Introduction

Since 2011, the State of California's fiscal situation has dramatically turned around. The 2013-14 Budget was the state's most fiscally responsible budget in well over a decade. Under current estimates, the year-to-year gaps between spending and revenues have been erased for the foreseeable future. The overhang of billions of dollars in budgetary debt accumulated in prior years has been reduced. The surging stock market has given the state a capital gains tax revenue windfall of several billion dollars.

By making targeted expenditures, the 2014-15 Governor's Budget builds upon last year's investments in K-12 education, higher education, and health and human services. The Budget also takes further steps to reduce global warming with targeted investments of Cap and Trade auction proceeds, and makes strides towards a sustainable water policy.

Despite the recent improvements in our budget situation, there remain a number of major risks that threaten the state's new-found fiscal stability, including the remaining budgetary debt and hundreds of billions of dollars in longer term liabilities.

The state's fiscal history is riddled with budgets that made permanent obligations—both spending increases and tax cuts—based on temporary revenue increases. After these spikes in revenues disappeared—as they always do—the state was forced to cut programs and raise taxes. This Budget seeks to avoid this unproductive boom-and-bust cycle. Instead of using one-time revenues to spend on permanent programs, it instead uses that money to make the state's first deposit into its Rainy Day Fund since 2007, repay money owed to our schools, pay off the Economic

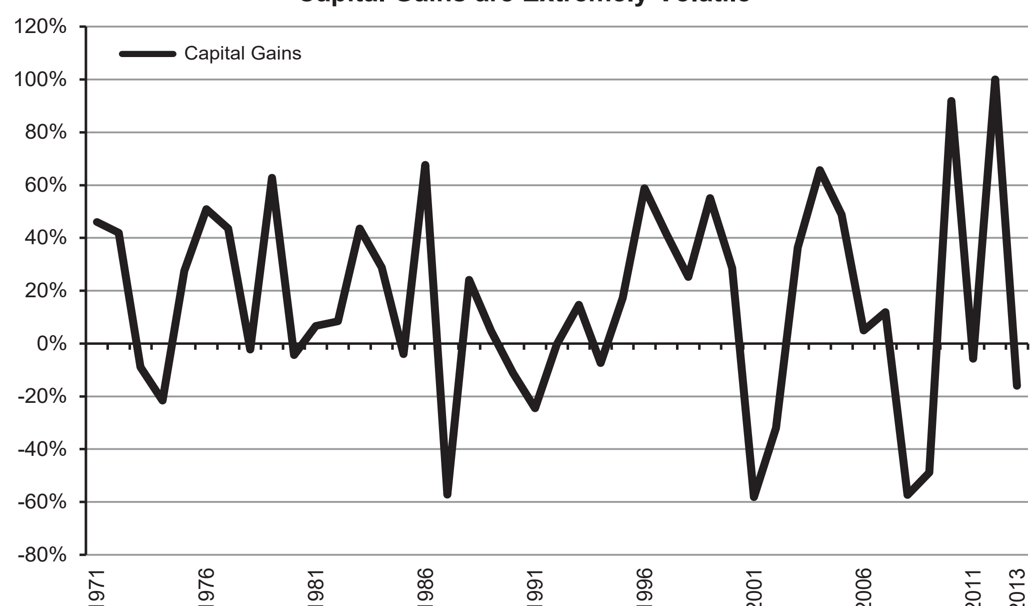
Recovery Bonds sold to balance the budget in 2004, and make one-time investments to shore up the state's aging infrastructure. This Budget also proposes a constitutional amendment to strengthen California's Rainy Day Fund so we can pay off our longer term liabilities and be prepared for any future decreases in revenue.

Achieving and Maintaining Fiscal Balance

When Governor Brown took office in 2011, the state faced a $26.6 billion immediate budget problem and estimated annual gaps between spending and revenues of roughly $20 billion. The last three budgets rejected the previous reliance on gimmicks, borrowing, and deferrals. The budgets addressed the $20 billion annual deficit through temporary taxes approved by the voters and 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.

Three years later, the state is now on its most stable fiscal footing in more than a decade. While the overall economy has modestly improved in fits and starts, the stock market soared through most of 2013. Consequently, 2013-14 and likely 2014-15 revenues will be driven upwards on the strength of capital gains. The Budget assumes that the state will receive about $4 billion in these windfall capital gains revenues above the amount received in "normal" years. Yet, as shown in Figure INT-01, it is clear that capital gains rarely have normal years. Instead, they tend to be extremely volatile: bulleting upwards only to crash dramatically shortly thereafter.

Figure INT-01
Capital Gains are Extremely Volatile



In addition, the quarter-cent sales tax increase under Proposition 30 will expire at the end of 2016, and the income tax rates on the state's wealthiest residents will expire at the end of 2018. The combination of the capital gains surge and the temporary Proposition 30 revenues should leave no doubt that the state's modest surplus must be carefully guarded.

Maintaining the stability of the past year will require fiscal restraint. There are numerous risks, each of which could hit the state's budget to the tune of hundreds of millions, or billions, of dollars. Navigating the following risks and pressures will require fiscal discipline so the state maintains the capacity to weather those that do materialize.

- Threat of Recession—The Budget assumes the continued modest economic expansion of the past couple of years. Yet, economic expansions do not last forever. In the post-war period, the average expansion has been about five years; the longest expansion was ten years. As of December 2013, the current expansion has lasted four-and-a-half years. While there are few signs of immediate contraction, we know from history that another recession is inevitable.
- Federal Fiscal Challenges—The recent federal budget provides greater stability to the federal government's fiscal situation, after a tumultuous October when operations shut down. Yet, the federal government still faces both short- and long-term fiscal issues, including the need to raise the debt ceiling in February. As has been common in the past, the federal government could shift costs to the state to address its own fiscal challenges.
- Capital Gains—As described above, capital gains are the state's most volatile revenue source. With an estimated 9.9 percent of the General Fund tax revenues relying on capital gains in 2014-15, the Budget is heavily dependent on the continued performance of the stock market.
- Prison Population Cap—At the time the Budget was prepared, negotiations were ongoing regarding a time extension for the state to meet the court-ordered 137.5 percent of capacity threshold. The Budget assumes that the federal court grants a two-year extension to meet the cap. However, if that extension is not granted, the state will have to spend more on short-term capacity (and reconsider proposed rehabilitation expenditures) to avoid the early release of prisoners who committed serious or violent crimes.
- Redevelopment Dissolution—Between 2011-12 and 2014-15, cities, counties, special districts, and schools are estimated to receive over $7 billion in revenues that

previously would have been spent by redevelopment agencies. These dollars have been invested in core local public services such as police and fire protection, and have been critical to the state balancing its budget. However, recent court decisions, if finalized and upheld, would put more than $3 billion of these funds at risk.

- Health Care Costs — 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.
- Debts and Liabilities — 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. Recent state budgets have reduced this debt from $34.7 billion to $24.9 billion. In addition, the state faces hundreds of billions of dollars in other long-term cost pressures, debts, and liabilities. As shown in Figure INT-02, retirement-related unfunded liabilities total $218 billion. Combined with the other liabilities shown in Figure INT-03, total long-term liabilities stand at $355 billion. These liabilities will constrain the state's finances in the future.

Figure INT-02
Unfunded Retirement Liabilities

	($ in Billions)
State Retiree Health	$63.8
State Employee Pensions	45.5
Teacher Pensions	80.4
University of California Employee Pensions	12.0
University of California Retiree Health	13.0
Judges' Pensions	3.1
Total	**$217.8**

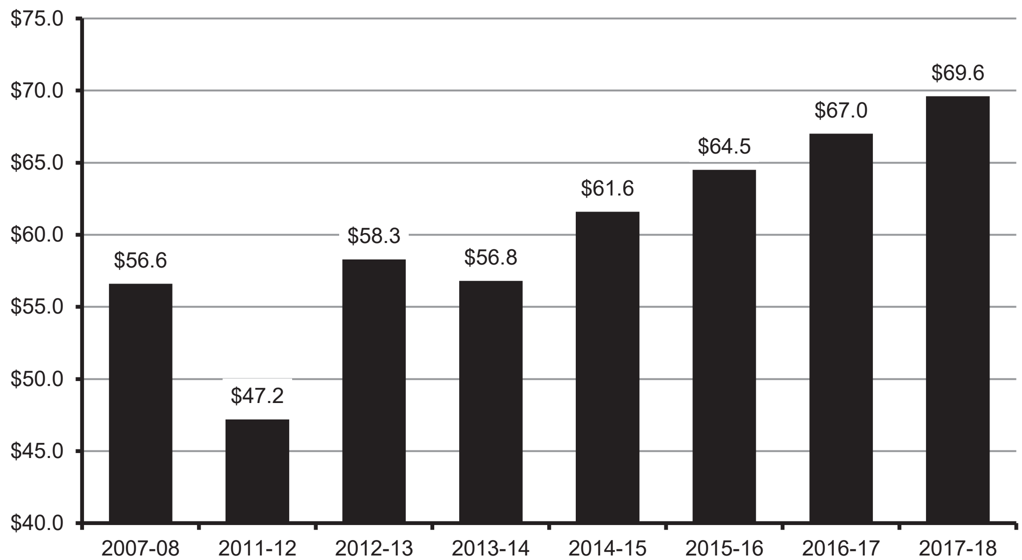
Figure INT-03
California's Long-Term Liabilities

	($ in Billions)
Proposition 98 Maintenance Factor	$4.5
Unemployment Insurance Debt	8.8
Wall of Debt	24.9
Unfunded Retirement Liabilities	217.8
Deferred Maintenance	64.6
Unissued Bonds	33.9
Total	**$354.5**

Continuing to Invest in Education

Proposition 30 was premised on the need to increase funding for education. For the first time since the recession began in 2008, the 2013-14 Budget invested in, rather than cut, education spending. Increasing revenues offer the opportunity for the 2014-15 Budget to advance this reinvestment even further through an infusion of $10 billion in new Proposition 98 funding this year and billions more in the next few years. As shown in Figure INT-04, the minimum guarantee of funding for K-14 schools was $56.6 billion in 2007-08 and sank to $47.2 billion in 2011-12. From this recent low, funding is expected to grow to $69.6 billion in 2017-18, an increase of $22 billion (47 percent).

Figure INT-04
Budget Continues to Invest in Education
(Dollars in Billions)



K-12 Education

For K-12 schools, funding levels will increase by $3,410 per student through 2017-18, including an increase of more than $2,188 per student in 2014-15 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. By committing the most new funding to districts serving low-income students, English language learners, and youth in foster care, the Budget supports real equal opportunity for all Californians.

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. The Budget provides stable funding growth over multiple years and eliminates the need for further tuition increases. By developing multiyear sustainability plans and focusing on reducing the time it takes a student to successfully complete a degree, the universities can ensure their systems are financially viable over the long term. Increased funding must be tied to getting students their degrees in a timely manner, not just admitting more students. The community college and the university systems must work together to develop innovative and ambitious approaches so students can successfully complete their degrees, and the Budget includes grant funding to encourage these innovations. The Budget expands community colleges' recent efforts to improve student success, with a particular focus on achievement in underrepresented student groups.

Strengthening the Safety Net

While the state has made very difficult programmatic reductions over the past three years, California has maintained its safety net for the state's neediest and most vulnerable residents. 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.

- The implementation of federal health care reform will provide health care coverage to millions of Californians over the next few years. The Budget commits $670 million in new General Fund spending to fund the expansion of Medi-Cal benefits, including mental health, substance use disorder, adult dental, and specialized nutrition services.
- The increase in the minimum wage by 25 percent to $10 per hour by the start of 2016 will provide a needed income boost to many working Californians.

- Grants provided under CalWORKs are currently below the level provided in 1987. The Budget funds a 5-percent grant increase, and creates a three-year pilot program for the state's most vulnerable low-income families with children to provide stable child care and to remove barriers to employment.

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 identified infrastructure needs for both new construction and maintenance continue to grow.

The Budget includes the release of the state's five-year infrastructure plan for the first time since 2008. Rather than solely focusing on new projects, the plan identifies the costs of maintaining the state's *existing* assets — an estimated $64.6 billion in deferred maintenance. By finally addressing this backlog of deferred maintenance, the state will keep its assets functioning longer and reduce the need to build costlier new infrastructure. The Budget includes an $815 million package of funding for critical deferred maintenance in state parks, highways, local streets and roads, K-12 schools, community colleges, courts, prisons, state hospitals, and other state facilities.

Addressing Climate Change and Water Sustainability

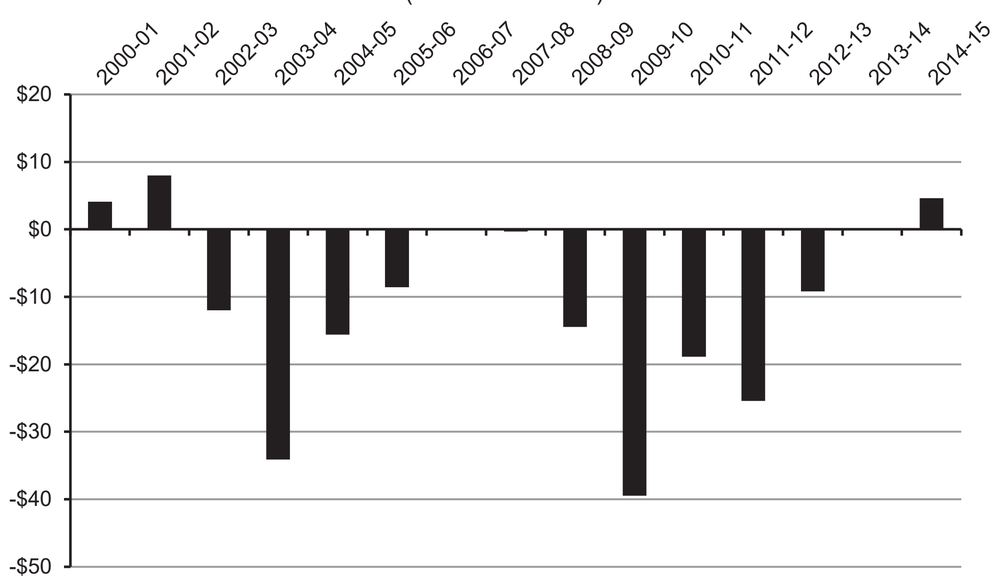
The California Global Warming Solutions Act of 2006 (AB 32) established California as a global leader in reducing greenhouse gas emissions. To advance this effort, the Budget proposes to invest $850 million of Cap and Trade auction proceeds to support existing and pilot programs that will reduce greenhouse gases, with a particular emphasis on assisting disadvantaged communities. The plan includes the repayment of $100 million that was loaned to the General Fund in 2013-14, with the remaining balance being repaid within the next few years. The proposed projects will modernize the state's rail system, including high-speed rail, encourage local communities to develop in a sustainable manner, reduce transportation emissions, increase energy, water, and agricultural efficiency, restore forests in both urban and rural settings, and create incentives for improved recycling.

Likewise, the Budget supports improved management of our water resources. The Water Action Plan identifies key steps over the next five years to craft more sustainable water policies. The Budget proposes $619 million in expenditures to support the plan's efforts to expand water storage capacity, improve drinking water in communities where available supplies are substandard, increase flood protection, and increase regional self-reliance. The Cap and Trade and Water Action Plans are integrated efforts to address the state's environmental challenges in the coming decades. For instance, a portion of the Cap and Trade proceeds will be used to improve water efficiency and restore wetlands and watersheds—key goals of the water plan.

Paying Down Debts and Liabilities and Saving for a Rainy Day

The state's modest surplus is a welcome reprieve from recent budget crises. The source of the surplus—a windfall from volatile capital gains—and the temporary Proposition 30 tax revenues means that the surplus will be short-lived. As shown in Figure INT-05, since 2000, the state has had two short periods that lacked budget deficits. Yet based on the rapid turn of the stock market, capital gains, and the economy, these periods of fiscal balance quickly turned into budget crises. Both times, in January 2001 and in

Figure INT-05
Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]
(Dollars in Billions)



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

January 2007, the state's finances plunged by $40 billion in just two years and forced the state to cut programs and raise taxes. During these short periods of revenue growth, the state made ongoing commitments presuming that the growth would be permanent. Learning from the state's recent history and seeking to avoid the same traps of the past, the Budget uses the surplus to pursue two goals that enhance the state's long-term fiscal capacity—paying down debts and liabilities, and saving a portion for a rainy day.

Paying Down Debts and Liabilities

In 2011, the Wall of Debt's level of outstanding budgetary borrowing totaled $34.7 billion. As shown in Figure INT-06, the debt has already been reduced to less than $25 billion. The Budget reduces this debt by more than $11 billion this year, and fully eliminates it by 2017-18. No longer will billions each year be needed to pay for the expenses of the past, instead of meeting current needs. The three key Budget proposals are:

Figure INT-06

Budget Plan Would Eliminate the Wall of Debt

(Dollars in Billions)

	End of 2010-11 [1/]	End of 2013-14 [2/]	End of 2014-15 [3/]	End of 2017-18 [3/]
Deferred payments to schools and community colleges	$10.4	$6.1	$0.0	$0.0
Economic Recovery Bonds	7.1	3.9	0.0	0.0
Loans from Special Funds	5.1	3.9	2.9	0.0
Unpaid costs to local governments, schools and community colleges for state mandates	4.3	5.4	5.4	0.0
Underfunding of Proposition 98	3.0	2.4	1.8	0.0
Borrowing from local governments (Proposition 1A)	1.9	0.0	0.0	0.0
Deferred Medi-Cal Costs	1.2	1.8	1.7	0.0
Deferral of state payroll costs from June to July	0.8	0.8	0.8	0.0
Deferred payments to CalPERS	0.5	0.4	0.4	0.0
Borrowing from transportation funds (Proposition 42)	0.4	0.2	0.1	0.0
Total	**$34.7**	**$24.9**	**$13.1**	**$0.0**

[1/] As of 2011-12 May Revision

[2/] Based on 2013 Budget Act policies

[3/] As of 2014-15 Governor's Budget

- Eliminate School Deferrals—During the height of the recession, the state deferred almost 20 percent of annual payments to schools and community colleges, meaning that schools and colleges received one-fifth of their funds a year after they spent them. Some schools and colleges were able to borrow to manage these deferrals, while others had to implement the deferrals as cuts. Those that borrowed incurred substantial interest costs, which led to dollars being taken out of the classroom. The Budget proposes repayment of the $6 billion in remaining deferred payments, providing certainty of funding and eliminating borrowing costs.

- Pay off the Economic Recovery Bonds—Years of failing to balance the state budget led to the voters approving $15 billion in Economic Recovery Bonds in 2004 to cover budget deficits from as far back as 2002. Today, the state continues to dedicate $1.6 billion in annual sales tax revenues to service this debt. By making a supplemental payment of $1.6 billion this year, the state will retire the last of the bonds and finally finish paying for the 2002-03, 2003-04, and 2004-05 budgets.
- Make Early Loan Payments—The Budget makes early payments on two loans—transportation loans totaling $340 million and the Cap and Trade loan totaling $100 million. By paying down these debts, the state is able to make the critical investments in maintaining the state's highways and roads, and addressing climate change.

The Wall of Debt is the state's most immediate liability constraining the ability of the state to emerge from its fiscal troubles. However, it is only a subset of the state's many long-term liabilities. As shown in Figure INT-03, the future liabilities—to schools, public employees' pensions and retirement health benefits, infrastructure debt, deferred maintenance, and unemployment insurance—total $355 billion. These liabilities were built up over decades, and likewise, it will take decades to pay them off. Not all of the costs will fall upon the state's General Fund. However, it is critical that the state develop a plan to address these liabilities which will crowd out the state's ability to take on new ongoing commitments. The Budget begins the process of making a dent in these liabilities, such as with a $3.4 billion Proposition 98 maintenance factor payment and the $815 million deferred maintenance package. In other cases, such as for the unemployment insurance and teachers' retirement liabilities, the Administration will spend the coming year working with stakeholders to craft strategies to address them.

Saving for a Rainy Day

Equally important as addressing the state's long-term liabilities is saving some funds for the state's next budget shortfall. The state's tax structure requires those residents who can most afford it to pay the greatest share of their incomes. This progressive tax system creates a heavy dependence on capital gains and the state's wealthiest residents, with one key downside being that revenues swing both up and down quickly. Instead of shifting the overall tax burden to be less progressive, a preferred option is to better manage the revenue spikes.

The state's voters took the first step in this direction with the passage of Proposition 58 in 2004. For the first time, the Constitution required the state to adopt a balanced budget and directed 3 percent of annual revenues into a Rainy Day Fund, the Budget Stabilization Account. Yet, in only a few years, the weaknesses in Proposition 58 have become clear. The state has suspended the rainy day transfer every year since 2007. There are no restrictions on when deposited funds can be withdrawn, and the deposits (unless suspended) are required in equal amounts in both the lean and abundant years.

In 2010, the Legislature passed a constitutional amendment, ACA 4, as an effort to strengthen the state's Rainy Day Fund. It is scheduled to be on the November 2014 ballot. It would be a clear improvement over the existing structure—tightening the rules on when deposits should be made and when withdrawals are allowable. Yet, it does not give the state the option to pay off its liabilities, does nothing to address the sharp ups and downs of Proposition 98, and bases deposits on revenues from the past 20 years rather than on spikes in capital gains.

In lieu of Proposition 58 and ACA 4, the Budget proposes a constitutional amendment to strengthen the Rainy Day Fund. The key components are:

- Basing deposits on when capital gains revenues rise to more than 6.5 percent of General Fund tax revenues.
- Creating a Proposition 98 reserve, whereby spikes in funding would instead be saved for future years of decline. This would smooth school spending to prevent the damage caused by cuts. The reserve would make no changes to the guaranteed level of funding dedicated to schools under Proposition 98.
- Doubling the maximum size of the Rainy Day Fund from 5 percent to 10 percent of revenues.
- Allowing supplemental payments to the Wall of Debt or other long-term liabilities in lieu of a year's deposit.
- Limiting the maximum amount that could be withdrawn in the first year of a recession to half of the fund's balance. This will ensure that the state does not overly rely on the fund at the start of a downturn.

The Administration will work with the Legislature to replace ACA 4 with this improved amendment to be placed on the November 2014 ballot. In the meantime, the Budget makes a down payment on saving for a rainy day by making the constitutional 3-percent deposit for 2014-15. Under current constitutional provisions, half goes to make a supplemental payment to pay off the Economic Recovery Bonds as described above and the other half — $1.6 billion — will be deposited into the Rainy Day Fund.

The Budget proposes a multiyear plan that is balanced, pays off budgetary debt from past years, saves for a rainy day, and makes wise investments in education, the environment, public safety, infrastructure, and California's extensive safety net.