Introduction

In 2011, the state faced $20 billion in expected annual gaps between its revenues and spending. Just two years later, California is on its most stable fiscal footing in well over a decade. With the tough spending cuts enacted over the past two years and new temporary revenues provided by the passage of Proposition 30, the state's budget is projected to remain balanced for the foreseeable future.

The Budget invests in both K-12 and higher education. These investments are critical to provide Californians, regardless of their financial circumstance, access to high-quality academic and career education, improve educational attainment, and support critical thinking and civic engagement—thereby strengthening the foundation for sustainable growth. The Budget also expands health care coverage as the state implements federal health care reform. It also preserves the state's safety net and pays down debt.

Despite the dramatic budgetary changes of the past two years, there remain a number of major risks and pressures that threaten the state's new-found fiscal stability, including the overhang of billions of dollars in debt accumulated in prior years.

Achieving Fiscal Balance

When Governor Brown took office, the state faced a $26.6 billion short-term budget problem and estimated annual gaps between spending and revenues of roughly $20 billion. The 2011-12 and 2012-13 budgets rejected the past reliance on gimmicks,

borrowing, and deferrals. These two budgets addressed the $20 billion annual deficit through spending cuts, primarily in corrections, health and human services, and education. In total, these budgets provided three dollars of spending cuts for every dollar in temporary tax revenues approved by the voters.

The two budgets achieved the following goals:

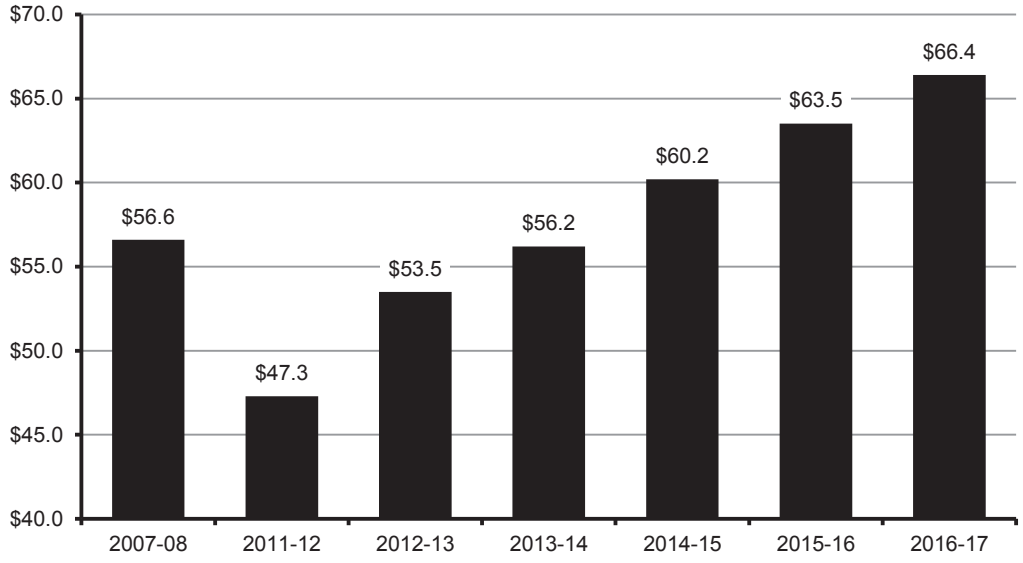
- Realigning public safety programs to bring government closer to the people.
- Implementing a downsizing plan for the California Department of Corrections and Rehabilitation. The plan is intended to satisfy the U.S. Supreme Court's order requiring reduced crowding and end federal court oversight of our prison system. It will reverse the trend of prison spending that has consumed a growing percentage of the General Fund budget. Over time, spending will decline from 11 percent to 7.5 percent of the General Fund.
- Eliminating redevelopment agencies to increase funding for schools, police, fire, and other core local services.
- Refocusing the state's welfare program on getting people back to work. The total number of months an adult can receive a monthly cash benefit has been reduced from 60 months to 48 months. Furthermore, the benefit is only provided to the adult for up to 24 months unless the individual is meeting federal work requirements. The Budget provides specific funding to implement these reforms.
- Making tough cuts across state government to align spending with available tax dollars. Grants to low-income seniors and persons with disabilities (State Supplementary Payment) have been reduced to 1982 levels. CalWORKs grants have been reduced to below 1987 levels. The Williamson Act subventions, child care and dependent tax credit refunds, and the Healthy Families Program were eliminated.
- Reducing the state workforce by more than 30,000 positions. The state workforce is at its lowest level as a share of the state's population in almost a decade—and California already had one of the nation's lowest levels of government employment.
- Overall General Fund spending is down from its peak of $103 billion in 2007-08 to $93 billion in 2012-13, a decrease of $10 billion, or 10 percent. As a share of the economy, General Fund spending in 2011-12 and 2012-13 remains at its lowest level since 1972-73.

While the state has made very difficult programmatic reductions over the past two years, California has maintained its safety net for the state's neediest and most vulnerable residents. Compared to other states, it continues to provide broader health care coverage to a greater percentage of the population, including in-home care; guarantees access to services for persons with developmental disabilities; makes available higher cash assistance to families and continues that assistance to children after their parents lose eligibility; and provides very generous financial aid to those seeking higher education in California.

Reinvesting in Education

Proposition 30, the Governor's Initiative, was premised on the need to reinvest in education. For the first time since the recession began in 2008, with the passage of the Initiative, the Governor's Budget reinvests in, rather than cuts, education funding. As shown in Figure INT-01, 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 is expected to grow to $66.4 billion in 2016-17, an increase of $19 billion (40 percent).

Figure INT-01
Budget Reinvests in Education
(Dollars in Billions)



K-12 Education

For K-12 schools, funding levels will increase by almost $2,700 per student through 2016-17, including an increase of more than $1,100 per student in 2013-14 over 2011-12 levels. This reinvestment also provides the opportunity to correct historical inequities in school district funding. By allocating new funding to districts on the basis of the number of students they serve, all California school districts can improve. By committing the most new funding to districts serving English language learners and low-income students, the Budget ensures that our educational system supports equal opportunity for all Californians. This new funding will be coupled with new, but simplified, accountability measures. The goal is to ensure sufficient flexibility at the local level so that those closest to the students can make the decisions.

Higher Education

The budget plan also invests in the state's higher education system to maintain the quality and affordability of one of California's greatest strengths. Since 2007-08, systemwide tuition and fees have increased by $5,556 (84 percent) at the University of California and by $2,700 (97 percent) at the California State University. The Budget provides stable funding growth over multiple years and should eliminate the need for further tuition increases—if the universities rise to the challenge by deploying their teaching resources more effectively. By focusing on reducing the time it takes a student to successfully complete a degree, the state can ensure a system that is financially sustainable over the long term. For the state's universities and community colleges, the Budget provides 5 percent growth to each system. A similar level of funding is proposed to be provided in future years.

Expanding Health Care

Medi-Cal, the state's Medicaid health care program for low-income families, currently serves one out of every five Californians (more than 8 million individuals). The program currently receives 20 percent of the General Fund budget. As the state implements its commitment to federal health care reform, these numbers will increase. The Budget includes $350 million General Fund to begin to pay for this federally required expansion of coverage.

In addition to the required expansion of coverage, states have the option under federal health care reform to expand coverage to include medically indigent adults. The federal

government promises to provide 100 percent funding in the short term for much, but not all, of the costs associated with the expansion. States will bear a portion of expansion costs on a permanent basis. The Budget outlines two possible approaches to the optional expansion—a state-based approach or a county-based approach. Each approach has its own set of strengths, challenges, risks, and benefits.

Expansion of health care under either approach will have a significant effect on both state and county finances. Under the current system, counties provide health care to medically indigent adults using a combination of their own and state 1991 realignment funds. The implementation of health care reform provides a unique opportunity to focus on the future of the state-county relationship. The goal is to fairly allocate risk, strengthen local flexibility, and clearly delineate the respective responsibilities of the state and the counties.

A Balanced Budget Plan for the Coming Years

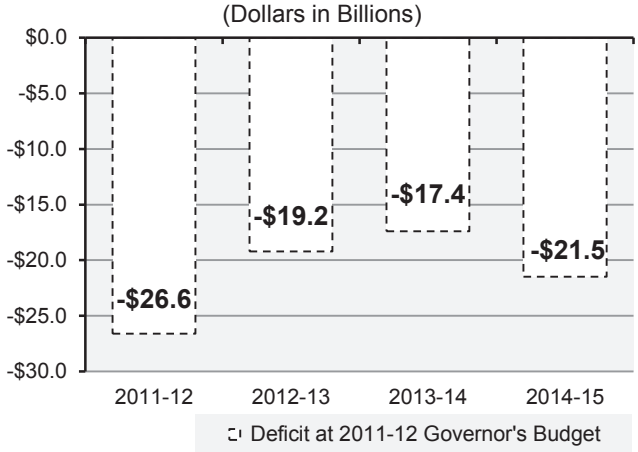
The Budget proposes a multiyear plan that is balanced, maintains a $1 billion reserve, and pays down budgetary debt from past years. Overall General Fund spending is projected to grow by 5 percent, from $93 billion in 2012-13 to $97.7 billion in 2013-14. The vast majority of the spending growth is in education and health care.

Absent changes, the 2013-14 budget is projected to be balanced—but without an adequate reserve. To create a $1 billion reserve, the Budget proposes:

- Suspending four newly identified mandates. ($104 million)
- Using 2012-13 funds appropriated above the Proposition 98 minimum guarantee to prepay obligations to schools under the *CTA v. Schwarzenegger* settlement. ($172 million)
- Continuing the use of miscellaneous state highway account revenues to pay for transportation bond debt service. ($67 million)
- Extending the hospital quality assurance fee. ($310 million)
- Extending the gross premiums tax on Medi-Cal managed care plans. ($364 million)

Under current projections, the Budget is expected to remain in balance in future years. This represents the first time in over a decade that future spending is expected to stay within available resources. Figure INT-02 shows the roughly $20 billion annual shortfalls projected just two years ago that have been eliminated.

Figure INT-02
Last Two Budgets Have Eliminated $20 Billion Annual Shortfalls*
(Dollars in Billions)



*Under current projections, the state would have operating surpluses of $851 million in 2013-14, $47 million in 2014-15, $414 million in 2015-16, and $994 million in 2016-17.

The state's budget remains balanced only by a narrow margin. The 2012 Budget Act assumed and spent the revenue provided by Proposition 30. In addition, this revenue is temporary, with the sales tax expiring at the end of 2016 and the income tax expiring at the end of 2018. The state must begin to plan now to ensure that the budget will remain balanced after the revenue expires.

A number of risks could quickly return the state to fiscal deficits:

- In addressing its own fiscal challenges, the federal government could shift costs to the state.
- While the Budget projects modest economic growth, the pace of the nation's and state's economic recovery remains uncertain.

- The federal government and the courts have hindered the state's past efforts to reduce spending and could again interfere with the successful implementation of budget actions authorized in 2011-12 and 2012-13.
- Rising health care costs will continue to strain the state budget.

The state's budget challenges have been exacerbated by the Wall of Debt—an unprecedented level of debts, deferrals, and budgetary obligations accumulated over the prior decade. In 2013-14 alone, the state will dedicate $4.2 billion to repay this budgetary borrowing—paying for the expenses of the past, instead of meeting current needs. Moving forward, continuing to pay down the Wall of Debt is key to increasing the state's fiscal capacity. In 2011, the level of outstanding budgetary borrowing totaled $35 billion.

Figure INT-03

Budget Plan Would Reduce Wall of Debt to Less than $5 Billion

(Dollars in Billions)

	End of 2010-11 [1/]	End of 2012-13 [2/]	End of 2016-17 [2/]
Deferred payments to schools and community colleges	$10.4	$8.2	$0.0
Economic Recovery Bonds	7.1	5.2	0.0
Loans from Special Funds	5.1	4.1	0.0
Unpaid costs to local governments, schools and community colleges for state mandates	4.3	4.9	2.5
Underfunding of Proposition 98	3.0	2.4	0.0
Borrowing from local government (Proposition 1A)	1.9	0.0	0.0
Deferred Medi-Cal Costs	1.2	1.7	1.1
Deferral of state payroll costs from June to July	0.8	0.7	0.7
Deferred payments to CalPERS	0.5	0.4	0.0
Borrowing from transportation funds (Proposition 42)	0.4	0.2	0.0
Total	**$34.7**	**$27.8**	**$4.3**

[1/] As of 2011-12 May Revision

[2/] As of 2013-14 Governor's Budget

As shown in Figure INT-03, the debt has already been reduced to less than $28 billion. Under current projections, it will be reduced to less than $5 billion by the end of 2016-17.

Figure INT-04

Unfunded Retirement Liabilities

	($ in Billions)
State Retiree Health	$62.1
State Employee Pensions	38.5
Teacher Pensions	64.5
University of California Employee Pensions	12.8
Judges' Pensions	3.3
Total	**$181.2**

California will still need to address other looming liabilities, such as the deficit in the state's Unemployment Insurance Fund and the more than $100 billion in unfunded liabilities in retiree health and pension systems. In addition, as Figure INT-04 also shows, the retirement systems for University of California employees and teachers have accumulated $77 billion in liabilities which will need to be addressed.

The state has $37.6 billion in authorized infrastructure bonds that have yet to be sold. Nevertheless, this sum is relatively small when compared to the money California must spend to maintain and modernize its infrastructure in the coming years.

The boom and bust in our state's budget over the last decade is something we should not repeat. Instead, the state must live within its means, pay down debt, and build up a "rainy day" fund — all to ensure a stable government that earns the respect of the citizens that pay for it.