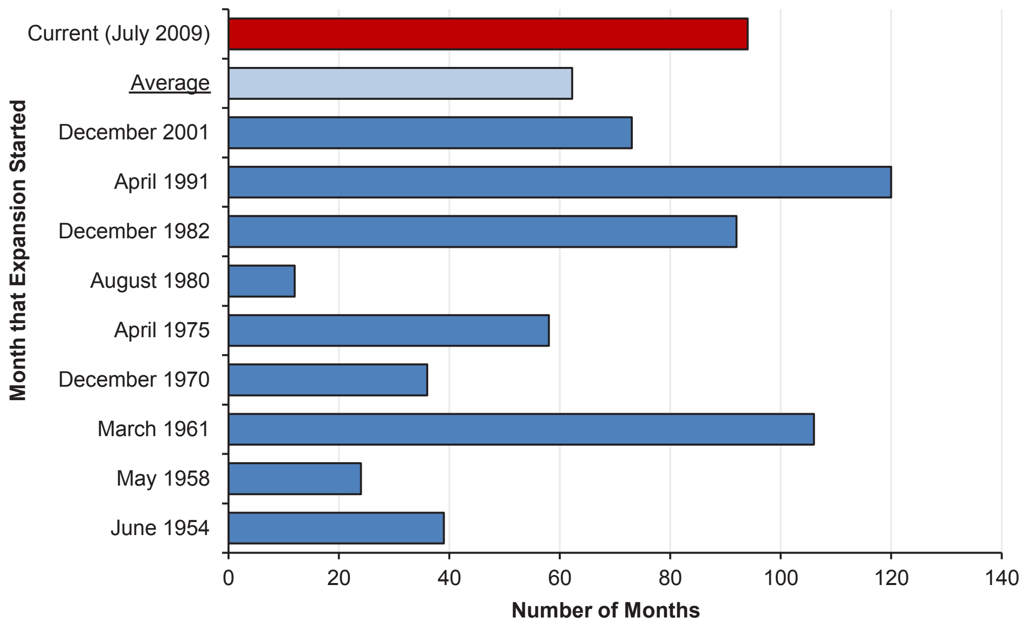
Over the past year, however, state revenues began to lag expectations. Compared to the 2016 Budget signed in June, the January Budget revenue forecast reflected a $5.8 billion reduction. Since January, the stock market has surged. As a result, the May Revision reflects higher revenues of $2.5 billion. Yet, this forecast remains $3.3 billion below the 2016 Budget forecast from one year ago. Consequently, the budget—which remained precariously balanced even in the strongest revenue years—is considerably more constrained than in any year since 2012.

The modestly improved fiscal outlook compared to January allows the May Revision to advance several key priorities:

- Increasing Money for Schools—With an increased Proposition 98 minimum guarantee, the May Revision increases funding for the Local Control Funding Formula for K-12 education, providing a total increase of $1.4 billion in 2017-18.
- Maintaining County Fiscal Health—Under current law, about $600 million in In-Home Supportive Services (IHSS) costs would be borne by county realignment funds next year. The May Revision substantially mitigates these increased costs and preserves counties' ability to provide key safety net programs.
- Restoring Child Care—The January Budget proposed pausing scheduled provider rate increases, but the May Revision restores the $500 million child care package from the 2016 Budget.
- Reducing Pension Liabilities—The May Revision proposes a $6 billion supplemental payment to CalPERS with a loan from the Surplus Money Investment Fund that will reduce unfunded liabilities, stabilize state contribution rates, and save $11 billion over the next two decades. The General Fund share of the repayment will come from Proposition 2's revenues dedicated to reducing debts and long-term liabilities.

The state must also continue to plan for and save for tougher budget times ahead. The federal government is contemplating actions—such as defunding health care for five million Californians, eliminating the deductibility of state taxes, and zeroing out funding for organizations like Planned Parenthood—that could send the state budget into turmoil. Moreover, by the time the budget is enacted in June, the economy will have finished its eighth year of expansion—only two years shorter than the longest recovery since World War II (see Figure INT-01). A recession at some point is inevitable.

Figure INT-01
Current Recovery Is Approaching Three Years Longer than Average



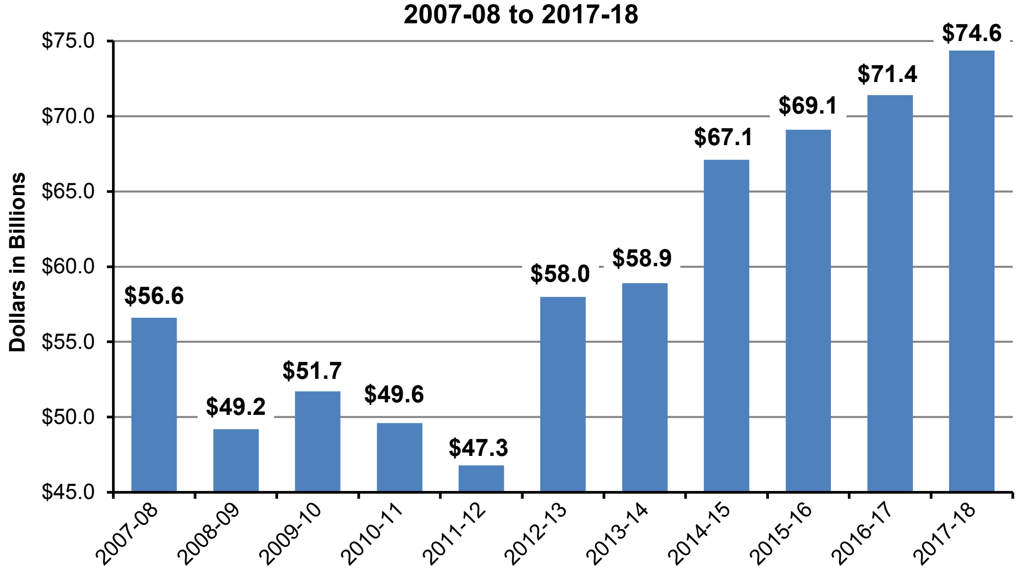
Preserving Core Achievements

The May Revision maintains a balanced budget while preserving the state's core achievements from the past four years.

K-12 Education

As shown in Figure INT-02, 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. Funding is expected to grow to $74.6 billion in 2017-18—an increase of $1.1 billion since January and $27.3 billion over six years (58 percent).

Figure INT-02
Proposition 98 Funding
2007-08 to 2017-18



For K-12 schools, funding levels will increase by about $4,058 per student in 2017-18 over 2011-12 levels. This reinvestment provides the opportunity to correct historical inequities in school district funding with $1.4 billion in new funding to continue implementation of the Local Control Funding Formula. The formula focuses most new funding to districts with low-income students, English Learners, and students in foster care. The Budget increases the formula's implementation to 97 percent complete. The increased funding also eliminates the deferral of funding that was included in the January Budget.

Higher Education

The Administration's higher education efforts—keeping student costs low, promoting new technology and innovation, and improving graduation rates—will support students' success in achieving their educational goals. The May Revision continues to provide each university system and the community colleges with annual General Fund growth. The May Revision also prevents a scheduled reduction in financial aid awards to low-income students at private colleges and universities, while tying those extra expenditures to meeting state goals regarding serving low-income students, expanding online education, and easing the transfer process from community colleges. In response to the State Auditor's review of the UC Office of the President, the May Revision sequesters $50 million in UC funding until such time that the Auditor's recommendations and other UC commitments are implemented.

Counteracting the Effects of Poverty

California has an extensive safety net for the state's neediest residents who live in poverty. Since 2012, the General Fund has supported new poverty-focused obligations totaling almost $19 billion annually. Based on reduced revenues, the January Budget proposed pausing scheduled rate increases for child care providers and an expansion of slots for preschool. The May Revision reverses that proposal, resulting in over a $500 million increase for child care programs from 2016-17 through 2018-19.

In January, the Administration determined that the Coordinated Care Initiative, begun in 2012-13, was not cost-effective. Under existing law, this determination would result in about $600 million in state savings and a corresponding increase in annual county realignment IHSS costs (by returning to the historic cost-sharing ratio for the program). The May Revision prioritizes the mitigation of this increase to county costs by contributing $400 million from the General Fund and then smaller amounts in future years as realignment revenues grow. This funding will allow counties to continue providing key health, social, and mental health services to the state's residents.

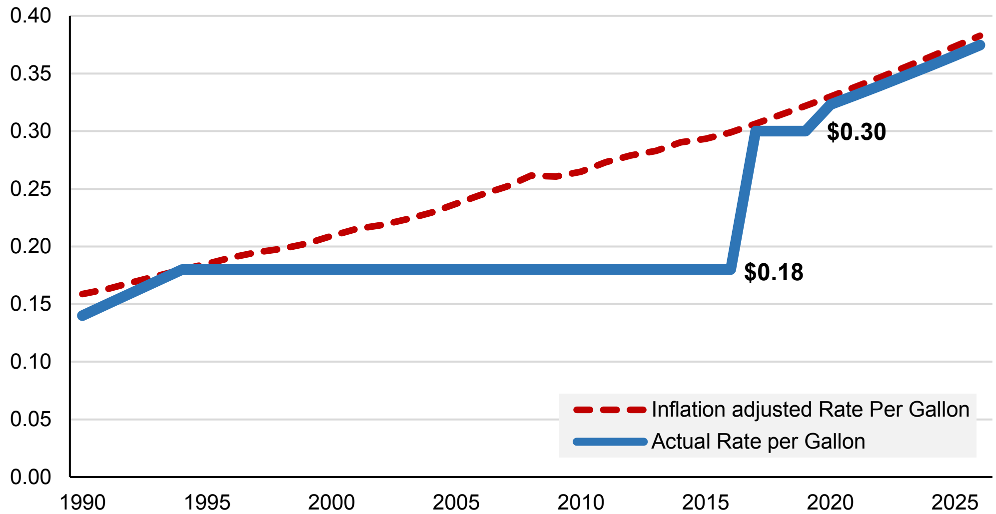
Strengthening Infrastructure

The repair, maintenance, and efficient operation of the state's transportation system are vital to California's economic growth. State and local funding has fallen dramatically below the levels needed to maintain the system, and a recent transportation study found that Californians spend on average $762 annually on vehicle repair costs due to poorly maintained roads. California continues to be in the top five states with the longest commutes.

In response, the Legislature and Governor agreed on a historic transportation funding package this spring, contained in The Road Repair and Accountability Act of 2017 (SB 1). The funding package returns the gas tax's purchasing power to 1994 levels (see Figure INT-03) and will provide $54 billion in new funding over the next decade, split evenly between state and local funding. The May Revision reflects the first $2.8 billion of new funding to:

- Focus on "fix-it-first" investments to repair neighborhood roads and state highways and bridges.
- Make key investments in trade and commute corridors to support continued economic growth and implement a sustainable freight strategy.

Figure INT-03
SB 1 Restores Lost Purchasing Power for the Gas Tax



- Match locally generated funds for high-priority transportation projects.
- Invest in passenger rail and public transit modernization and improvement.

Drivers deserve improved performance and efficiency at Caltrans in exchange for paying more (less than $10 per month for most drivers). The package enhances oversight by the California Transportation Commission and the new Inspector General. Moreover, new performance metrics will allow the state to hold Caltrans accountable for its improvement of state highways. State and local governments must implement the SB 1 plan in a cost-effective manner without delay.

Paying Down Debts and Liabilities

Over the past several years, the Governor and Legislature have taken significant steps to address the long-term costs of state retirement programs. 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. In 2016, the state and its employees began to share equally in the prefunding of retiree health benefits to eliminate the unfunded liability over three decades, now estimated at $76.5 billion.

As shown in Figure INT-04, the state now has $282 billion in long-term costs, debts, and liabilities. The vast majority of these liabilities—$279 billion—are related to retirement costs of state and University of California employees. These retirement liabilities have grown by $51 billion in the last year alone due to poor investment returns and the adoption of more realistic assumptions about future earnings.

Figure INT-04

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

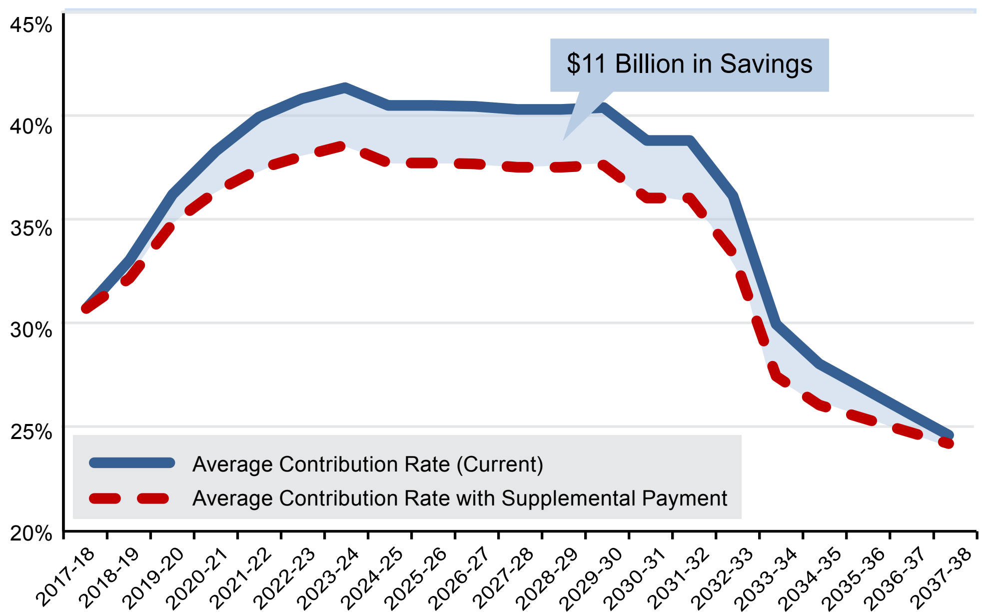
(Dollars in Millions)

	Outstanding Amount at Start of 2017-18	Proposed Use of 2017-18 Pay Down at Governor's Budget	Changes from Governor's Budget	Proposed Use of 2017-18 Pay Down at May Revision
Budgetary Borrowing				
Loans from Special Funds	$1,365	$252	$0	$252
Underfunding of Proposition 98—Settle-Up	1,043	400	203	603
Repayment of pre-Proposition 42 Transportation Loans	706	235	0	235
State Retirement Liabilities				
State Retiree Health	76,533	100	-11	89
State Employee Pensions	59,578	0	427	427
Teachers' Pensions[1/]	101,586	0	0	0
Judges' Pensions	3,489	0	0	0
Deferred payments to CalPERS	627	0	0	0
University of California Retirement Liabilities				
University of California Employee Pensions	15,141	169	0	169
University of California Retiree Health	21,860	0	0	0
Total	**$281,928**	**$1,156**	**$619**	**$1,775**

[1/]The state portion of the unfunded liability for teachers' pensions is $29.332 billion.

Absent additional action to address these growing liabilities, paying off retirement liabilities will require an increasing percentage of the state budget. For example, the state's contributions to CalPERS are on track to nearly double from $5.8 billion ($3.4 billion General Fund) in 2017-18 to $9.2 billion ($5.3 billion General Fund) in 2023-24. In response, the May Revision proposes a $6 billion supplemental payment to CalPERS through a loan from the Surplus Money Investment Fund. This payment is expected to earn a 7 percent return from CalPERS, compared to the less than 1 percent currently earned from the fund. Over the next two decades, this supplemental payment will save an estimated $11 billion (after paying the costs of the loan). Figure INT-05 illustrates that the supplemental payment will lower the state's contribution rates by an average of 2.1 percent of payroll. The General Fund costs associated with the payment will be repaid with Proposition 2's dedicated revenues for long-term liabilities.

Figure INT-05
Supplemental Retirement Payment Would Save Billions

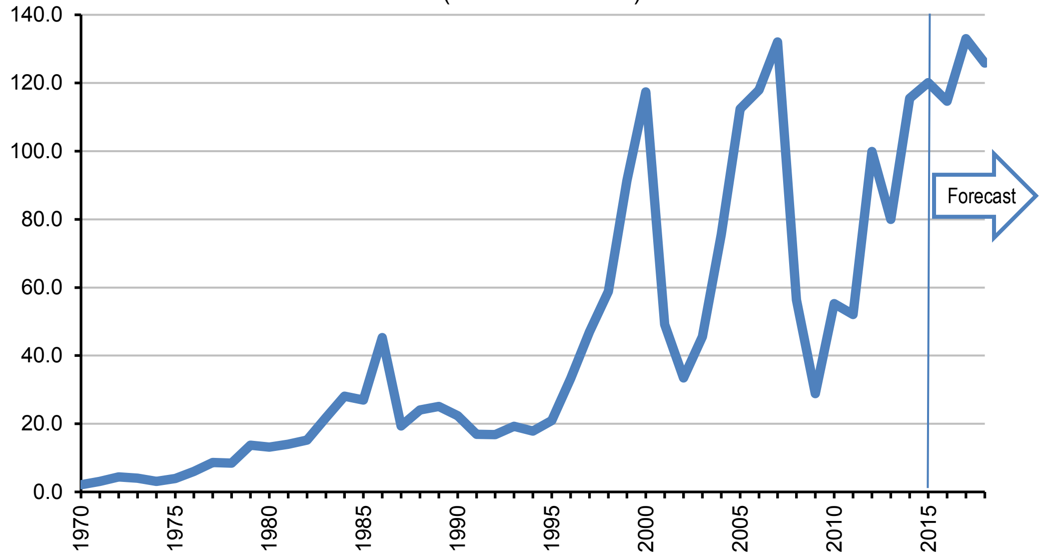


Maintaining a Balanced Budget in Uncertain Times

Over the next several years, California faces dramatically higher risks than normal, with major threats that could drive the budget significantly out of balance.

The May Revision reflects a modest improvement in the state's fiscal outlook—primarily from the recent rise in the stock market. As shown in Figure INT-06, the May Revision would be relying on an all-time high of capital gains in 2017—the state's most volatile and unpredictable revenue source.

Figure INT-06
Volatile Capital Gains on the Rise
(Dollars in Billions)



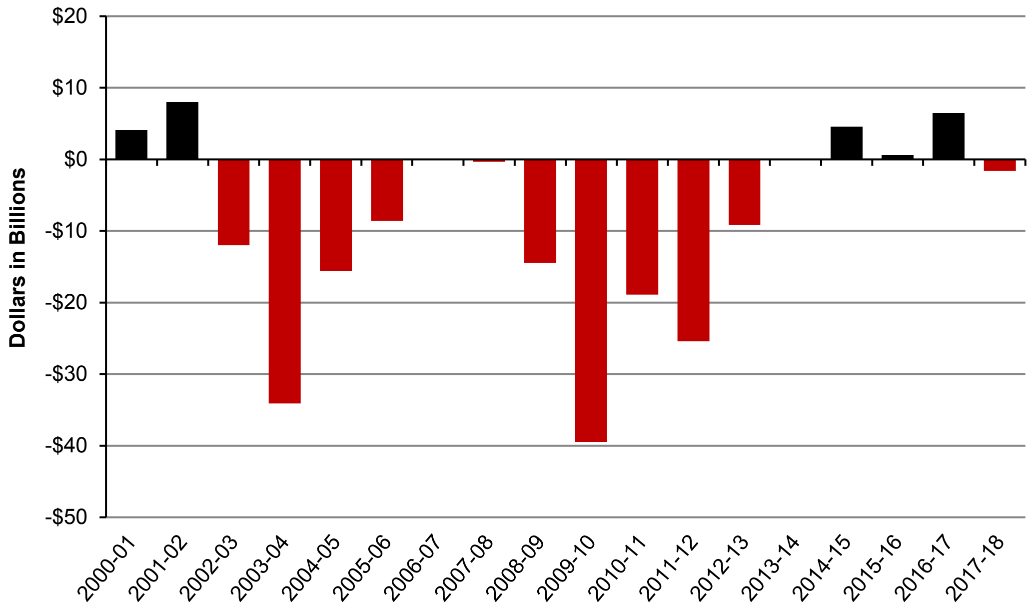
The May Revision assumes the continued expansion of the economy. Yet, economic expansions do not last forever. In the post-war period, the average expansion has been about five years, and the current expansion is approaching three years longer than that. A moderate recession will drop state revenues by about $20 billion annually for several years.

The May Revision also assumes the continuation of existing federal fiscal policy. Yet, Congress and the President have suggested major changes to Medicaid, trade and immigration policy, and the federal tax structure. Many of the proposed changes could have serious and detrimental effects on the state's economy and budget. For instance, the repeal of the Affordable Care Act passed by the House of Representatives in early May would cost the state an estimated $4.3 billion in lost federal funds in 2020, increasing to $18.6 billion by 2027 (with a General Fund impact of $3.3 billion in 2020, increasing to $13 billion in 2027). Such a massive cost shift to the state would necessitate major spending cuts and threaten the health care of the 5 million Californians who have gained coverage in recent years.

Proposition 2 establishes a constitutional goal of having 10 percent of tax revenues in the Rainy Day Fund. By the end of 2017-18, the state's Rainy Day Fund will have a total balance of $8.5 billion (66 percent of the constitutional target). While a full Rainy Day

Fund might not eliminate the need for further spending reductions in case of a recession or major federal policy changes that trigger a budget crisis, saving now will allow the state to spend from its Rainy Day Fund later to soften the magnitude and length of any necessary cuts. In contrast, the state was forced to address the huge budget shortfalls from 2002 through 2012 shown in Figure INT-07 without the benefit of a significant Rainy Day Fund.

Figure INT-07
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]



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