Introduction

As the state's economy has recovered from the Great Recession, the past five budgets have significantly increased spending—through historic growth in education funding, the creation of the state's first earned income tax credit, a minimum wage that will increase to $15 per hour over time, and the expansion of health care coverage to millions of Californians. The state has also paid down its budgetary borrowing and addressed long-standing problems such as restoring fiscal health to its retirement benefit plans and making major improvements to the state's transportation and water systems.

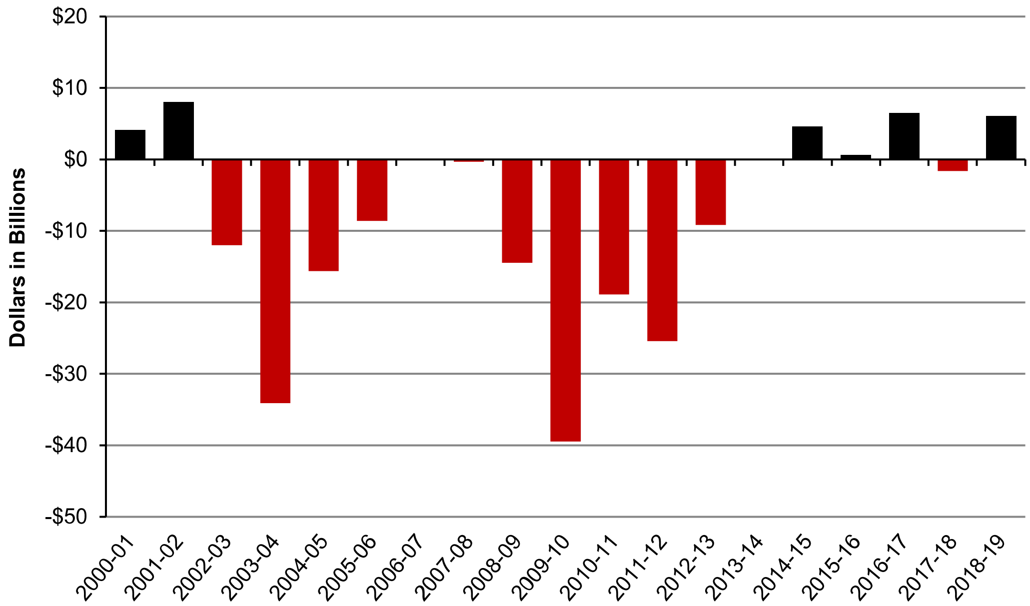
The January Budget was projected to have a healthy one-time surplus and focused the new funds on building up the state's Rainy Day Fund to prepare for the next recession. Since that time, revenues have continued to grow. Capital gains are projected to be at an all-time high and state unemployment is at an all-time low. Despite strong fiscal health in the short term, the risks to the long-term health of the state budget continue to mount—the effects of the 2017 federal tax bill remain uncertain, the nation faces a host of global risks and the volatility of the stock market has returned.

By the end of 2018-19, the U.S. will have matched the longest recovery in modern history. The best way to buffer against uncertainty and protect against future cuts is to continue building the state's reserves and avoid making substantial new ongoing obligations. Consequently, the May Revision proposes to use the surplus on one-time spending to address long-standing infrastructure needs, homelessness and mental health.

Maintaining a Balanced Budget in Uncertain Times

California's fiscal stability—driven by a balanced budget and a recovering state economy—has been a welcome reprieve from prior budget deficits. As shown in Figure INT-01, the state's short periods of balanced budgets in the 2000s were followed by massive budget shortfalls. The risks of the budget returning to deficits continue to grow:

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 (January).

Federal Government and Tax Bill

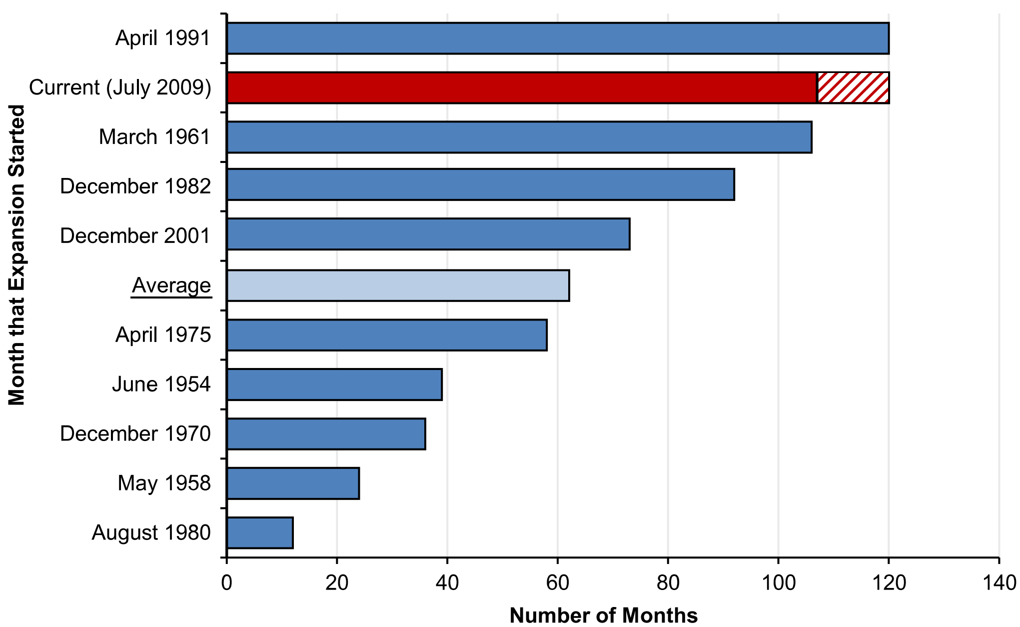
The federal extension of the Children's Health Insurance Program will provide temporary fiscal assistance to the state; yet, California's relationship with the federal government has never been more uncertain. Actions by the federal government could easily overwhelm the state's fiscal capacity. The January Budget's economic and revenue forecasts were finalized prior to the enactment of the federal tax package at the end of December. The May Revision assumes the tax changes will provide a temporary boost to the national economy and provide fiscal gains to many Americans, especially the wealthiest. However, this boost is likely to come at a long-term cost as it will take economic growth from future years and increase income inequality.
By growing the federal deficit to more than $1 trillion each year, the tax package is essentially borrowing from the future to subsidize corporate stock buybacks and executive bonuses. However, the full implications for the state's taxpayers and on federal-state programs will not be known for many years.

The increasing federal deficit caused by the tax bill will also create more pressure for the federal government to cut spending programs through rescissions or some other mechanism. Historically, this has meant shifting a greater burden to states. For instance, the congressional Medicaid proposals that have been debated over the past two years would have shifted tens of billions of dollars in permanent Medi-Cal costs to the state General Fund. Although they have been defeated to date, there is a major risk that they, or similar proposals, could reappear in future years.

Recession

The May Revision assumes the continued expansion of the economy and a balanced budget through the forecast period. But economic expansions don't last forever. In the modern era, the average expansion has lasted about five years. By the end of the 2018-19 fiscal year, as shown in Figure INT-02, the U.S. will have matched the longest recovery in modern history.

Figure INT-02
Current Recovery Is Approaching The Longest Ever

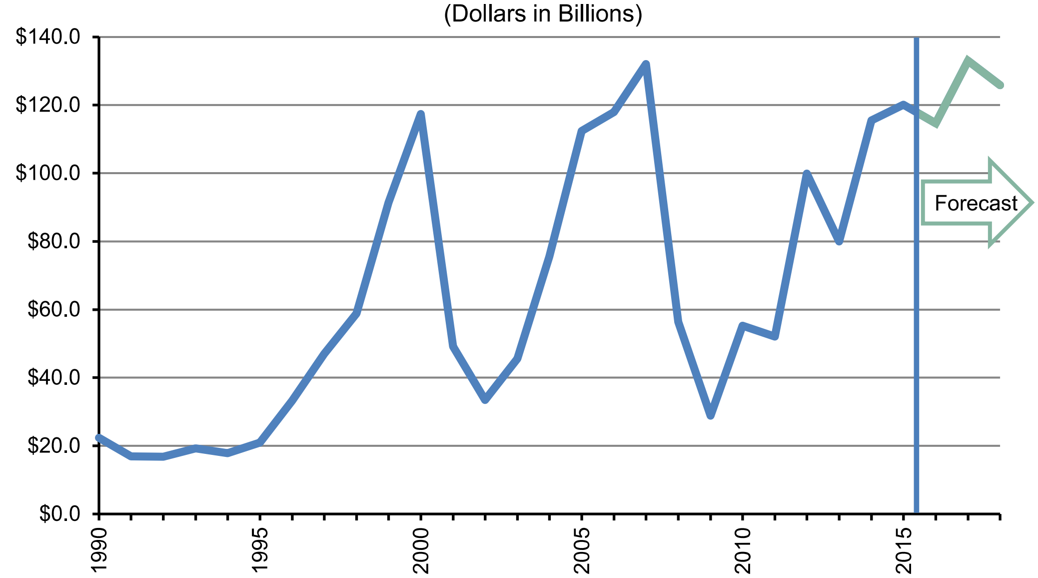


A moderate recession will drop state revenues by over $20 billion annually for several years. Economic forecasts generally do not predict recessions at a particular time. As such, based on the current strength of the economy, the May Revision forecasts growth for the foreseeable future. By continuing to assume economic growth, however, the May Revision forecast is based on factors that history would suggest are extremely unlikely to come to fruition. For example, in recent history, the state's unemployment rate has dipped below five percent only twice, in 2000 and 2006. Each time, full employment was short-lived at 7 months and 11 months respectively. The state's unemployment rate fell to an all-time low of 4.3 percent in February and March, and at that point had been below 5 percent for 11 months. Yet, the May Revision assumes the state will remain below five percent throughout the forecast—an unprecedented length of time.

Capital Gains

The state's most volatile revenue source—capital gains—is expected to reach an all-time high in 2017 and is forecast to stay at levels never achieved previously through 2022 as shown in Figure INT-03. To achieve these levels, the stock market would need to continue an unprecedented run without a correction.

Figure INT-03
Volatile Capital Gains on the Rise
(Dollars in Billions)



Planning for the Next Recession

The next recession will be upon California soon enough, so a full Rainy Day Fund and a commitment to prudent one-time spending are the best tools available to guide the state through it.

Filling the Rainy Day Fund

Proposition 2, passed by the voters in 2014, establishes a constitutional goal of reserving 10 percent of tax revenues in a Rainy Day Fund by increasing deposits during high capital gains years. By the end of 2017-18, the state's Rainy Day Fund will have a total balance of $9.4 billion (71 percent of the constitutional target). The state's primary short-term fiscal goal should continue to be fully filling the Rainy Day Fund by the time the next recession begins. The May Revision maintains the January proposal to provide a supplemental deposit to fully fill the Rainy Day Fund this year.

Focusing on One-Time Expenditures

The May Revision reflects the receipt of $8 billion in higher revenues through 2018-19 compared to the January Budget. From this amount, the state must pay for substantially higher program costs and ongoing commitments it has made and expanded in recent years, such as Medi-Cal, Cal Grants, child care, In-Home Supportive Services and foster care reform. With the remaining funds, the May Revision makes few new permanent commitments. Instead, in recognition of the growing risks that the state budget faces, it proposes nearly $4 billion in one-time General Fund spending, focused in three areas:

- Infrastructure ($2 billion)—The state has massive liabilities from years of deferred maintenance. The proposal will target these funds to the universities, courts, state facilities and flood control. Investments are also proposed for high-priority capital expenditures.
- Homelessness ($359 million)—In the coming year, new revenues dedicated to addressing the rising cost of housing will begin to flow (from a bond and a fee on real estate transactions). As a bridge to these funds, the May Revision includes a $359 million package of funding to focus on the state's most vulnerable populations and assist local governments in their immediate efforts to address homelessness, including $50 million for individuals with mental illness.
- Mental Health ($312 million)—Although primarily a county responsibility, mental health issues affect the entire state. The May Revision includes funding for enhanced early detection of mental health problems and the education of mental health professionals. The proposals include the repayment of $254 million plus interest in mandate claims to give counties additional resources for youth with mental illness. The May Revision also proposes to place the $2 billion No Place Like Home bond on the November ballot to accelerate the delivery of housing projects to serve the mentally ill.

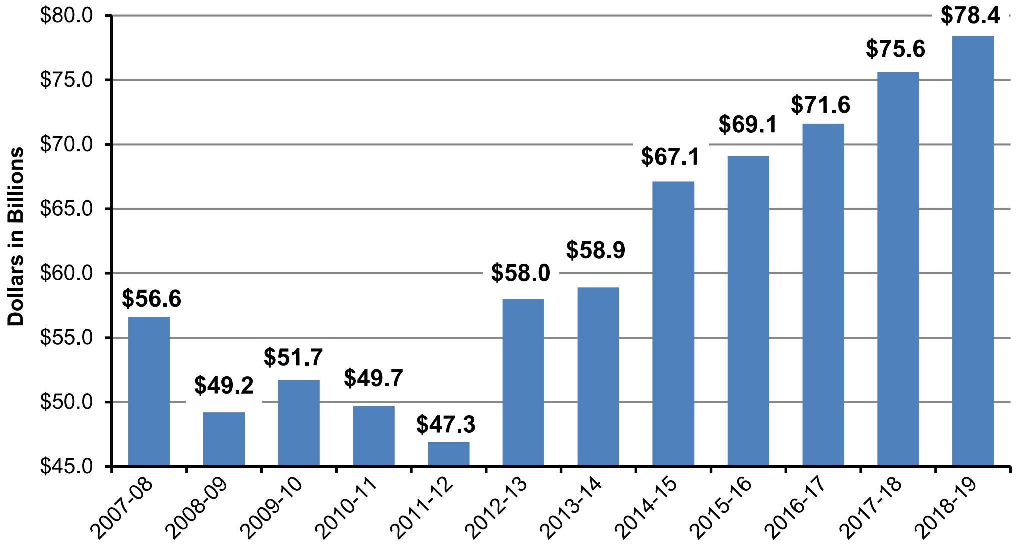
More Money for Schools

Proposition 30 in 2012 and Proposition 55 in 2016 both increased funding for public education from their reduced levels during the Great Recession.

K-12 Education

As shown in Figure INT-04, the minimum guarantee of funding for K-14 schools in 2007-08 was $56.6 billion, sinking to $47.3 billion in 2011-12 at the depth of the state budget crisis. From this recent low, funding has grown substantially, and will continue to grow to $78.4 billion in 2018-19—an increase of $31 billion (66 percent) in seven years.

Figure INT-04
Proposition 98 Funding
2007-08 to 2018-19



For K-12 schools, 2018-19 funding levels will increase by about $4,600 per student over 2011-12 levels. Available funding will allow the state to reach 100 percent implementation of the Local Control Funding Formula, correcting historical inequities in school district funding, as well as permanently increasing the formula's base to assist districts in accommodating rising costs. To enhance certainty for districts regarding funding levels, the May Revision proposes a revised Proposition 98 certification process. This process will result in future certifications occurring more quickly (the last certification was for 2008-09) and increase certainty regarding the payment of outstanding obligations to schools.

Higher Education

The Administration has continually sought to keep student fees low, promote new technology and innovation and improve graduation rates, all in support of students' success in their educational goals. The May Revision continues the new ongoing resources for higher education proposed in January. With these increases, since their recent lows, the University of California has received $1.2 billion in new funding, the California State University has received $1.6 billion and the community colleges $2.4 billion. Over the same time period, funding for state financial aid, primarily to support low-income students, has increased by $861 million, to a total of $2.4 billion. The May Revision also provides each university system with $100 million in new one-time deferred maintenance funding from the overall allocation described below.

The state's decades-old community college apportionment formula—which favors counting the number of students at a desk at a particular point in time—is not the most effective way for community colleges to reach their goals. Instead, the January Budget proposed a new funding formula that provides supplemental funding to those districts that serve low-income students and provides grants to districts for each student who completes a degree or certificate. As the formula is implemented, no district would receive less funding than currently provided. The May Revision adjusts the new formula to reflect the substantial feedback that colleges and others provided in recent months, providing additional funding to reward successful outcomes for economically disadvantaged students.

Similarly, based on feedback, the May Revision refines the January proposal to create the California Online College by specifying more details on measuring student success, improving governance, developing curriculum, obtaining accreditation and undertaking collective bargaining.

Counteracting the Effects of Poverty

While California's economic condition has improved since the Great Recession, much of the gains have benefitted the state's wealthiest residents. The recently enacted federal tax package threatens to exacerbate this gap in wealth. Since 2012, the General Fund has committed approximately $21 billion in new annual funding for poverty-focused programs to enhance the state's already extensive safety net for the state's neediest residents.

In addition to full implementation of the K-12 Local Control Funding Formula—which heavily emphasizes services to the state's neediest students—the May Revision expands the Earned Income Tax Credit to workers between the ages of 18 and 25 and those above 64. In addition, the credit's income limits are adjusted to reflect the minimum wage increase to $12 per hour in 2019. The May Revision continues to provide billions of dollars in additional funding to pay for:

- Expanding health care coverage under the federal Affordable Care Act, which provides millions of Californians with insurance.
- Restoring various health benefits to low-income Californians that were eliminated during the recession, including adult dental services.

- Repealing of the maximum family grant rule in CalWORKs, which denied aid to children who were born while their parents were receiving aid.
- Increasing child care and early education provider rates and the number of children served.

Combatting Climate Change

California has acted decisively and aggressively to reduce greenhouse gas emissions and address climate change, with a state goal to reduce emissions 40 percent below 1990 levels by 2030. The state's most cost-effective approach to meeting that target is the Cap and Trade Program, which allows the private sector to determine the most appropriate path for reducing emissions through the quarterly auction of pollution credits. In addition to the direct emission reductions required under the program, the state has appropriated $6.5 billion in auction proceeds to further reduce emissions by funding transit and high-speed rail, affordable housing near jobs and services, forest and watershed improvements, healthy soils, recycling and home energy upgrades. The state has prioritized the expenditure of these funds in disadvantaged communities.

The Legislature strengthened Cap and Trade last year by extending the program through 2030. Earlier this year, the Administration proposed $1.25 billion in additional Cap and Trade spending from auction proceeds. The May Revision proposes $50 million in additional auction proceeds (along with other funding) to implement the recently released Forest Carbon Plan that aims to improve the health and resiliency of California's forests against the increasing threats of fire and disease caused by climate change.

Strengthening Infrastructure

The construction and maintenance of key physical infrastructure is one of the core functions of state government. Infrastructure allows for the movement of goods across the state and the delivery of public services. The deferred maintenance on existing state infrastructure is staggering—estimated to total $20 billion, not including roads and highways. The May Revision includes $2 billion to address the most critical deferred maintenance projects such as levees, high priority state facilities and facilities that are the responsibility of the state's universities and court systems. The 2016-17 Budget also began a major investment in renovating Sacramento's aged and inadequate state office infrastructure, and the May Revision proposes using cash—rather than borrowing—to implement the next components of the plan. Under the state Constitution, once the state's Rainy Day Fund is filled, any additional deposits will be dedicated for additional infrastructure projects.

Paying Down Debts and Liabilities

As shown in Figure INT-05, the state has $291 billion in long-term costs, debts and liabilities. The vast majority of these liabilities—$287 billion—are related to retirement costs of state and University of California employees. Over the past several years, the Governor and Legislature have taken significant steps to address the long-term costs of its retirement programs.

Figure INT-05

Debts and Liabilities Eligible for Accelerated Payments Under Proposition 2

(Dollars in Millions)

	Outstanding Amount at Start of 2018-19 [2/]	Proposed Use of 2018-19 Pay Down at Governor's Budget	Changes from Governor's Budget	Proposed Use of 2018-19 Pay Down at May Revision
Budgetary Borrowing				
Loans from Special Funds	$1,248	$205	$0	$205
Weight Fees	1,150	325	57	382
Underfunding of Proposition 98—Settle-Up	440	100	0	100
Non-Proposition 98 Mandates (Pre 2004)	18	0	18	18
Pre-Proposition 42 Transportation Loans	471	235	0	235
State Retirement Liabilities				
State Retiree Health	91,008	195	0	195
State Employee Pensions	58,765	475	136	611
Teachers' Pensions[1/]	103,468	0	0	0
Judges' Pensions	3,277	0	0	0
Deferred payments to CalPERS	682	0	0	0
University of California Retirement Liabilities				
University of California Employee Pensions	10,851	0	0	0
University of California Retiree Health	19,331	0	0	0
Total	**$290,709**	**$1,535**	**$211**	**$1,746**

[1/] The state portion of the unfunded liability for teachers' pensions is $35.3 billion.

[2/] For retiree health and pensions, the amounts reflect latest actuarial report available.

In 2012, the California Public Employees' Pension Reform Act was enacted to save billions of taxpayer dollars by capping pension 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 by 2046. In 2015, the state and its employees began to share equally in the prefunding of retiree health benefits to eliminate a then $72 billion unfunded liability. In 2017-18, the state made a $6 billion supplemental payment to CalPERS that is estimated to save a net $4.8 billion in required pension contributions over the next two decades.

Despite these efforts, California's unfunded liabilities continue to rise—by $15 billion since the release of the January Budget alone. If not for the above-noted efforts, these liabilities would be billions of dollars higher. Accounting for all of these actions, and under current assumptions, the state now has plans in place to pay off these liabilities over the next 30 years. The state's multiyear spending forecast accounts for the expected increases in these costs while keeping spending in line with revenues. In other words, the state can continue to manage its retirement expenses while the long-term savings under 2012's pension reform law phase in. California's local governments are facing even greater pressures in accommodating these rising costs.

Maintaining Fiscal Balance Will Be An Ongoing Challenge

The past six years have been the longest stretch of balanced budgets in recent history. With a volatile revenue structure and limited spending flexibility, the California budget demands constant vigilance to stay in balance. These six years of relative fiscal stability illustrate the benefits of a prudent approach to budgeting—building up a Rainy Day Fund, avoiding overcommitting one-time revenues and making tough decisions when necessary. These years provide a sharp contrast to the decade of budget crises that preceded it—a decade that was defined by using one-time revenues from capital gains for ongoing expenditures while deferring tough decisions through borrowing and gimmicks. The next recession will be upon California soon enough, but a full Rainy Day Fund and a commitment to prudent one-time spending are the best tools available to guide the state through it.