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Introduction

The Governor's Budget reflected California's 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. However, substantial risks, uncertainties, and liabilities remain.

The May Revision maintains the fundamentals of the Governor's Budget. It reflects that the state's economic and budget recovery is continuing. However, the national economic outlook has dimmed since the Governor's Budget and recent federal actions have slowed the pace of the state's economic growth.

In the past four months, the state has experienced a multibillion dollar increase in current-year cash receipts. Yet, the influx is expected to be short-lived. Schools will benefit from this one-time increase, as well as from the implementation of the Local Control Funding Formula. The May Revision also proposes an affordable and sustainable path for a state-based expansion of health care coverage and a commensurate shift in some responsibilities to counties. It preserves the state's safety net, encourages job growth, and pays down debt.

Changes since the Governor's Budget

The May Revision reflects the net changes in the national and state economic outlook, the corresponding effects on revenues and the state's obligation to schools, as well as other spending adjustments.

Among the key developments are:

- A downward revision in the short-term economic outlook due to recent federal actions. Specifically, the federal government did not extend the 2-percent payroll tax reduction that had been in place in 2011 and 2012. This action was not assumed in the Governor's Budget economic forecast. As a result, forecasted personal income growth in 2013 has been cut almost in half—from 4.3 percent to 2.2 percent. In addition, the federal government allowed the sequester of tens of billions of dollars in spending.
- The May Revision reflects, as required by Proposition 98, $2.9 billion in additional funds in the current year for K-12 schools and community colleges. The May Revision proposes that these one-time funds be used to reduce the deferral of payments to schools and community colleges, and to support the implementation of new academic standards.
- Medi-Cal experiencing higher costs of $467 million, principally as a result of the federal government and courts either rejecting or delaying approval of previously adopted legislative actions.
- The costs of borrowing for both short-term cash and long-term infrastructure investments have been reduced by $484 million. This was made possible by the state's improved fiscal condition.

The May Revision includes several key investments that will help successfully implement recent programmatic changes. It proposes an additional $48 million in CalWORKs for job training and subsidized employment opportunities to assist Californians in getting back to work under program reforms adopted last year. The May Revision also includes an additional $72 million (for a total of $107 million) for county probation departments because of responsibilities they have incurred in assisting the state in reducing its prison population.

Proposed legislation aims to strengthen the state's economic development programs to bolster the business environment and reintegrate people into the workforce.

By revamping the existing enterprise zone and hiring credit programs in a revenue neutral manner, the state can encourage manufacturing investment and increase employment in high poverty areas across the state.

Reinvesting in Education

With the passage of Proposition 30, the 2012-13 and 2013-14 budgets will reinvest in, rather than cut, education funding. From 2011-12 through 2016-17, the Proposition 98 minimum funding guarantee will increase from $47.3 billion to $66.5 billion, an increase of more than $19 billion.

For K-12 schools, funding levels will increase by $2,754 per student through 2016-17. As shown in Figure INT-01, the May Revision increases funding for higher education by between $1,503 and $2,491 per student through 2016-17.

Figure INT-01
Budget Increases Funding Per Student

	2011-12	2016-17	Funding Increase
K-12 Education	$7,175	$9,929	$2,754
Community Colleges	$4,893	$6,396	$1,503
California State University	$5,868	$7,803	$1,935
University of California	$10,630	$13,121	$2,491

The May Revision provides $1,046 more per K-12 student in 2013-14 than was provided in 2011-12, with an additional $170 dollars per student to support the implementation of the Common Core—new standards for evaluating student achievement in English-language arts and math. The upcoming Budget also provides the opportunity to correct historical inequities in school district funding. In January, the Governor's Budget proposed an overhaul of school funding to create a more just allocation of resources and increase local flexibility. The May Revision makes modest modifications to this Local Control Funding Formula to address issues raised over the past few months—the basic approach remains the same. All California school districts can improve under this formula with new ongoing funding based on the number of students served. By committing the most new funding to districts serving English language learners, students from low-income families, and foster youth, the formula ensures that the students most in need of help have an equal opportunity for a quality education.

When fully implemented, it is projected that the formula will spend 80 cents of every dollar on base grants for every student in a district, 16 cents for every English learner, low-income student, or foster child in a district, and 4 cents for those districts who have a particularly high concentration of English learners, students from low-income families, and foster youth. While the concentration funds represent only a small portion of the total dollars, they are critically important to those districts with the greatest challenges. Academic research confirms that a large concentration of English learners, students from low-income families, and foster youth presents the greatest and costliest challenge to effective teaching. Investing in these students now will better prepare the entire state for the future.

This new funding will be coupled with strong accountability. These measures will allow communities to govern their schools locally—but provide authority to county offices of education and the state to step in if districts fail to improve. Districts will be required to spend the entire amount allocated for English learners, students from low-income families, and foster youth for the benefit of these students. Independent audits and county and state oversight will make sure this occurs.

Expanding Health Care

Medi-Cal currently serves more than one out of every five Californians. Federal health care reform will significantly expand that coverage. The May Revision proposes a state-based approach to the optional expansion of care allowed under federal law. This expansion will significantly increase health care coverage and access new federal dollars. The law, however, also comes with costs, risks, and uncertainties.

The state currently dedicates about $1.5 billion annually to counties for health care, primarily for services for indigent adults—many of the same people who will move to Medi-Cal under the new law. While the need for county indigent services will continue and preserving a safety net is a priority, the state cannot—and should not—pay for the same services twice. Consequently, the May Revision proposes that over time, as the state takes on more responsibility for health care, counties take on more financial responsibility for certain human services programs. To ensure adequate funding remains at the county level for safety net services, dollars would only be redirected based on actual county-by-county experience. The goal is to allocate risk fairly, strengthen local flexibility, and clearly delineate the respective responsibilities of the state and the counties.

A Balanced Budget Plan, But Risks Remain

The May Revision proposes a multiyear plan that is balanced, maintains a $1.1 billion reserve, and pays down budgetary debt. Yet, the budget remains balanced only by a narrow margin. Further, the state must begin to plan now to ensure that the budget will remain balanced after the temporary Proposition 30 tax revenues expire.

Risks

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

- The pace of the economic and revenue recovery is still uncertain. Limited international growth may dampen the pace of domestic expansion. The forecast for revenues attributable to capital gains remains subject to considerable volatility.
- In recent years, under court orders, the state has significantly reduced prison crowding and improved the quality of the health care provided in prisons. If the state is unsuccessful in convincing the federal courts that it is now meeting the constitutionally required level of care, significant costs totaling hundreds of millions of dollars annually may be imposed.
- Rising health care costs could strain the state budget. Medi-Cal is the budget's second largest program. Additionally, the state provides health benefits to its own employees and retirees. As the state implements federal health care reform, budgetary spending will become even more dependent on the rate of health care inflation. If this inflation rises faster than expected, annual General Fund spending could quickly rise by hundreds of millions of dollars.
- 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 approved budget actions. For example, the Budget relies on the orderly dissolution of redevelopment agencies to defray state education costs of $1.5 billion in 2013-14. Yet, there are more than 70 active lawsuits from former redevelopment agencies. The Budget also relies on about $450 million in lower spending from a Medi-Cal provider rate reduction originally adopted in 2011, but that remains tied up in federal court.
- Actions taken by the federal government to address its own fiscal challenges could further strain the state budget. Such a strain could take many forms—such as

shifting of program costs from the federal government to states or reducing overall federal spending in California.

Debts

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. The May Revision dedicates billions to repay this budgetary borrowing. 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. As shown in Figure INT-02, the debt will be reduced to less than $27 billion this year. Under current projections, it will be reduced to below $5 billion by the end of 2016-17.

Figure INT-02
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	$6.4	$0.0
Economic Recovery Bonds	7.1	5.2	0.0
Loans from Special Funds	5.1	4.6	0.5
Unpaid costs to local governments, schools and community colleges for state mandates	4.3	4.9	3.1
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	2.0	1.1
Deferral of state payroll costs from June to July	0.8	0.7	0.0
Deferred payments to CalPERS	0.5	0.4	0.0
Borrowing from transportation funds (Proposition 42)	0.4	0.3	0.0
Total	**$34.7**	**$26.9**	**$4.7**

[1/] As of 2011-12 May Revision

[2/] As of 2013-14 May Revision

Future Liabilities

Balancing the budget was a critical step in returning the state to fiscal stability. Maintaining that stability will require more work. California still needs to address other liabilities that have been created over many decades. For example, beginning in 2015-16, the state will begin to pay hundreds of millions of dollars more to the California Public Employees'

Retirement System to help pay down the $38.5 billion unfunded liability for state employees' pensions. Those higher payments will need to continue for decades.

Between now and 2016-17, the costs for retired state employees' health care is projected to rise by 59 percent. Yet, the state has not set aside significant money to address the $63.8 billion in unfunded liabilities for future obligations. That liability increases by billions of dollars each year.

The state also has tens of billions of dollars in deferred maintenance on the critical infrastructure that allows for the delivery of key public services and the movement of goods across the state.

These liabilities and others were built up over many decades. Eliminating the liabilities will also take many years, but doing so will constrain the state's capacity to make other investments.

The May Revision outlines a budget that lives within our means, now and for many years to come. But risks and uncertainties remain. Only by continuing to exercise fiscal discipline can the state avoid repeating the boom and bust cycles of the last decade.

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